Tax Accounting

BY JAMES E. SALLES

In this month's column:

- *Badell v. Commissioner*[1] and TAM 200040004[2] highlight the taxation of advance payments and illuminate the sometimes hazy line between an "advance payment" and debt.
- The Tax Court defers a CPA's deduction for prepaid rent in *Howe v. Commissioner*.[3]
- The IRS issues Revenue Procedure 2000-38,[4] prescribing specialized timing rules for mutual fund distributors' commission expenses.
- The National Office rules in LTR 200023031[5] that the right to deferred payment of a lottery prize is not a taxable "cash equivalent" despite a limited ability to assign it.

ADVANCE PAYMENTS FEATURED

Advance payments are amounts that are paid—and, on the accrual basis, unpaid amounts that become currently due[6]—before the recipient provides the corresponding consideration (such as goods or services). Advance payments are taxable income, and absent special circumstances—or a specific relief provision—are taxable in full in the year of receipt.[7] Loans or deposits, by contrast, represent amounts that the borrower/recipient is expected to pay back, and are not taxable income at all.

Advance Payments Versus Loans

There are numerous authorities addressing whether a given payment represents a taxable advance payment or a nontaxable deposit. The most prominent recent example is *Commissioner v. Indianapolis Power & Light Co.*,[8] in which the Supreme Court held that a utility did not realize income from its customers' deposits because it had an "obligation to repay [each deposit] . . . so long as the customer fulfills his legal obligations."[9] The Court contrasted the situation of the recipient of an advance payment who "is assured that, so long as it fulfills its contractual obligation, the money is its to keep."[10]

Jim Salles is a member of Caplin & Drysdale in Washington, D.C.

Indianapolis Power makes it clear that a remittance that the agreement obliges the provider to *repay* is a deposit, even if it might later be applied against charges if the parties so agree or the buyer defaults. On the other hand, a remittance that the parties agree will be applied toward future services, for example, is an advance payment, even if the provider might have to refund it in certain circumstances.[11]

Disguised Advance Payments

If one party pays another in the expectation that the liability will be "worked off" one way or another, that is an advance payment. Courts have refused to recognize purported "loans" that are effectively paid off in advance. In *Heyn v. Commissioner*, 39 T.C. 719 (1963), the taxpayer compromised a breach of contract claim against a former employer in exchange for five equal annual payments. At the same time, however, the employer "loaned" him a discounted amount that was nominally repayable on the same amounts and in the same dates as payments were due under the settlement. The court held that the employee had to report the discounted amount in the year of the settlement, because it was a foregone conclusion that the "loan" was not going to be paid back.[12]

A kindred line of authorities holds that once two parties agree to offset mutual obligations, they cannot artificially defer the tax consequences. For example, *Seay v. Commissioner* [13] and *Carroll v. Commissioner* [14] involved a lawyer and his client who agreed that the lawyer's $75,000 fee was to be offset against a preexisting loan. The Tax Court held that the lawyer had taxable income and the client an immediate deduction as soon as the agreement was reached, even though they had agreed that the offset would take place in three annual installments.

TAM 200040004

In TAM 200040004,[15] an employer made purported loans to its employees calling for repayment over the following five years. The required payments corresponded to bonuses the employer guaranteed to pay over the same period to those remaining in its employ. The

National Office determined that the loans were really advance payments of wages, the borrowers' potential liability if they quit their jobs being "more in the nature of liquidated damages for breach of the employment contract rather than a payment of principal and interest."

The tax treatment of the employees was not at issue in TAM 200040004, although the National Office left little doubt as to its opinion on the subject. The ruling addressed the timing of the employer's deductions. Because the employer was an accrual method taxpayer, its deductions were governed by the "all events" test, including the "economic performance" requirement,[16] which is met as the services are performed.[17] The ruling allowed the employer to deduct the amount of the "loan" ratably over the term of the agreement.

Badell v. Commissioner

Badell v. Commissioner[18] served up the old advance payment wine in a new bottle: a services barter arrangement. The taxpayers in *Badell* were shareholders in a cash basis subchapter "S" corporation through which they conducted their law practice. One of the shareholders engaged a construction company, a law firm client, to install a slate roof on his home.

The construction company billed the law firm for the bulk of the amount due in 1994, but made no attempt to collect. In the meantime, the law firm rendered the contractor monthly bills for its services, gradually building up a receivable that it made no move to collect, either. The contractor reported income in 1994—although it is not clear on what basis—and thereafter offset its receivable against the legal fees payable. The law firm reported nothing until after a revenue agent had appeared on the scene, when the parties suddenly began making payments on the reciprocal balances.

There was conflicting testimony as to the "real deal" between the parties, but the owner of the contracting company had told the revenue agent that it had not attempted to collect the account because the law firm was going to "work off" the balance. The court believed him, and found that the offsetting balances were not *bona fide* receivables and payables, but reflected a barter arrangement under which services the contractor performed in 1994 were exchanged for the law firm's services between 1994 and 1996. The full value of the contractor's services[19] was income to the law firm in 1994.

CPA MAY NOT DEDUCT PREPAID RENT

The Regulations generally prohibit both cash and accrual method taxpayers from deducting an expenditure that "results in the creation of an asset having a useful life which extends substantially beyond the taxable year."[20] The Ninth Circuit's decision in *Zaninovich v. Commissioner*,[21] left-handedly endorsed in subsequent Supreme Court dicta,[22] suggests a "one-year rule" of convenience for cash basis taxpayers.

The "one-year rule" is not the sole element of the inquiry, however. Revenue Ruling 79-229,[23] distilling the accumulated wisdom of a clutch of primitive tax shelter cases, furnishes a "three-prong test" for determining when cash basis taxpayers are allowed to deduct prepayments. Revenue Ruling 79-229 permits a current deduction if:

- the taxpayer makes a real "payment" rather than a deposit;
- for a business purpose "and not merely for tax avoidance"; and
- the result is not a "material distortion of income."

The courts have generally accepted this "three-prong test," apart from some debate on the minutiae of its application.

Prepayment tax shelters fell out of fashion long ago, with the enactment of restrictions on deductions for prepaid interest[24] and farm supplies,[25] and the advent of the "at risk" and "passive loss" rules and other innovations directed at tax shelters generally. However, the "three-prong test" continues to reflect the law as to deductions for prepayments that are not controlled by a specific provision. In particular, the "business purpose" requirement remains alive and well, as the Tax Court has just demonstrated in *Howe v. Commissioner*.[26]

Howe involved a cash basis accountant who, for somewhat obscure reasons, suddenly prepaid rent for the third and fourth year of a five-year office lease. The court framed the issue as whether the taxpayer had a "substantial business reason," and did not believe his testimony that he prepaid to secure a renewal on favorable terms, especially as negotiations did not begin until two years later. Consequently, the taxpayer's immediate deduction was confined to the rent attributable to the year of payment.

MUTUAL FUND COMMISSIONS

Field Service Advice 200016002, discussed in the July issue,[27] addressed securities firms' income and deductions from the distribution of mutual funds. Mutual fund distributors receive "12b-1 fees" from the fund issuer, and pay commissions to their sales staff on sales to brokerage customers.

There can be timing differences between when the fees are reported as income and when the commissions are deductible. The taxpayer in FSA 200016002 deducted commissions as sales were made, but did not have to accrue its fee income until the end of the month, because the amount of the fees was not determinable until then. In *Johnson v. Commissioner*,[28] the Eighth Circuit, in a decision despised by the IRS, accelerated a deduction to match the timing of a "directly related" income item. However, the field service advice explicitly rejected trying to invoke the same "matching" principle to defer the commission deductions until the corresponding fee income was reported. The taxpayer thus benefited from a one-month "lag" between the deduction and the associated income hit.

The period of deferral in FSA 200016002 was only one month. However, a variety of different fee structures and commission arrangements apply to different classes of shares in different funds. Commissions paid too far in advance of the associated fee income may be capitalizable as creating an asset "having a useful life which extends substantially beyond the taxable year."[29]

Revenue Procedure 2000-38

The IRS has now issued Revenue Procedure 2000-38,[30] addressing situations where a mutual fund distributor pays commissions before it receives its fees under Rule 12b-1. Taxpayers to which the procedure applies may choose between amortizing the commissions

- over the period over which the "12b-1 fees" are to be paid;
- over five years; or
- over their "useful lives," determined taking into account both the fee payout schedule and an allowance for redemptions of shares.

Pooling of commissions paid with respect to a particular share issue in a single year is permitted—required in the case of the "five year method"—and there are various provisions for an accelerated deduction if the taxpayer loses or disposes of its rights to receive future fees. Changes of method are generally subject to the "automatic consent" rules of Revenue Procedure 99-49,[31] with incentives for changes in the taxable year including January 1, 2001.

ASSIGNABLE RIGHTS NOT ALWAYS "CASH EQUIVALENTS"

A letter ruling released in August may shed new light on the IRS' position on an old issue—the doctrine of "cash equivalence."

The *Cowden* Standard

A cash basis taxpayer is taxed upon receipt of an obligation that is a "cash equivalent." In what is far and away the most quoted case on the subject, *Cowden v. Commissioner*,[32] the court held that:

> if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

The *Cowden* court evidently intended its formulation as a shorthand summary of the facts of the case before it rather than a comprehensive summary of the prior case law. For example, some earlier courts had held notes to be cash equivalents even when they traded at heavy discounts.[33] There remains some uncertainty about how far the doctrine of cash equivalence applies outside of the classic situation described in *Cowden*.

Section 1001(b)

This uncertainty about how far the doctrine of cash equivalence applies has been compounded by the existence of a related line of authorities under Code section 1001(b), which includes in the "amount realized" upon the sale or other disposition of property "the fair market value of the property (other than money) received." The "common law" analysis under section 1001(b)—largely displaced, since 1980, by the installment sales method—took property into account in this computation if it had "ascertainable market value." Authorities addressing whether notes or other obligations had "ascertainable market value" under section 1001 frequently referenced the authorities addressing "cash equivalence" under section 451 and vice versa. The close relationship between the two standards has led commentators, the author among them, to conclude that they might be the same.[34]

In a key section 1001 case, *Warren Jones Co. v. Commissioner*,[35] the Ninth Circuit held that the taxpayer had to include secured "real estate contracts"—marketable but only at a discount of 40% or so—in computing its "amount realized." In reversing the Tax Court, which had relied on *Cowden*,[36] the Ninth Circuit did not hold that *Cowden* was inapplicable under section 1001, but apparently concluded that the *Cowden* formulation was intended "principally as a description of the obligation involved in that case" rather than as a talismanic test. The Court of Claims followed *Warren Jones Co. in Campbell v. United States*,[37] on similar facts except that the obligations involved were nonnegotiable notes.

Warren Jones Co. and similar cases suggested that "cash equivalence" might be extended to reach any form of contract right, even if not conventional debt, that could be assigned for value—hence, for example, the anti-assignment clauses commonly encountered in nonqualified deferred compensation agreements. Contract rights cannot be cash equivalents if they cannot be assigned at all.

LTR 200031031

A recent private ruling hints that the IRS, at least, may see a distinction between the two Code provisions, and will not invoke the section 1001 case law to argue that a contract right must necessarily be a cash equivalent under section 451 merely because it may be assigned for value. In LTR 200031031,[38] state lottery authorities sought assurances that a change in the law to permit winners to assign their rights to the future payment of prizes would not result in all winners being taxable immediately upon the value of their unpaid installments.

After discussing both Cowden and Warren Jones Co., the ruling stated that the Ninth Circuit in Warren Jones Co. "did not hold that the fair market value of property received in an exchange is a cash equivalent" but was confined to section 1001. It then analyzed the lottery prize assignment agreements under the four-part Cowden test. As these were individually negotiated, and subject to court approval to boot, they did not meet the standard of being "frequently transferred to lenders or investors at a discount not substantially greater than the prevailing premium for the use of money."[39] Therefore, the IRS ruled, they were not "cash equivalents." Moreover, the fact that an individual winner might make use of the assignment option would not result in nonassigning winners being taxed.

LTR 200031031 involved a request for a ruling by state authorities on relatively sympathetic facts, and as a private ruling, has no precedential value. It will be interesting to see whether the IRS and Justice will recognize the same distinction between the authorities under sections 451 and 1001 in a litigated case.

1. 80 T.C.M. (CCH) 422 (2000).
2. June 12, 2000.
3. 80 T.C.M. (CCH) 380 (2000).
4. 2000-40 I.R.B. 310 (released Sept. 15, 2000).
5. May 5, 2000.
6. See, e.g., Reg. § 1.451-5(a)(1), (a)(2)(ii), defining advance payments for goods.
7. E.g., Schlude v. Commissioner, 372 U.S. 128 (1963).
8. 493 U.S. 203 (1990).
9. Id. at 209.
10. Id. at 211.
11. See, e.g., Cox v. Commissioner, 43 T.C. 448 (1965).
12. Accord, on similar facts, United States v. Ingalls, 399 F.2d 143 (5th Cir. 1968), cert. denied, 393 U.S. 1094 (1969).
13. 33 T.C.M. (CCH) 1406, 1408-09 (1974).
14. 30 T.C.M. (CCH) 249, 254-55 (1971).
15. June 12, 2000.
16. I.R.C. § 461(h); Reg. § 1.461-1(a)(2).
17. I.R.C. § 461(h)(2)(A); Reg. § 1.461-4(d)(2).
18. 80 T.C.M. (CCH) 422 (2000).
19. See Reg. § 1.61-2(d)(1).
20. Regs. §§ 1.263(a)-2(a), 1.461-1(a)(1)-(2).
21. 616 F.2d 429 (9th Cir. 1980), discussed in 1(7) *Corporate Business Tax'n Monthly* 33, 35 (April 2000).
22. See Hillsboro National Bank v. Commissioner, 460 U.S. 370, 384 (1983).
23. 1979-2 C.B. 210.
24. I.R.C. § 461(g).
25. See I.R.C. § 464(a).
26. 80 T.C.M. (CCH) 380 (2000).
27. 1(10) *Corporate Business Tax'n Monthly* 32, 34 (July 2000).
28. 184 F.3d 786 (8th Cir. 1999), rev'g 108 T.C. 448 (1997), discussed in 1(2) *Corporate Business Taxation Monthly* 28 (November, 1999).
29. Regs. §§ 1.263(a)-2(a), 1.461-1(a)(1)-(2).
30. 2000-40 I.R.B. 310.
31. 1999-52 I.R.B. 1, discussed in 1(6) *Corporate Business Taxation Monthly* 29, 29 (March 2000).
32. 289 F.2d 20, 24 (5th Cir. 1961).
33. E.g., Andrews v. Commissioner, 3 T.C.M. (CCH) 526 (1944) (scrip issued as interest included at 20% of face).
34. See 570 T.M., Accounting Methods—General Principles, IV.B.1.a.(3) at A-58 to -59 & nn. 700-03 and authorities cited.
35. 524 F.2d 788 (9th Cir. 1975), rev'g 60 T.C. 663 (1973).
36. 60 T.C. at 668-69.
37. 661 F.2d 210 (Ct. Cl. 1981).
38. May 5, 2000.
39. 289 F.2d at 24.