Tax Accounting

By James E. Salles

Revenue Procedure 2004-34,[1] which allows a limited deferral for most types of advance payments, was accompanied by a ruling and two new procedures addressing credit card issuers' fee income.

Annual Fees: The IRS vs. the Tax Court

Revenue Procedure 2004-34 superseded Revenue Procedure 71-21,[2] which was confined to payments for future services. Whether and when credit card fees might be deferred under the earlier procedure was disputed. In 1985, the IRS ruled that annual membership fees were ineligible because they were "payments for property rights" similar to standby commitment fees, and cardholders were not paying for services, but for access to credit.[3] The IRS consistently adhered to this position as to payments for basic card privileges, although later conceding that amounts paid for "real" member services might be deferrable.[4]

The Tax Court considered Revenue Procedure 71-21's application to card fees in two opinions issued on the same day in 1996. The taxpayer in *Barnett Banks of Florida v. Commissioner*[5] began charging annual fees when it added a range of new member services. The fee was ratably refundable if the cardholder canceled membership. The court held that the fees fell under Revenue Procedure 71-21 because they were paid for future services. The fees in *Signet Banking Corp. v. Commissioner*,[6] by contrast, were specifically described as paid to establish credit and were not refundable once paid. The Tax Court, and later the Fourth Circuit, held that, whether or not the fees were for services, the procedure did not apply because performance was complete when the cards were issued.

American Express

The taxpayer in *American Express Co. v. United States*[7] had traditionally reported fee income currently. Denied permission to change to ratable reporting, American Express sued for a refund, contending that its refundable annual fees more closely resembled Barnett's than Signet's. However, both the Court of Federal Claims and the Federal Circuit declined to draw "close factual distinctions" based on the Tax Court cases and instead deferred to the IRS's interpretation of its own procedure.

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There are procedural differences among the cases. The taxpayers in *Barnett* and *Signet* had been amortizing the fees into income. Internal Revenue Code (IRC) Section 446(b) allows the IRS to change the taxpayer's method of accounting only "if the method used does not clearly reflect income." The IRS cannot make a taxpayer change from a method that *does* clearly reflect income to a supposedly better method.[8] The Tax Court therefore had to decide whether the IRS had abused its discretion in determining that the taxpayers' methods did not clearly reflect income. Theoretically, the change might be disallowed even if the taxpayers' methods did not comply with Revenue Procedure 71-21, so long as they "clearly reflected income." By contrast, American Express had to show not merely that ratable reporting would be an acceptable option, but that the IRS's refusal to grant permission to change methods was an abuse of discretion. Courts have found an abuse of discretion when the IRS obstructs a change from an incorrect method;[9] however, reporting income currently was not patently wrong. The taxpayer's only real argument was that the IRS failed to apply published guidance that covered the case.[10] Moreover, the Court of Federal Claims suggested that the IRS may be due more deference in ruling on a request for a change than in evaluating the taxpayer's existing method.[11]

The interpretation of Revenue Procedure 71-21 was nonetheless central to all three cases. An IRS

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failure to follow its own procedures may be an abuse of discretion under either of two grounds. The government can generally change legal interpretations retroactively,[12] but the IRS may be bound when it has specifically invited reliance,[13] as arguably in the case of published rulings and procedures.[14] Other authorities[15] have held that the IRS's duty to avoid arbitrary distinctions among taxpayers[16] requires it to apply a valid[17] administrative pronouncement so long as it remains outstanding.

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The Tax Court in *Barnett* implicitly invoked these administrative law doctrines when it held that the IRS position on card fees was "inconsistent with the intended purpose and benefit" of Revenue Procedure 71-21. *American Express* addressed the reliance and nondiscrimination issues more directly. The courts' conclusion that the IRS's position was "reasonable"—and in any event well known—effectively foreclosed a reliance argument.[18] The Federal Circuit concluded that the ultimate question was whether treating issuers as a class differently from other types of taxpayers was so arbitrary as to be an abuse of discretion, and held that it was not.

The New Guidance

These developments left the law somewhat confused. The Tax Court in *Barnett* saw the annual fee as a "payment for services," namely the conveniences associated with "the opportunity to use . . . cards for payment,"[19] while the extension of credit was compensated by interest charges. The courts in *American Express* seemed to agree with the IRS that the fees were largely paid to obtain credit, or access to credit, noting among other things that no interest was charged on normal "float."[20] That aside, there remained the possibility that taxpayers might face different treatment depending on their current method. Revenue Procedure 2004-34 dealt with the first problem. The new procedure removes the limitation to payments for "services," but adds certain exceptions, including one covering "payments with respect to" credit card agreements.[21] Whether card fees are paid for services is therefore now irrelevant. The accompanying guidance is directed at providing a workable set of rules for the future.

Revenue Ruling 2004-52 holds that annual fees are not interest and accrual issuers must normally report them on the due date, relying on earlier rulings[22] that read *Schlude v. Commissioner*[23] to require that income accrue when first received, due, or earned. Requiring immediate reporting would be consistent with the treatment of other membership fees,[24] but not unchallengeable. Some courts have held that *Schlude* does not require immediate inclusion of a payment for performance on a fixed date.[25] A court might conclude that a fee for *access* to credit accrues over time, particularly if it is refundable. The early rulings' characterization of annual fees as "payments for property rights" may also suggest an analogy to option premiums, which are allowed "open transaction" treatment.[26] Revenue Procedure 2004-32[27] likely preempts such disputes by allowing issuers an election to report card fees over the period to which they relate. Taxpayers may switch between immediate and ratable reporting using the automatic consent procedures. The new procedure waives the usual restrictions on such changes for calendar years 2003 through 2004 and fiscal years 2004 though 2005, and promises that the IRS will not challenge taxpayers' use of a ratable inclusion method in earlier years.

The other new procedure, Revenue Procedure 2004-33,[28] deals with "late fees" on delinquent balances. While such fees were not at issue in the court cases, there has been some doubt about how they should be treated. Late fees are usually treated as interest for tax purposes, but may not be when they are for "a specific service performed in connection with the customer's account."[29] A late fee that was really for a service might at least in theory have been eligible for deferral, although it would likely have been difficult to meet the other requirements. Revenue Procedure 2004-33 simplifies the picture by allowing issuers that do not sell to their cardholders to simply elect to treat all late fees as interest for all purposes, including the special rules for pools of credit card obligations and other debt subject to prepayment.[30] Similar provisions for method changes and protection for past years are included.

1. 2004-22 I.R.B. 991, discussed in J. Salles, "Tax Accounting," 5(11) *Corp. Bus. Tax'n Monthly*, 20–23 (August 2004).

2. 1971-2 C.B. 549.

3. Gen. Couns. Mem. 39434 (May 31, 1985); LTR 8543004 (July 18, 1985); LTR 8537002 (May 22, 1985).

4. American Express Co. v. United States, 262 F.3d 1376 (Fed. Cir. 2001), brief for the United States, 2000 WL 34251380 at n.18.

5. 106 T.C. 103 (1996).

6. 106 T.C. 117 (1996), *aff'd*, 118 F.3d 239 (4th Cir. 1997).

7. 47 Fed. Cl. 127 (2000), *aff'd*, 262 F.3d 1376 (Fed. Cir. 2001).

8. *E.g.*, Capitol Federal Savings & Loan v. Commissioner, 96 T.C. 204, 210 (1991) (collecting cases).

9. *E.g.*, Security Benefit Life Insurance Co. v. United States, 517 F. Supp. 740, 772–773 (D. Kan. 1980), *aff'd*, on other issues, 726 F.2d 1491 (10th Cir. 1984).

10. *See* 47 Fed. Cl. at 132.

11. 47 Fed. Cl. at 135 n.5.

12. *See, e.g.*, Dickman v. Commissioner, 465 U.S. 330, 342–343 (1984); *cf.* I.R.C. § 7805(b).

13. Gehl Co. v. Comm'r, 795 F.2d 1324 (7th Cir. 1986); LaCroy Research Systems v. Comm'r, 751 F.2d 123 (2d Cir. 1984); Addison International, Inc. v. Comm'r, 90 T.C. 1207 (1988) (reviewed), *aff'd*, 887 F.2d 660 (6th Cir. 1989).

14. Rev. Proc. 89-14, 1989-1 C.B. 814; *see, e.g.*, Estate of Shapiro v. Commissioner, 111 F.3d 1010, 1018 (2d Cir. 1997), *cert. denied*, 118 S. Ct. 686 (1998).

15. *E.g.*, Estate of McLendon v. Commissioner, 135 F.3d 1017 (5th Cir. 1998); Rauenhorst v. Commissioner, 119 T.C. 157, 172–173 (2002).

16. Baker v. United States, 748 F.2d 1465 (11th Cir. 1984); IBM v. United States, 343 F.2d 914, 920–921 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966).

17. *Cf.* American Stores Co. v. Commissioner, 170 F.3d 1267, 1278 (10th Cir.), *cert. denied*, 528 U.S. 875 (1999) (McLendon inapplicable when taxpayer's reading of revenue ruling contradicted the statute).

18. 47 Fed. Cl. at 133.

19. 106 T.C. at 110–111.

20. 262 F.3d at 1,380 n.4.

21. Rev. Proc. 2004-34 § 4.02(3), 2004-22 I.R.B. 991, 992.

22. *See, e.g.*, Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 80-308, 1980-2 C.B. 162.

23. Schlude v. Commissioner, 372 U.S. 128 (1963).

24. *E.g.*, American Automotive Ass'n v. United States, 367 U.S. 687 (1961); *cf.* I.R.C. § 456.

25. *E.g.*, Tampa Bay Devil Rays, Ltd. v. Commissioner, 84 T.C.M. (CCH) 394 (2002), discussed in J. Salles, "Tax Accounting," 4(3) *Corp. Bus. Tax'n Monthly*, 18–20 (December 2002).

26. *See, e.g.*, Rev. Rul. 78-182, 1978-1 C.B. 265, holdings B.1 and D.1.

27. 2004-22 I.R.B. 988.

28. 2004-22 I.R.B. 989.

29. Rev. Rul. 74-187, 1974-1 C.B. 48.

30. *See* I.R.C. § 1272(a)(6)(C)(iii).