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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES A. NELSON
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Attn: Marilyn Devin

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Marking to market certain unbilled receivables

This Field Service Advice responds to your memorandum dated February 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

- A =
- B =
- C =
- D =
- E =
- F =
- G =
- H =
- I =
- J =
- K =
- L =
- M =
- N =
- O =
- P =

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Q =

R =

S =

Parts =

Set =

DATE 1 =

DATE 2 =

DATE 3 =

DATE 4 =

ISSUES

1. Whether the taxpayer may mark to market its unbilled receivables (anticipated income) under I.R.C. § 475.
2. Whether I.R.C. § 751(c) is applicable to the determination of whether the taxpayer's unbilled receivables represent indebtedness.

CONCLUSIONS

1. Under the facts and circumstances of this case, the taxpayer's unbilled receivables constitute neither evidence of indebtedness nor evidence of an interest in indebtedness, and, therefore, do not meet the definition of a "security" within the meaning of § 475(c)(2) and cannot be marked to market under § 475.
2. The taxpayer's unbilled receivables are not "unrealized receivables" under § 751(c) because § 751(c) applies to subchapter K only.

FACTS

A, the taxpayer, manufactures parts as a subcontractor. The parts with which this case concerns are the Parts. A pair of complete Parts is referred to as a Set.

The taxpayer entered into a contract ("the Agreement") with B, the purchaser of the Parts and the customer. Pursuant to the terms of this contract, the taxpayer would manufacture the Parts to the purchaser's specifications in each order. The parties agreed in the contract that B would order up C Sets, with an option to order additional Sets. If B ordered fewer than C Sets, the contract provided for B to pay

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the taxpayer \$D. Additionally, if B terminated the contract, or if there was a “cancellation for convenience,” B would be required to pay additional amounts.

The Agreement set forth a fixed price for the Sets with an index-based escalations clause, that is, the prices of certain labor and commodity expenses would fluctuate based on statistical indices. The first three test Sets cost \$D each; the next three Sets cost \$E; the next Sets, up to a total number of F Sets, cost \$G each; and after F Sets, the price was lowered to \$H.

In addition to the costs of the Sets, B paid the taxpayer \$I for its non-recurring costs, including special tools.

The parties did not establish a time-table for delivery of the completed Sets. The Agreement stated that B would advise the taxpayer of the quantity needed by sending a purchase order (“Purchase Order”), giving the taxpayer at least Q months advance notice of a purchase. Each Set was manufactured to B’s specifications and needs. Additionally, the taxpayer agreed not to manufacture any parts in advance of the reasonable flow time needed to fill the Purchase Orders. Thus, the taxpayer did not incur any costs for labor, materials, or subcontracts for any set until it actually received a Purchase Order for a specific number of shipsets.

The Agreement states that it specifically does not constitute an order for any of the products and is not to be construed as authorizing work, but, instead, all orders are placed and work authorized by the issuance of Purchase Orders. See Section 4.A. The Agreement also provides that the delivery schedule for products ordered under the Agreement will be established in the purchase orders. See Section 4.G.

Subsection 6.B. provides, in part, that:

For each shipment of Products, Subcontractor shall submit an original invoice marked “original” and one copy marked “copy” to the appropriate [B] Accounts Payable Department.

Subsection 9.C. provides that the taxpayer will protect B’s production inventory by carrying a guaranteed minimum buffer inventory to be agreed upon by both parties. The inventory was subject to annual review and audit by B. Other than the agreed-upon buffer inventory, the taxpayer did not manufacture any Sets ahead of time.

Each of B’s orders for Parts contained the following information: the type and quantity of products, the delivery schedule and the delivery dates of the finished Parts. B was required to pay the established price for all Parts that the taxpayer delivered that were acceptable to B’s specifications. B was obligated to pay for the

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delivered and acceptable Parts no later than S days after the later of either the contractually scheduled or the actual delivery date, and typically paid within R to S days of the shipment.

Section 6 contains the terms and conditions for payment under the Agreement. Paragraph 6.A.1. and provides as follows:

[B] shall pay Subcontractor in United States dollars the prices set forth in Exhibit D for all Products delivered hereunder. Subcontractor must provide [B] an accurate invoice before any payment can be made. Payment due date shall be [S] days after the contractually scheduled or actual delivery of acceptable Product(s), whichever is later.

The length of time between B's order of the Sets and the beginning of the delivery of the Sets averaged approximately 9 months. Often the taxpayer received an order in a year different from the year of delivery of the finished Sets. As of the taxpayer's year end, there could be Purchase Orders outstanding for which no manufacturing expenses had yet been accrued.

The Purchase Orders that were outstanding at the end of each year, but not yet accrued, represented the taxpayer's anticipated income, which the taxpayer considered as its "unbilled receivables." The taxpayer marked these unbilled receivables to market in the tax years ending DATE 1, DATE 2, DATE 3, and DATE 4.

Subsection 9.B. provides that:

Subcontractor will not, without [B]'s prior written consent, manufacture in advance of the reasonable flow time required to accomplish prompt delivery in accordance with [B]'s delivery dates; nor will Subcontractor deliver any such Products more than one (1) week in advance of such delivery dates without [B]'s written consent. [B] reserves the right to return, shipping charges collect, or to store at Subcontractor's expense, all such Products received by [B] in advance of such required delivery dates.

Subsection 9.D. states as follows:

[B] and Subcontractor agree to develop a program which minimizes the standing inventory at [B]. This program is defined as "Just In Time" (JIT). Subcontractor and [B] shall work together to achieve

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and maintain JIT deliveries within ninety (90) days after execution of this Agreement.

Section 10 provides for B's right to inspect and test the products prior to acceptance. All products are subject to preliminary inspection and test by a representative of B and the Federal Aviation Administration at all times and places, including during the period of manufacture. All products, other than those purchased as spares, are subject to final inspection and acceptance, notwithstanding any preceding inspections, up to the time of acceptance by B's customer of the aircraft upon which the product is installed.

Section 12.B.1. provides that, in the event of a termination of work under the contract, the taxpayer must stop work as specified in a notice from B, terminate all related subcontracts, and assign to B all rights and obligations under the subcontracts. Further, the taxpayer must transfer title and deliver to B any fabricated or unfabricated parts, work in process, completed work, supplies, and other materials produced or acquired for the work terminated or make its best effort to sell any such property, as directed by a representative of B.

The taxpayer accrued the following amounts of gross revenue and unbilled receivables for the following years:

TAX YEAR	INCOME	UNBILLED RECEIVABLES
DATE 1	\$ <u>J</u>	\$ <u>J</u>
DATE 2	\$ <u>K</u>	\$ <u>L</u>
DATE 3	\$ <u>M</u>	\$ <u>N</u>
DATE 4	\$ <u>O</u>	\$ <u>P</u>

The taxpayer accounted for its income and expenses from these contracts by using the percentage of completion method pursuant to I.R.C. § 460. Pursuant to this method, the taxpayer accrued income annually on Purchase Orders as work was performed and costs were incurred.

LAW AND ANALYSIS

Issue 1

A dealer in securities may mark to market its securities that are not held as inventory. I.R.C. § 475(a). For purposes of § 475(c), a security is defined as any of the following: (A) share of stock in a corporation; (B) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (C) note,

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bond, debenture, or other evidence of indebtedness; (D) interest rate, currency, or equity notional principal contract; or (E) evidence of an interest in or a derivative financial instrument in any of the foregoing.

The taxpayer has argued that the definition of security for purposes of § 475 should be read broadly to include any right to payment or extension of credit, including its unbilled receivables. Essentially, the taxpayer contends that it extended credit to B during the production phase and that such credit was evidenced by the amount of the unbilled receivables that it recorded on its books at the end of its taxable year.

The taxpayer's second argument is that § 475(c)(2)(E) was intended to broaden the scope of § 475(c)(2)(C) by requiring that the taxpayer show only evidence of an interest in a note, bond, debenture, or other evidence of indebtedness, rather than the interest itself. Under this theory, the taxpayer maintains that the unbilled receivables represent a right to payment based upon the Agreement and the unbilled receivables qualify as evidence of its partially completed obligation under this same Agreement, thereby creating evidence of B's obligation to pay for the partially completed products.

The agent determined that the unbilled receivables did not qualify as indebtedness under § 475(c)(2) because (i) the Purchase Orders did not represent an obligation to pay an identifiable amount, and (ii) the Taxpayer was not yet entitled to bill the customer for the work that had been completed.

In this case, because the taxpayer's unbilled receivables represent the full price due for products ordered under a purchase order, the question to be addressed is whether this amount constitutes a valid indebtedness or evidence of an interest in indebtedness under § 475(c) as described above. In light of the terms of the Agreement between the parties and other facts and circumstances, the unbilled receivables represent neither a valid indebtedness of B nor evidence of an interest in indebtedness.

The taxpayer's unbilled receivables represent the price for products ordered under a Purchase Order and provided by the taxpayer in accordance with the terms of the Agreement. Under the Agreement, B was not obligated to pay for a product until the product was delivered, installed, and accepted by B.

In addition, the provisions of the Uniform Commercial Code (UCC), Article 2 - Sales reinforce our interpretation, for federal income tax purposes, of the obligations of B under the Agreement.¹ Section 2-105(2) of the UCC mandates that goods must be both existing and identified before any interest in them can pass. Goods which are

¹ The Uniform Commercial Code has been adopted in California. 23A Cal. Code §§ 1101 et seq. California law governs the terms of the contract at issue. Section 42.B.

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not both existing and identified are “future” goods and a purported present sale of future goods or of any interest therein operates as a contract to sell. A contract to sell is not a present sale of goods, but instead an agreement to sell goods at a future time. Section 2-106(1). Section 2-310(a) provides that payment is due at the time and place at which the buyer is to receive the goods, unless otherwise agreed. Under section 2-310(d), where the seller is required or authorized to ship the goods on credit, the credit period generally runs from the time of shipment.

Unless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods. See Section 2-401(2).

In light of the terms of the Agreement, B did not have an obligation to pay the taxpayer the full price due under a Purchase Order until the products were delivered, installed, and accepted in accordance with the Agreement. Prior to such performance by the taxpayer and acceptance by B, the unbilled receivables do not constitute valid evidences of indebtedness for purposes of § 475(c)(2)(C). With respect to the taxpayer’s second argument, there is no evidence that the unbilled receivables were structured or defined to avoid being characterized as indebtedness for purposes of § 475. Under the facts of this case, the taxpayer’s unbilled receivables represent neither indebtedness nor evidence of an interest in an indebtedness, and, therefore, do not meet the definition of a security within the meaning of § 475 and the taxpayer’s argument is not persuasive.

Issue 2

The taxpayer has argued that its unbilled receivables represent evidence of an interest in indebtedness for purposes of § 475. To support its position that the unbilled receivables fall under the definition of securities for purposes of § 475(c), and, thus, were eligible to be marked to market, the taxpayer has pointed to I.R.C. § 751(c) and regulations thereunder to show that unrealized receivables represent a “right to payment” in another area of the Internal Revenue Code (“the Code”).

Section 751 constitutes an exception to capital gain treatment when consideration is received as a result of a transfer of all or part of a partner’s interest in a partnership. Specifically, § 751(a)(1) provides that any money or the fair market value of any property received by a transferor partner that is attributable to unrealized receivables of the partnership shall be considered ordinary income.

Section 751(c) provides, in part, that for purposes of subchapter K of the Code, the term unrealized receivables includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for – (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

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Treas. Reg. § 1.751-1(c)(1)(ii) provides that the term unrealized receivables, as used in subchapter K, chapter 1, means any rights (contractual or otherwise) to payment for:

Services rendered or to be rendered, to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to a payment for work or goods begun but incomplete at the time of the sale or distribution.

(Emphasis added).

Whether the right to future payments under the long term contracts in the instant case would be considered unrealized receivables for the purposes of § 751 (assuming it was distributed by a partnership to a partner), is a question of fact and not of law, dependent on whether the taxpayer had begun work on the Sets that were the subject of the Purchase Orders. Under the facts presented, the amounts the taxpayer refers to as unbilled receivables represent anticipated income on outstanding Purchase Orders on which no manufacturing has apparently begun. Therefore, these amounts would not be considered unrealized receivables under § 751(c). See Rev. Rul. 73-301, 1973-2 C.B. 215. See also, Miller v. United States, 181 Ct. Cl. 331 (1967).

Although the unbilled receivables are not unrealized receivables under § 751(c), this determination is not relevant to the issue arising under § 475. Both § 751(c) and the regulations thereunder specifically state that the definition of unrealized receivables contained therein is applicative for purposes of subchapter K only. Accordingly, the definition of unrealized receivables contained in § 751(c) is not relevant to the resolution of the issue in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

On its tax returns for the tax years ending DATE 1 through DATE 4, the taxpayer accounted for its income and expenses from these contracts by using the percentage of completion method of accounting under I.R.C. § 460. Pursuant to this method, the taxpayer accrued income proportionately with the amounts it had expended on the manufacture of Sets during each year. I.R.C. § 460. We note that

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the application of § 460 was not at issue in this case; nevertheless, it appears that the taxpayer has applied § 460 correctly.



Please call if you have any further questions.

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