Tax Accounting

By James E. Salles

In this month's issue:

- Revenue Ruling 2002-71[1] illustrates the treatment of a debt hedge under Treas. Regs. section 1.446-4.
- Revenue Procedure 2002-65[2] extends an optional system of "track maintenance allowances" to smaller railroads.
- In *Tampa Bay Devil Rays, Ltd. v. Commissioner,*[3] The Tax Court allows deferral of income from advance payments under a "common law" exception to the *Schlude* doctrine.
- Another procedure on taxable year changes, and guidance on advance payments and the "nonaccrual experience method" under section 448, are expected late in the year.

Ruling Illustrates "Hedge Timing" Rules

The Internal Revenue Service has issued a new ruling illustrating how the "hedge timing rules" in Treas. Regs. section 1.446-4 apply to debt hedges. Revenue Ruling 2002-71[4] involved the issuer of a ten-year debt instrument that entered into a notional principal contract (NPC) to hedge interest risk for the first five years of the debt's term. The NPC was properly identified so as to be treated as a hedge under both the "character" rules in Reg. section 1.1221-2 and the "timing" rules of Reg. section 1.446-4.

Reg. section 1.446-4 requires generally that the timing of income, deduction, gain, or loss from a hedging transaction must "reasonably match" the reporting of the transaction being hedged.[5] Hedges of debt instruments must be accounted for "by reference to the terms of the debt instrument and the period or periods to which the hedge relates."[6]

The taxpayer in the ruling terminated the NPC two years into its five-year term. The issue was how to account for any termination payment that the taxpayer might make (or receive). The IRS ruled that the termination payment should be amortized over the remainder of the initial term of the NPC if the debt remains outstanding. If the debt were retired in the meantime, then the rest of the termination payment would be taken into account at that time along with any other unamortized costs associated with the financing.

Railroad "Track Maintenance Allowances"

Last year, the "*INDOPCO* Coalition" proposed what was in effect a return to the pre-1981 repair allowance system for depreciable property.[7] Thus far, Treasury and the IRS have opted to confine the proposed-regulations-to-be to intangible assets.[8] However, a new revenue procedure extends a variant of a repair allowance system that applies to railroads' track maintenance costs. Railroad accounting is a specialized area, but the IRS' initiative may suggest some openness to experimenting with an allowance system for a broader class of assets.

An earlier procedure, Revenue Procedure 2001-46, prescribed an allowance system for "Class I" railroads (generally, railroads with over $250 million in assets).[9] Such railroads have to follow the federally prescribed Uniform System of Accounts and file an annual report on Form R-1 with the Surface Transportation Board.[10] The new procedure, Revenue Procedure 2002-65,[11] prescribes a modified allowance system for smaller "Class II" and "Class III" railroads that do not file a Form R-1.

Revenue Procedure 2002-65 permits eligible railroads to elect the "track maintenance allowance method" of accounting. An electing railroad first calculates the total outlays on track structure ("track structure expenditures"), including both "current additions" capitalized for financial reporting purposes and items treated as operating expenses on the books. The railroad then subtracts from that combined total the portion that is attributable to "new track structure" acquired, constructed, or restored to use during the year. This leaves the portion of the "track structure expenditures" deemed attributable to existing track. Three quarters of that amount is considered the "track maintenance allowance" and is allowed as a deduction for tax

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purposes, while the remaining quarter is capitalized into the various track accounts, generally in proportion to the amounts capitalized on the books.

The procedure generally provides automatic consent for taxpayers to make a change to the "track maintenance allowance method" in their first or second taxable year ending after December 31, 2001.[12] If a railroad's track expenditures are currently under consideration in a tax proceeding, it may choose between a prospective change with no audit protection for earlier years and a standardized settlement under which the change would generally be made in the earliest open year.[13]

Tax Court Recognizes Exception to *Schlude*

A recent memorandum case appears to mark the first time that the Tax Court has explicitly recognized a "common law" exception to the so-called "*Schlude* doctrine" that generally requires accrual basis taxpayers to report advance payments as income in the year of receipt.

The Supreme Court "Trilogy"

The Supreme Court considered the taxation of advance payments for services in three well-known cases decided in the late 1950s and early 1960s. *Automobile Club of Michigan v. Commissioner*[14] held that the taxpayer could not take membership dues into income ratably over the period of membership, because the division of the dues into monthly amounts was "purely artificial." *American Automobile Ass'n v. United States*[15] reached the same result on similar facts, with the court emphasizing that the taxpayer could not predict whether or when it would be called upon to perform under any particular membership contract. Finally came *Schlude v. Commissioner,*[16] involving an Arthur Murray dance studio. Again, the court required the taxpayer to immediately report customers' payments under contracts that called for a given number of hours of dancing lessons, emphasizing that it was not certain when the lessons would be provided, or even that they would be provided at all.

Under what is frequently referred to as the "*Schlude* doctrine," it is clear that taxpayers cannot put off reporting advance payments merely because, for example, the payments would be treated as deferred income in financial statements.[17] However, there was still some question about whether the Supreme Court was establishing a *per se* rule that advance payments were always immediately taxable or merely extending well-established law that generally disallows the use of financial "reserves" for tax purposes.[18] In all three of the Supreme Court cases, the taxpayer had the income in hand, and while the taxpayer was clearly going to incur some costs in the future, whether and when performance would occur under any particular contract, and how much it might cost, was uncertain.

Differing Interpretations

The IRS' position since *Schlude* has been that true advance payments (as distinguished from deposits[19]) are always immediately taxable unless some specific statutory or administrative relief applies.[20] In the immediate aftermath of *Schlude*, there was language in a number of Tax Court opinions,[21] as well as those of some other courts,[22] that favored the IRS' view. Some courts, however, concluded that the Supreme Court leaves room for an exception in the relatively rare case where the taxpayer can show, on a transaction-by-transaction basis, that receipts *necessarily* relate to goods or services that definitely must be, and have not yet been, provided.

The issue in *Artnell Co. v. Commissioner*[23] was whether the Chicago White Sox could defer income from advance sales of baseball tickets. The Tax Court read the Supreme Court case law as establishing that "[prepaid] income is taxable upon receipt except when Congress expressly provides for its deferment."[24] On appeal, however, the Seventh Circuit concluded that the facts in *Artnell* were distinguishable from the Supreme Court cases because, except for rain dates, performance was certain to occur on a fixed schedule. Notwithstanding the Supreme Court cases, the appellate panel held, "there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the Commissioner rejects it,"[25] and remanded for consideration of whether the White Sox' accounting met that standard. On remand, the Tax Court upheld the taxpayer's deferral method as more clearly reflecting income than the IRS' proposed alternative. The Court of Claims adopted a similar approach in *Boise Cascade Corp. v. United States*,[26] allowing advance payments for engineering services to be deferred when there was a "fixed and definite" obligation to perform under each contract.

Thereafter, the Tax Court's position has been somewhat uncertain. The court has repeatedly distinguished *Artnell* and *Boise Cascade* when the taxpayer fails to demonstrate the same "certainty of performance."[27] However, it seems to have avoided firmly committing to follow those cases on sufficiently similar facts[28] (except when it has to do so[29] because appeal lies to the Seventh Circuit).[30]

Tampa Bay Devil Rays

Finally, however, *Tampa Bay Devil Rays, Ltd. v. Commissioner*[31] has confronted the court with facts essentially indistinguishable from *Artnell*. The taxpayer deferred the income from advance season tickets (and the minimal associated expenses) until the games were played. The IRS sought to require immediate inclusion of the ticket income. The court noted that "[i]n subsequent opinions, we have stated that *Artnell Co.* will be limited to its facts,"[32] but concluded that the Devil Rays' situation fell within the "narrow fact pattern" that permitted deferral.

The court may have decided an issue of first impression without realizing it. Notably, the various earlier cases cited as limiting *Artnell* to its facts had not expressly decided (and in some instances had expressly not decided) that the Tax Court *would* follow the Seventh Circuit on the same facts. While the memorandum opinion does not explicitly say so, in applying *Artnell* in a case not appealable to the Seventh Circuit *Tampa Bay Devil Rays* effectively overruled the Tax Court's long-reversed decision in the *Artnell* case itself. In any event, the case would seem to signal the Tax Court's acceptance of the "certainty of performance" exception as a general, if narrow, exception to the immediate taxation of advance payments.

More Accounting Guidance Expected

In comments to the American Bar Association (ABA) Tax Section's tax accounting committee in mid-October, Treasury attorney Sharon Kay discussed the status of a number of pending accounting projects.[33] Among the items currently expected by year-end are...

- New guidance on advance payments that may eliminate some controversies about the classification of payments as for goods, services, or something else, and liberalize the administrative relief for payments for services, which is currently confined to payments for services to be performed in the following taxable year.[34]
- A new procedure for changes of taxable years by individuals, to complement the recently released procedures for passthrough entities and corporations.[35]
- Guidance reflecting the recent amendments to section 448 affecting the "nonaccrual experience method."[36]

1. 2002-44 I.R.B. 763.

2. 2002-41 I.R.B. 700.

3. 84 T.C.M. (CCH) 394 (2002).

4. 2002-44 I.R.B. 763, 2002 WL 31316718.

5. Reg. § 1.446-4(b).

6. Reg. § 1.446-4(e)(4).

7. "*INDOPCO* Coalition Proposed Capitalization Principles," Tax Analysts Doc. No. 2001-26125 (Sept. 6, 2001); see J. Salles, "Tax Accounting," 3(3) Corp. Bus. Tax'n Monthly 38 (Dec. 2001).

8. Advance Notice of Proposed Regulations, REG-125638-01, RIN 1545-BA00.

9. 49 C.F.R. 1201.1-1(a)(1).

10. 49 C.F.R. 1241.11 (2002).

11. 2002-41 I.R.B. 700.

12. Rev. Proc. 2002-65, § 6.02-.03.

13. Rev. Proc. 2002-65, §§ 6, 8.

14. 353 U.S. 180 (1957).

15. 367 U.S. 687 (1961).

16. 372 U.S. 128 (1963).

17. See, e.g., *Artnell v. Commissioner*, 400 F.2d 981, 983 (7th Cir. 1968) (discussed below); *cf. Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 539-44 (1979) (financial and tax accounting have different objectives).

18. E.g., *Brown v. Helvering*, 291 U.S. 193 (1934).

19. See, e.g., *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

20. I.R.C. §§ 455 (prepaid subscription income), 456 (prepaid membership dues); Reg. §§ 1.451-4 (trading stamps and coupons), 1.451-5 (advance payments for goods and long-term contracts); Rev. Proc. 2002-36, 2002-21 I.R.B. 993 ("capital cost reduction" payments by lessees); Rev. Proc. 97-38, 1997-2 C.B. 479 (certain warranty contracts); Rev. Proc. 71-21, 1971-2 C.B. 549 (payments for the following year's services).

21. E.g. *William O. McMahon, Inc. v. Commissioner*, 45 T.C. 221, 227 (1965); *Bell Electric Co. v. Commissioner*, 45 T.C. 158, 166 (1965); *Cox v. Commissioner*, 43 T.C. 448, 455-56 (1965).

22. E.g., *McAllister v. Commissioner*, 417 F.2d 581 (9th Cir. 1969) (per curiam); *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105, 1108-09 (6th Cir. 1969).

23. 48 T.C. 411 (1967), *rev'd and rem'd*, 400 F.2d 981 (7th Cir. 1968), *on remand* 29 T.C.M. (CCH) 403 (1970).

24. *Artnell*, 48 T.C. at 416.

25. 400 F.2d at 984-85.

26. 530 F.2d 1367 (Ct. Cl.), *cert. denied*, 429 U.S. 867 (1976).

27. E.g., *Johnson v. Commissioner*, 108 T.C. 448, 491-93 (1997), *aff'd in part, rev'd in part on other grounds*, 184 F.3d 786 (8th Cir. 1999); *Chesapeake Financial Corp. v. Commissioner*, 78 T.C. 869, 881-82 (1982); *T.F.H. Publications, Inc. v. Commissioner*, 72 T.C. 623, 644-45 (1979), *aff'd without published opinion*, 622 F.2d 579 (3d Cir. 1980); *Standard Television Tube Corp. v. Commissioner*, 64 T.C. 240, 242 (1975); *JFM, Inc. v. Commissioner*, 67 T.C.M. (CCH) 3020, 3021-2 to -3 (1994).

28. See, e.g., *Chesapeake Financial*, 78 T.C. at 881 (court need not decide whether to adopt rationale of *Artnell* and *Boise Cascade* because they were distinguishable); *Collegiate Cap & Gown Co. v. Commissioner*, 37 T.C.M. (CCH) 960, 965 (1978) (following *Artnell* where appeal lay to the Seventh Circuit "without necessarily implying that we accept the Seventh Circuit's approach in comparable cases not appealable to that Circuit").

29. See *Golsen v. Commissioner*, 54 T.C. 742, 756-58 (1970) (reviewed), *aff'd on other issues*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

30. *Collegiate Cap & Gown Co. v. Commissioner*, 37 T.C.M. (CCH) 960 (1978) (rentals of graduation apparel).

31. 84 T.C.M. (CCH) 394 (2002).

32. Id. at 399.

33. See "Accounting Guidance is in the Offing, Says Treasury Official," 67 Tax Analysts' Daily Tax Highlights & Documents 762 (Oct. 22, 2002).

34. Rev. Proc. 71-21, § 3.02, 1971-2 C.B. 549, 549.

35. Rev. Proc. 2002-37, 2002-22 I.R.B. 1030, Rev. Proc. 2002-38, 2002-22 I.R.B. 1037, and Rev. Proc. 2002-39, 2002-22 I.R.B. 1046, discussed in J. Salles, "Tax Accounting," 4(1) Corp. Bus. Tax'n Monthly 34 (Oct. 2002) and 4(2) Corp. Bus. Tax'n Monthly 25 (Nov. 2002).

36. See J. Salles, "Tax Accounting," 3(11) Corp. Bus. Tax'n Monthly 28 (Aug. 2002).