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MEMORANDUM FOR: **Assistant Regional Counsel (Large Case)**

FROM: **Deborah A. Butler**
Assistant Chief Counsel (FIELD SERVICE)

SUBJECT:

Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated July 31, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. Field Service Advice issued to Examination or Appeals is advisory only, and does not resolve the Service position on an issue, or provide the final basis for closing a case. This document is not to be relied upon or otherwise cited as precedent.

LEGEND:

X =
A =
B =
C =
D =
E =
F =
G =
H =
J =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
"a" = $
"b" = $

ISSUE:

Whether vendor rebates and a signing bonus should be included in X's income under I.R.C. §§ 61 and 451 in Year 1.

CONCLUSION:

If it is determined that X's treatment of vendor rebates and the signing bonus for financial reporting purposes clearly reflects income, the same treatment should be used for tax purposes. In addition, based on the facts presented, we conclude X's right to receive the signing bonus and any vendor rebates earned by the close of Year 1 was fixed for purposes of the all events test by the end of Year 1. Accordingly, any such rebates and the signing bonus should be included in income in Year 1.

FACTS:

We rely on the facts set forth in your memorandum. In addition, we have reviewed the copies of contracts and other documents that were included with your memorandum.

X is a corporation in the business of operating . We assume for purposes of this analysis that X is an accrual basis taxpayer using a calendar year.

During Year 1, X either entered into or had preexisting agreements with several vendors. Although the terms of the contracts varied, the contracts typically quoted a price for various products and provided for adjustments to the stated contract price. In addition, the contracts generally provided for volume discounts and rebates. Many of the contracts provided for the discounts to increase proportionately as the volume of purchases increased. In addition, the contracts usually contained minimum purchase requirements, where the rebates were contingent on X purchasing product from the vendor in at least an equal volume to the previous year. Another typical provision was that X was required to use a particular vendor exclusively for a particular type of product.

The payment terms also varied. However, as a general matter, the contracts provided for X to be paid on a semi-annual or quarterly basis.

X's contract with A was for an eight-year term. The contract with A included a signing bonus if the contract was signed by September 30, Year 1. Under this provision, A agreed to pay X a signing bonus in the amount of "a" in the form of a credit memo prior to November 1, Year 1. The contract also provided that under certain circumstances the bonus must be returned to A. The contract required X to refund the entire bonus to A no later than October 1, Year 4, if X failed to convert an entity owned by X from the use of competitive products to the use of A's products by September 30, Year 4. The contract also provided for X to repay A a proportionate amount of the bonus in the event X terminated the contract early.

The contract was signed on September 26, Year 1. A issued a credit memo on X's behalf on October 26, Year 1. Funds in the amount of "a" were wired to X on October 25, Year 2. The wire transfer references the conversion bonus. We believe, although the facts on this point are not clear, that the fund transfer corresponded to the time X fulfilled its contractual obligation to A. Further, it is unknown whether X reported the signing bonus in Year 2.

LAW AND ANALYSIS

Section 451(a) provides that the amount of an item of income shall be included in gross income in the taxable year it is received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is properly accounted for as of a different period. Under an accrual method of accounting, income is includible in gross income in the taxable year when all events have occurred which fix the right to receive such income and the amount of income can be determined with reasonable accuracy. Treas. Reg. §§ 1.446-1(c)(ii) and 1.451-1(a).

In this case, it is our understanding that X uses a hybrid method of accounting. For purposes of this analysis, we assume X uses an accrual method to account for items similar to the bonus and rebates. We also understand that X has not argued that the amount of income cannot be determined with reasonable accuracy. Accordingly, the sole issue is whether in Year 1 all events have occurred which fix X's right to the signing bonus and to the volume discounts and rebates.

Generally, the right to receive income is fixed at the earlier of when the income is: (1) actually or constructively received; (2) due; or (3) earned by performance. Johnson v. Commissioner, 108 T.C. 448, 459 (1997). Any one of these criteria is sufficient independently to require accrual under the all events test. Id. at 462-463. Thus, it is the fixed right to receive the income that is controlling, not whether there has been actual receipt of the income. Charles Schwab Corp. v. Commissioner, 107 T.C. 282, 291-292 (1996).

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting, but also the accounting treatment of any item. Treas. Reg. § 1.446-1(a). Except for deviations permitted or required by special accounting rules, a taxpayer is generally required to compute taxable income using the same method of accounting used to compute book income, unless that method of accounting does not clearly reflect income. Treas. Reg. § 1.446-1(a); see also Applied Communications, Inc. v. Commissioner, T.C. Memo. 1989-469.

In Applied Communications, Inc. v. Commissioner, T.C. Memo. 1989-469, the taxpayer's revenues were generated from the design, development and maintenance of electronic funds transfer systems. In addition to its software business, the taxpayer began a separate business activity selling computer hardware in 1977. The taxpayer accounted for the software business using the cash method, but accounted for the hardware business using an accrual method. Beginning in 1981, the taxpayer adopted the accrual method for both its software and hardware revenues for financial reporting purposes. The taxpayer also used accrual accounting for its reports to the SEC and financial institutions, and for other business purposes. For tax purposes, however, the taxpayer continued to use the cash method for software revenues.

The Commissioner determined that the taxpayer's method of accounting did not clearly reflect income. Accordingly, the taxpayer was required to change to accrual accounting for the software business. In rejecting the taxpayer's argument that its method of accounting clearly reflected income, the court was persuaded by the fact that the taxpayer used an accrual method to report its financial results to shareholders, to creditors and to the general public. The court found it incongruous for the taxpayer to contend that the cash method more clearly reflected income for tax purposes when it represented its earnings under an accrual method for all other purposes.

In the instant case, it is our understanding that, for financial reporting purposes, X included the signing bonus and rebates in income in Year 1. We believe it may be argued under the rationale of Applied Communications that these items should be treated the same for tax purposes as for financial reporting purposes, unless X can show that this treatment does not clearly reflect income.

The Volume Discounts and Rebates

As indicated above, under an accrual method of accounting the right to receive income is fixed at the earlier of when the income is actually or constructively received; the income is due; or the income is earned by performance. Based on our review of the contracts you provided, it appears likely in the case of the volume discounts and rebates, that X earned the right to receive some portion of the rebates by year end Year 1 through performance. Accordingly, we agree with your conclusion that X's right to the earned rebates became fixed when goods were purchased from the vendors in the volumes required during the time period required. To the extent the facts indicate that X was in compliance with the terms of its contracts at the end of Year 1, the rebate income should accrue.

The Signing Bonus

In analyzing the all events test, there are at least two lines of authority dealing with the conditions under which a taxpayer's right to receive income becomes fixed. The first concerns the situation where the taxpayer receives advance payments for services to be performed in the future.

In American Automobile Association v. United States, 367 U.S. 687 (1961), an accrual basis taxpayer received advance payments on annual membership dues. For tax purposes, the taxpayer reported only a portion of the prepaid dues based on the number of months in that taxable year covered by those dues. The balance accrued over the remaining membership period in the following taxable year. The Commissioner took the position that the taxpayer was required to report the entire amount of prepaid dues in the taxable year received.

In upholding the Commissioner's position that the all events test was met when the dues were received, the Supreme Court considered the fact that the taxpayer provided services on demand. Because there was no fixed time for performance on the contract, the Court concluded the taxpayer's method of accounting was "purely artificial." Id. at 691. The Court also considered the fact that the taxpayer's method of accounting for the dues did not respect the criteria of annual tax accounting. Id. at 692.

In Schlude v. Commissioner, 372 U.S.128 (1963), the Court revisited this issue. In Schlude, the taxpayers offered dancing lessons under various payment plans. The taxpayers reported income for tax purposes on an accrual basis. Customers either paid a cash down payment in advance with the balance due in installments, or they paid a portion of the down payment in cash, with the remainder of the down payment paid in installments and the balance of the contract price paid by a debt instrument. By their terms the contracts were noncancellable and nonrefundable.

The Commissioner adjusted gross income to include the advance payments and the full face amounts of the notes used to pay the balance. Relying on AAA, the Court upheld the adjustments, reiterating that "[f]or an accrual basis taxpayer, 'it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income.'" Id. at 137 (quoting from Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184 (1934)).

However, in Commissioner v. Indianapolis Power & Light Co., 493 US 203 (1990), the Court determined customer deposits required to insure payment of future bills for electric service should not be treated as income even though the taxpayer actually received the deposits and the deposits were commingled with the taxpayer's general funds and at all times were subject to the taxpayer's unfettered use and control. The deposited amounts were refunded to the customer when he made timely payments for a specified period of time, or alternatively, when the customer satisfied a credit test. At the customer's option the deposit could be repaid or applied against future bills. Under these circumstances, the Court rejected the notion that the payments constituted advance payments for electricity. According to the Court, the issue turned on the rights and obligations assumed by the taxpayer at the time the deposits were made. Id. at 209. Because the deposits were subject to an express obligation to repay, either when the customer terminated service, or established good credit, the Court concluded the taxpayer did not enjoy complete dominion over them. The Court distinguished the deposits from advance payments by indicating that with advance payments, the seller is assured that it may keep the money so long as it fulfills its contractual obligations. Id. at 210.

The second line of authority, beginning with Commissioner v. Hansen, 360 U.S. 446 (1959), discusses the situation where payment to the taxpayer is withheld or deposited in a reserve account. In Hansen, the taxpayers were accrual basis retail automobile dealers. They sold automobiles on credit and assigned the consumer installment paper to a finance company. The taxpayers' agreement with the finance company provided for the taxpayers to guarantee payment of the installment obligations of the consumers. At the time the consumer paper was assigned, the finance company paid the taxpayers the face amount of the note, less a specified percentage that was credited to a reserve account. As the note was paid, the finance company released amounts to the taxpayers. The taxpayers only reported amounts as they were released by the finance company.

The Commissioner took the position that the full contract price, including amounts held in reserve, should be included in income in the year of sale. The Supreme Court agreed, indicating that under the accrual method, it was the time of the acquisition of the fixed right to receive the reserves, not the time of their actual receipt that controlled when the reserves must be reported as income.

More recently, in Johnson v. Commissioner, 108 T.C. 448 (1997), the Tax Court examined the all events test in the context of determining when accrual basis taxpayers were required to report the portion of the price of multi-year-vehicle-service contracts (VSC's) that was required to be deposited in escrow. The VSC's covered a set period of time and obligated the taxpayers to make repairs or replace listed parts for a fixed price. The full purchase price of the VSC's was due and collected at the time of sale, but the purchaser had the option of canceling the VSC at any time by paying a nominal charge. If the contract was canceled, the purchaser was entitled to a refund of some or all of the purchase price, depending on the time of cancellation.

The contract also provided that a specific portion of the contract was to be held in escrow as a reserve fund to insure the taxpayers were financially able to cover any claims. The disposition of the purchase price of the contract was subject to detailed procedures and the taxpayers' access to the reserves held in escrow was strictly controlled.

The Commissioner determined the taxpayers' method of accounting did not clearly reflect income. Accordingly, the taxpayers' income was adjusted to include the full purchase price of the VSC's in the year of sale. The taxpayers argued that the amounts deposited in escrow pursuant to the contract terms should not be included in gross income until actually released to them because the contracts were executory contracts. According to the taxpayers, at the time the contracts were entered into, they were not entitled to any of the amounts held in escrow because they had not yet provided any repair services. Consequently, the taxpayers contended their right to the income was not fixed for purposes of the all events test. In addition, the taxpayers argued their situation was similar to that of the taxpayer in Indianapolis Power because, inasmuch as they were obligated to refund certain amounts at the purchaser's option, there was no guarantee that they would be allowed to keep the money.

The Tax Court rejected these arguments. In the court's view, the fact that the taxpayers had not performed any repair services under the VSC's at the time the purchase price was collected and deposited into escrow did not control whether the contract price should be included in income. Id. at 463. Neither was the court persuaded that the taxpayers' situation was similar to the situation in Indianapolis Power. Specifically, the court rejected the notion that refundability comprised the exclusive criterion for distinguishing taxable income from nontaxable deposits. Id.

at 471. Instead, the court indicated that the distinguishing factor in determining whether amounts were nontaxable deposits or taxable income was whether the taxpayer's right to retain the funds was contingent on the customers' future decisions to purchase services and have the amounts applied to the bill. Id. Thus, the court considered the extent to which the taxpayer, as opposed to the customer, controlled whether the funds would ultimately be retained as income.

In the instant case, the signing bonus is similar to an advanced payment in certain respects and similar to an amount held in reserve in others. According to the contract, the bonus was due if the contract was signed by a date certain. The contract was in fact signed by the specified date and the bonus was paid by credit memo in accordance with the terms of the contract. We acknowledge there may be a dispute on the issue of when the bonus was actually paid because the funds were not released to X until Year 2; however, we believe that the form of payment was in the nature of a debt obligation. Thus, X may be considered paid in Year 1. See Treas. Reg. § 1.61-2(d). If X is considered paid in Year 1, the payment has the characteristics of an advance payment. Under the advance payment line of authority, the bonus is included in income in the year of receipt, or when the amounts become due and payable, despite the fact that the required services have not been performed at the time of collection. See Schlude, 372 U.S. 128 (1963).

On the other hand, this case may be distinguished from the majority of advance payment cases because the bonus was subject to refund. In addition, X's access to the funds was not unrestricted until the funds were wired in Year 2. In this sense, the payment of the bonus is akin to an amount held in reserve. Under the line of authority dealing with amounts held in reserve, withheld amounts are includible in income as long as, at the time of receipt, the amounts are set aside for eventual payment to the taxpayer or for satisfaction of the taxpayer's obligations. Thus, in this case, the bonus, which would either be paid to X or returned to A in satisfaction of X's obligation, may be included in income in Year 1, despite the fact that X's access to the money was restricted and the funds were subject to forfeiture. Accordingly, we conclude there is sufficient authority to support accrual of the bonus in Year 1.

To the extent that X argues under Indianapolis Power that it did not enjoy complete dominion over the bonus, we believe the instant case is distinguishable. Unlike the situation in Indianapolis Power, as long as X fulfilled its contractual obligations, it was guaranteed it would be allowed to keep the money. Moreover, under the rationale of Johnson, the fact that release of the funds may have been delayed to secure X's executory obligations does not affect the timing of X's acquisition of a fixed right to the bonus. Although X's failure to fulfill its obligations might ultimately divest X of its right to the bonus, the conditions imposed in the contract are insufficient in our view to prevent X from acquiring a right to the bonus in Year 1 and do not preclude accrual of the income. See Schwab, 107 T.C. at 293-294.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The information we have been provided does not disclose X's position regarding when it contends these amounts should be accrued. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Any further questions about this matter may be directed to Susan Mosley at (202) 622-7900.

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