Tax Accounting

BY JAMES E. SALLES

In this month's column:

1. The Tax Court rules on the timing of income from discharge of indebtedness in *Lowry v. Commissioner*[1];
2. The Ninth Circuit, affirming the Tax Court in *Bob Wondries Motors, Inc. v. Commissioner*,[2] upholds the IRS' conditions on automobile dealers' use of a special method for reporting warranty income;
3. The Ninth Circuit also affirms the Tax Court in *Suzy's Zoo v. Commissioner*,[3] holding that the taxpayer "produced" greeting cards and stationery and was therefore subject to the uniform capitalization (UNICAP) rules;
4. The Eighth Circuit affirms the Tax Court in *MidAmerican Energy Co. v. Commissioner*,[4] holding that the taxpayer did not become entitled to a "deduction" when regulators reduced rates prospectively, and was required to report revenue earned but unbilled at year-end; and
5. The IRS issues proposed regulations under Code Section 446 providing that the special timing rules for transactions among members of a corporate consolidate group constitute a "method of accounting."

CONDITIONAL DISCHARGE OF INDEBTEDNESS

Gross income includes income from the discharge of indebtedness,[5] except as otherwise provided in Code Section 108. Discharge of indebtedness occurs in a variety of factual settings, and the "identifiable event"[6] that triggers taxation is sometimes not so easy to identify. A recent Tax Court memorandum case, *Lowry v. Commissioner*,[7] reviews some of the applicable authorities.

When debt is discharged by agreement between the parties, courts have consistently held that the discharge occurs when any conditions imposed under the agreement become met. An early case illustrates the point. In *Walker v. Commissioner*,[8] the taxpayer's partnership agreed with its creditors that its indebtedness would be forgiven if it paid the original principal. The agreement was concluded in 1927 but the debt was not actually forgiven until 1930. The Fifth Circuit held, as had the Board of Tax Appeals, that the 1927 agreement did not provide for "present forgiveness" but was "an agreement for forgiveness in the future, if and when the conditions were fulfilled." Therefore, the income from discharge of indebtedness was not reportable until 1930, when the conditions were met and the actual cancellation took place.

In *Shannon v. Commissioner*,[9] the taxpayers and their bank lender agreed that the taxpayers' debt would be forgiven once they paid the difference between the proceeds of the sale of collateral and a fixed amount. The agreement was executed and some of the collateral was sold in 1986, but the bank did not receive the proceeds and the additional payment until 1987. Had the 1986 agreement been to forgive the indebtedness in exchange for the taxpayers' *promise* to pay the reduced amount, the discharge of indebtedness income would have been realized in that year. However, because the agreement was conditional on the bank's receiving payment, the Tax Court held that the taxable event did not occur until 1987.

By contrast, *Rivera v. Commissioner*,[10] decided the month after *Shannon*, involved a workout agreement concluded in 1987 that provided that the taxpayer's debt would be forgiven in exchange for a part payment upon execution and a further payment a few months later. The final payment was not due until January 2, 1988, but the taxpayer actually paid during the last few days of 1987. The court held that the discharge took place in 1987, because once the taxpayer paid, "no contingency existed as to the forgiveness of the indebtedness," and the remaining formalities were "ministerial."

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In *Lowry*, the taxpayer's partnership agreed to convey property to its mortgagor in exchange for a covenant not to sue. The agreement was executed in 1993 but the partnership did not convey the property until 1994. Citing *Keith v. Commissioner*,[9] the Tax Court stated that real estate is considered transferred for tax purposes when the "benefits and burdens" of ownership pass. Since title to the property did not pass until 1994 and there was no evidence that the "benefits and burdens" of ownership had shifted earlier, the forgiveness became effective and the income was realized in 1994.

NINTH CIRCUIT SUSTAINS REV. PROC. 92-98

The Ninth Circuit, affirming the Tax Court in *Bob Wondries Motors, Inc. v. Commissioner*,[12] held that taxpayers electing the special method of reporting receipts from "service warranty contracts" under Revenue Procedure 92-98[13] had to calculate deductions as specified in that procedure, and could not use an alternate calculation that they contended more clearly reflected income.

Automobile dealers commonly maintain standing arrangements with insurance companies under which the insurers assume the dealers' warranty liabilities in exchange for a premium. The difference between what the customer pays the dealer for the warranty and what the dealer pays the insurance company represents the dealer's profit. Both payments are commonly lump sums paid at the beginning of the warranty term, typically several years.

The IRS position in such cases is that the customers' payments are income to the dealer because it is the *dealer* that contracts to provide the warranty protection, even if the insurer immediately assumes the risk. That characterization requires dealers to report the customers' payment as income in the year of receipt under the "*Schlude*[14] doctrine," which requires accrual taxpayers to report most advance payments as income in the year that they are received, even if performance occurs in a later year.[15] The dealer can deduct its payments to the insurer, but only over the lifetime of the contract.[16]

Revenue Procedure 92-98 attempted to deal with the resulting mismatch between income and deductions by giving taxpayers an election to report the warranty income over time, in exchange for reporting some extra "phantom" interest on the deferred amount. However, the procedure required electing taxpayers to report a full year's share of income in the first year, while the corresponding amortization deduction was calculated based on the number of months that the insurance contract was in effect during the year. For example, if the warranty were sold July 31, the dealer would have to report twelve months' income in that year while only deducting five months' expense.

The taxpayers in *Wondries Motors* elected to defer income under Revenue Procedure 92-98, but sought to cure the mismatch problem by taking a full year's deduction regardless of the contract date. However, the Ninth Circuit agreed with the Tax Court in that electing taxpayers had to apply the procedure according to its terms. The court rejected the taxpayers' attempt to rely on the "matching principle" recognized in *Johnson v. Commissioner,*[17] which it distinguished on its facts. The court also refused to consider the taxpayers' alternative argument that the receipts were not gross income in the first place, because they had failed to raise this argument at trial.

SUZY'S ZOO AFFIRMED

The IRS continued its winning streak in the Ninth Circuit with an affirmance in *Suzy's Zoo v. Commissioner*,[18] a Tax Court case that held that a greeting card company was a "producer" of property under the uniform capitalization (UNICAP) rules. Suzy's Zoo designed greeting cards and stationery, but contracted out the actual printing under contracts that left the printers responsible for the paper stock and other physical components until the job was complete. Nonetheless, the Tax Court held that Suzy's Zoo was the "producer" of the property, not merely a reseller, because the printers were contract manufacturers and never had any right to the finished product.

The Ninth Circuit agreed with the Tax Court that Suzy's Zoo produced the greeting cards and stationery. In general, contract manufacturers' activities are attributable to their customer,[19] and the regulations' exception for "routine purchase order[s] for fungible property"[20] did not apply. The regulations provide that the "producer" is "the owner of the property *produced*,"[21] and that was Suzy's Zoo; the printers never had any right to the printed goods. Therefore, Suzy's Zoo was ineligible for the various exceptions provided for *resellers* of property[22] and had to capitalize its production costs. The appellate court also affirmed the Tax Court's holding that the cumulative adjustment under Code Section 481 was properly imposed for fiscal 1994, when the taxpayer *actually* changed its accounting methods to comply with UNICAP, and not fiscal 1988, when the change should have been made.

EIGHTH CIRCUIT AFFIRMS IN *MIDAMERICAN ENERGY*

A number of recent cases—with sizable amounts at stake—have addressed different aspects of utilities' tax accounting practices. In *MidAmerican Energy Co. v. Commissioner,*[23] the Tax Court held in favor of the IRS on two separate issues involving Code Sections 1341 and 451(f). The Eighth Circuit has now affirmed.

Code Section 1341: The "Deduction" Issue

Code Section 1341 prescribes a favorable tax computation when a taxpayer reports income under "claim of right"[24] and is later determined not to have been entitled to the amount concerned. However, the special treatment only applies when a *deduction* becomes allowable because "it was established . . . that the taxpayer did not have an unrestricted right" to the income. The threshold issue is therefore whether the utility has a "deduction."

When regulators set utilities' rates lower than they otherwise would be to make up for excessive past charges, the utility does not get a deduction for the implicit "payback," but simply recognizes less gross income. This proposition holds true whether the reduction in rates was contemplated from the beginning,[25] is a product of a routine reconciliation of projected with actual costs,[26] or results from other unanticipated developments.

For example, many state regulators reduced rates prospectively to compensate for utilities' "windfall" when the Tax Reform Act of 1986 reduced corporate taxes below previously projected rates. The Tax Court held in *MidAmerican Energy* and its companion case, *Florida Progress Corp. v. Commissioner*,[27] that utilities were not entitled to a deduction in such circumstances. The courts in *WICOR, Inc. v. United States*[28] agreed, and extended the same analysis to an earlier similar order issued when the taxpayer adopted accelerated depreciation for state tax purposes.

The tax considerations are different when, instead of merely requiring utilities to charge less in the future, the regulatory order creates a fixed obligation to repay previously collected amounts regardless of future sales.[29] Such cases call for a second step to the analysis. If the repayment obligation was explicit from the outset, the transaction may be treated as a loan or a deposit, meaning that the utility will have neither gross income nor a deduction.[30]

On the other hand, if the receipts represented income in the first place, then the repayment creates a deduction to which Code Section 1341 potentially applies. For example, in *Dominion Resources, Inc. v. United States*,[31] the Fourth Circuit held that the taxpayer had a deduction when regulators ordered Virginia Power to make refunds to its customers based upon their electricity purchases over the preceding twelve months.

"Apparent" Versus "Actual" Rights

Even if the utility has a deduction, another potential obstacle to relief remains. Code Section 1341 applies only when the taxpayer originally has an apparent right to the income, but is later determined not to have been entitled to keep it. The provision does not apply if the taxpayer was *actually* entitled to the income, but later returns it for independent reasons.[32] The IRS position is that utilities cannot apply Code Section 1341 when regulators order a refund, because their right to collect the money in the first place was not questioned. The government lost this argument in *Dominion Resources*, but raised it again in *WICOR* and *MidAmerican*. The courts in *WICOR*[33] noted that *Dominion Resources* and other case law[34] favored the taxpayers on this issue, but this did the taxpayer little good in light of the courts' holding that the taxpayer did not have a deduction to which Code Section 1341 could apply.

Section 451(f)

Utilities traditionally reported revenues under the "cycle meter reading" method, under which income was reported as meters were read and the customers billed. On first glance, this practice seems contrary to the normal rule that accrual taxpayers must recognize income upon performance.[35] However, the IRS had allowed use of the "cycle meter reading" method, subject to a requirement of consistent financial reporting and other conditions.[36] Moreover, in *Orange and Rockland Utilities v. Commissioner*,[37] the Tax Court sanctioned the method as an acceptable variant of accrual accounting in its own right, although the holding may have turned in part on the specific regulatory scheme.

In 1986, Congress enacted Code Section 451(f), which specifically requires that utility income be accrued "not later than the taxable year in which services are provided," adding by way of belt to the suspenders that the year of accrual "shall not, in any manner, be determined by reference to the period in which the customers' meters are read." There had been relatively little controversy about this provision before *MidAmerican*.

The *MidAmerican* Decision

The appellate decision in *MidAmerican* closely tracks the Tax Court's analysis. The Eighth Circuit agreed with the Tax Court that Code Section 1341 did not apply because the rate order did not entitle the taxpayer to a deduction. The court concluded that *Dominion Resources* was distinguishable because the regulatory order in that case created a fixed obligation to repay. As in *WICOR*, the opinion noted that the case law favored the taxpayer on the issue of "apparent" versus "actual" right to the income, but the court did not actually have to decide the issue because of its holding on the deduction question.

The other issue in the case was whether Code Section 451(f) required the taxpayer to accrue revenues that it had earned but had not yet billed after the end of the year. The taxpayer argued that it was already in compliance with Code Section 451(f) because its regulatory pricing included a "purchased gas adjustment" that was intended to reflect gas costs for the entire billing month, regardless of when during the month the bill was issued. However, the Eighth Circuit concluded, as did the Tax Court, that the important consideration was what services the taxpayer was charging for, not how it computed the price, and held that Section 451(f) required reporting all income attributable to its customers' consumption during the year.

PROPOSED REGULATIONS UNDER SECTION 446

In what is billed as a technical change, the IRS has proposed regulations under Code Section 446 that specifically provide that the rules governing intercompany transactions among members of a consolidated group represent a method of accounting. The apparent purpose is to make it as clear as possible that the Tax Court's holding in *General Motors Corp. v. Commissioner*[38] no longer applies under current law.

General Motors involved a complicated series of dealings between General Motors Corporation (GM) and its financing affiliate General Motors Acceptance Corporation (GMAC), a member of its consolidated group. In the high interest rate environment of the early 1980s, GMAC subsidized interest rates by paying dealers more than fair market value for retail installment contracts and also itself making loans to larger "fleet customers" at below-market interest rates. GM compensated GMAC by making lump sum "rate support payments" when GMAC made or acquired the loan. These practices were common in the industry and both GM and GMAC had similar arrangements in place with unrelated parties.

In computing taxable income on a separate company basis, GM deducted the rate support payments as sales costs, while GMAC reported the loan discount (which reflected the rate support payments) as income over the lifetime of the loan. For some time, the group applied the intercompany transaction rules in the consolidated return regulations, which deferred GM's deduction for the rate support payments until GMAC reported the corresponding interest income. However, the taxpayer successfully argued at trial that these regulations as then in effect did not apply because GM's deductions and GMAC's income represented different "items," so that GM was entitled to a full current deduction.

The IRS' alternative argument was that GM, having applied the regulations in the past (properly or not), was bound to its prior reporting because it could not change accounting methods without IRS permission.[39] However, the Tax Court noted that the consolidated return regulations expressly provided that each member's separate taxable income would be calculated according to its own accounting methods,[40] and held that the special rules imposed in computing *consolidated* taxable income were not the accounting methods of any individual group member.

General Motors involved the taxable year 1985 and the court was applying what was already old law. In 1995, the regulations governing intercompany transactions had been rewritten and expanded to cover transactions like GM's, where the income and deductions flowed from the same transaction even though they may not technically have been the same "item."[41] The 1995 amendments also included a specific statement that the special timing rules applicable to intercompany transactions were to be considered the accounting methods of each member concerned.[42] The new proposal, by way of "belt and suspenders," would add similar language to the regulations under Code Section 446.[43] Technically, the proposed regulations would apply to taxable years beginning after November 7, 2001, but the IRS would presumably contend that they merely reiterate the law that has been in effect since 1995.

1. 82 T.C.M. (CCH) 499 (2001).
2. 268 F.3d 1156 (9th Cir. 2001), *aff'g Toyota Town, Inc. v. Commissioner*, 79 T.C.M. (CCH) 1457 (2000), discussed in J. Salles, "Tax Accounting," 1(8) Corp. Bus. Tax'n Monthly 29, 29-31 (May, 2000).
3. ___ F.3d ___ (9th Cir., Nov. 21, 2001), *aff'g* 114 T.C. 1 (2000), discussed in J. Salles, "Tax Accounting," 1(7) Corp. Bus. Tax'n Monthly 33, 33-34 (Apr. 2000).
4. 271 F.3d 740 (8th Cir. 2001), *aff'g* 114 T.C. 570 (2000), discussed in J. Salles, "Tax Accounting," 1(12) Corp. Bus. Tax'n Monthly 25, 25-26 (Sept. 2000).
5. I.R.C. § 61(a)(12), *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).
6. *See, e.g., Cozzi v. Commissioner*, 88 T.C. 435, 445-48 (1987).
7. 82 T.C.M. (CCH) 499 (2001).
8. 88 F.2d 170 (5th Cir. 1937), *aff'g White v. Commissioner*, 34 B.T.A. 424 (1936) (reviewed).
9. 66 T.C.M. (CCH) 1418 (1993).
10. 66 T.C.M. (CCH) 1682 (1993).
11. 115 T.C. 605 (2000), discussed in J. Salles, "Tax Accounting," 2(6) Corp. Bus. Tax'n Monthly 31, 36-37 (March, 2001).
12. 268 F.3d 1156 (9th Cir. 2001).
13. 1992-2 C.B. 512, *superseded by* Rev. Proc. 97-38, 1997-2 C.B. 479.
14. *Schlude v. Commissioner*, 372 U.S. 128 (1963).
15. Rev. Rul. 74-607, 1974-2 C.B. 149.
16. Rev. Proc. 97-37, app. § 5.03(3), 1997-2 C.B. 455, 474; Rev. Proc. 92-97, § 2.07, 1997-2 C.B. 510, 511; *see also, e.g., Commissioner v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942).
17. 184 F.3d 786 (8th Cir. 1999), discussed in J. Salles, "Tax Accounting," 1(2) Corp. Bus. Tax'n Monthly 28 (Nov. 1999).
18. 114 T.C. 1 (2000), *aff'd*, ___ F.3d ___ (9th Cir., Nov. 21, 2001).
19. I.R.C. § 263A(g)(2); 1.263A-2(a)(1)(ii)(B).
20. Regs. § 1.263A-2(a)(1)(ii)(B)(*2*)(*i*).
21. Reg. § 1.263A-2(a)(1)(ii)(A).
22. Reg. § 1.263A-3(a)(2)(ii), (a)(3).
23. 114 T.C. 570 (2000), *aff'd*, 271 F.3d 740 (8th Cir. 2001).
24. *See North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).
25. *E.g., Iowa Southern Utilities Co. v. United States*, 841 F.2d 1108 (Fed. Cir. 1988).
26. *E.g., Roanoke Gas Co. v. United States*, 977 F.2d 131 (4th Cir. 1992); *Southwestern Energy Co. v. Commissioner*, 100 T.C. 500, 501-07 (1993).
27. 114 T.C. 587 (2000).
28. 263 F.3d 659, 661-63 (7th Cir. 2001), *aff'g* 117 F. Supp.2d 864 (E.D. Wis. 2000).
29. *See Dominion Resources, Inc. v. United States*, 48 F. Supp. 2d 527, 532-33 & nn. 1-2 (E.D. Va. 1999), *aff'd*, 219 F.3d 359 (4th Cir. 2000).
30. *E.g., Houston Industries, Inc. v. United States*, 125 F.3d 1442 (Fed. Cir. 1997); *Illinois Power Co. v. Commissioner*, 792 F.2d 683 (7th Cir. 1986); *Florida Progress*, 114 T.C. at 597-603 ("over-recoveries" of fuel and energy compensation costs).
31. 219 F.3d 359 (4th Cir. 2000), *aff'g* 48 F. Supp. 527 (E.D. Va. 1999), previously discussed in J. Salles, "Tax Accounting," 2(1) Corp. Bus. Tax'n Monthly 36, 36-37 (Oct. 2000).
32. *See, e.g., Pahl v. Commissioner*, 67 T.C. 286 (1976); *Blanton v. Commissioner*, 46 T.C. 527 (1966).
33. 263 F.3d at 663; 117 F. Supp. 2d at 859-62.
34. *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983); *Prince v. United States*, 610 F.2d 350 (5th Cir. 1980).
35. *See, e.g.*, Rev. Rul. 74-607, 1974-2 C.B. 149.
36. Rev. Rul. 72-114, 1972-1 C.B. 124.
37. 86 T.C. 199 (1986).
38. 112 T.C. 270 (1999).
39. *See* I.R.C. § 446(e).
40. Reg. § 1.1502-17.
41. Reg. § 1.1502-13(b)(3)(i), as amended by T.D. 8597, 1995-2 C.B. 147, 164.
42. Reg. § 1.1502-13(a)(3)(i), as amended by T.D. 8597, 1985-2 C.B. 147, 162-63.
43. Prop. Reg. § 1.446-1(c)(2)(iii), REG-125161-01 (Nov. 6, 2001).