

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-141303-06

Director

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Years Involved:  
Date of Conference:

LEGEND:

Taxpayer	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=

L =  
M =  
N =  
O =  
P =

Example X =

#### ISSUES:

- (1) Whether amounts paid by customers to Taxpayer to O the N are deposits that are not includible in gross income upon receipt.
- (2) To the extent that the amounts are not deposits, (a) whether the amounts are advance payments that fall within the scope of Rev. Proc. 2004-34, 2004-1 C.B. 991; and if so (b) whether the acceleration provision of section 5.02(5)(b) of the revenue procedure requires the amounts to be included in income at the time the N are O for its customers.

#### CONCLUSIONS:

- (1) Amounts paid by customers to Taxpayer to O the N are not deposits and are includible in gross income upon receipt unless appropriately deferrable under its method of accounting.
- (2) The amounts received by Taxpayer are advance payments that fall within the scope of Rev. Proc. 2004-34. However, because the acceleration provision of section 5.02(5)(b) of the revenue procedure applies under the facts of this case, Taxpayer is required to include the amounts in income at the time the N are O for its customers.

#### FACTS:

Taxpayer provides services as an A, providing services through its B. In providing these services, Taxpayer contracts with D in advance for volume pricing and guaranteed availability of F, and C the O of these F, as merchant of record, for its customers, often at significant discounts to published rates. Taxpayer's revenues are derived from the difference between amounts Taxpayer pays D and amounts customers pay Taxpayer. Under the terms of the P, Taxpayer charges the customers' credit cards when N are O. There are no restrictions on Taxpayer's use of these funds, and Taxpayer deposits them in its regular bank account.

The amounts at issue in this case are amounts which Taxpayer receives from its customers for N that are O in one taxable year (year of receipt), where the F will be used by the customers in the succeeding taxable year.

Taxpayer is not an agent of D. Rather, Taxpayer C the O of F to its customers and is the merchant of record. As such, Taxpayer has a contractual obligation to its customers to C delivery by D of, and a contractual obligation to D to pay for, the F that it O. The timing of the payment to D is determined under the terms of the contract Taxpayer has with D, and is not determined under the terms of the P.

According to the terms of Taxpayer's P, a customer may change or cancel a N after it is O, confirmed, and charged to a customer's credit card. If a customer changes or cancels a N, Taxpayer generally charges the customer an additional fee of \$I, but this fee may be waived by Taxpayer in certain circumstances. In addition to the fee of \$I, a customer who changes or cancels a N must also pay any additional fees or forfeitures charged by D, pursuant to D's policies. Customers cancelled J% of the N that were O by Taxpayer in the year K.

Taxpayer may provide one or more of the following services to its customers before or after a N is O, or during a customer's use of F: (1) Responding to customer requests for additional information concerning D; (2) modifying the N; (3) changing the dates of, or customer names on, N; (4) modifying customer billing addresses and credit card information; (5) resending confirmation acknowledgments; (6) fielding requests regarding F; (6) addressing inquiries regarding the specific types of F that can be reserved; (7) responding to customer requests concerning the guarantee provided by Taxpayer to its customers; (8) responding to requests for changes to N made necessary by D; (9) addressing concerns related to other products, such as G; (10) responding to customer complaints regarding D; (11) responding to customer requests regarding the availability of refunds; and (12) confirming allowable H.

Taxpayer maintains its books and records, and files its tax returns, using the accrual method of accounting. For financial statement and tax reporting purposes, Taxpayer records the entire amount of a prepaid O as deferred revenue until a customer cancels the N or E, at which time the entire amount of revenue is recognized. Taxpayer is required to file audited financial statements annually with the Securities and Exchange Commission on Form 10-K.

#### LAW AND ANALYSIS:

##### ISSUE 1:

Section 61(a) of the Internal Revenue Code provides, in part, that gross income means all income from whatever source derived, including (but not limited to) compensation for services rendered, gross income derived from business, and gains derived from dealings in property.

In determining what constitutes income, the Supreme Court has stated that § 61(a) brings within the definition of income any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v.*

*Glenshaw Glass Co.*, 348 U.S. 426 (1955). See also *Burke v. United States*, 504 U.S. 229, 233 (1992). The Court has also consistently held that when “a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, expressed or implied, of an obligation to repay and without restriction as to their disposition, ‘he has received income....’” *James v. United States*, 366 U.S. 213, 219 (1961), quoting *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

Taxpayer asserts that the payments it receives from customers are deposits because they must be refunded (except for the \$1 cancellation fee) if the customer cancels the N. Taxpayer cites primarily to *Commissioner v. Indianapolis Power & Light Company*, 493 U.S. 203 (1990), in support of its position.

The field asserts that at the time of payment, Taxpayer contracted to O a N, and the amount paid to Taxpayer was full payment required under the terms of P. No portion of the prepaid O collected from the customers constitutes a deposit to Taxpayer. The payments made by the customers are income received for the service of making the N.

The taxpayer in *Indianapolis Power* was a regulated utility that required customers with suspect credit to make deposits with it to assure prompt payment of future utility bills. After a period of proven reliability in the payment of the monthly utility bills, customers were entitled to a refund of the deposit in cash or by check, but the customer could choose to apply the deposit against future bills. The Supreme Court determined that the deposits were not includible in the income of the utility because the utility lacked complete dominion over the deposit and because its rights to the deposit fund were subordinated to an obligation to repay. *Indianapolis Power*, 493 U.S. at 210-212. “The key is whether the taxpayer [that received the payment] has some guarantee that he will be allowed to keep the money.” *Id.* at 210. The court looked to two factors with respect to the deposits in support of its holding: (i) Customers who paid the deposit made no commitment to purchase services and (ii) The utility’s right to retain the money was contingent upon events outside its control. *Id.* at 214.

Likewise, in *Highland Farms, Inc. v. Commissioner*, 106 T.C. 237 (1996), the Tax Court held that entry fees were deposits. Highland Farms was a retirement community that charged a partially refundable entry fee upon initial occupancy of residential apartments and lodge facilities. Residents of the apartments and lodge were also charged monthly rent. A percentage of the entry fees paid was never refundable, while the balance was refundable in the event of death or removal by the resident. The refundable portion of the entry fee gradually became nonrefundable with the passage of time. The Tax Court determined that the refundable portion of the entry fee was a nontaxable deposit during the period that it remained refundable because, at the time of receipt, the taxpayer had “no unfettered ‘dominion’ over the money at the time of receipt.” *Id.* at 252.

In *Johnson v. Commissioner*, 108 T.C. 448 (1997), *aff’d* 184 F.3d 786 (8<sup>th</sup> Cir. 1999), the Tax Court explained the application and limits of *Indianapolis Power* as follows:

*Indianapolis Power and Light* did not purport to overrule [prior authority] and establish refundability as the exclusive criterion for distinguishing taxable sales income from nontaxable deposits in all cases. *Continental Ill. Corp. v. Commissioner*, 998 F.2d 513 (7<sup>th</sup> Cir. 1993), *aff'g on this issue* T.C. Memo. 1989-636. What distinguished the nontaxable deposits in the *Indianapolis Power and Light* line of cases from taxable income was not their refundability per se; ultimately the classification of these amounts as nontaxable deposits turned on the fact that the taxpayer's right to retain them was contingent upon the customer's future decision to purchase services and have deposits applied to the bill.

*Johnson v. Commissioner* at 471.

The facts of the present case are readily distinguishable from those of *Indianapolis Power and Highland Farms*. The payment of the entry fee (in *Highland Farms*) at the time of payment was not for services or property. Similarly, the payment of the deposit in *Indianapolis Power* was not for power to be provided because the customer had no obligation to purchase the power at the time the deposit was made. In fact, the deposit in *Indianapolis Power* was never to be used to purchase power as long as the customer paid the utility bills timely, unless the customer affirmatively chose to apply the deposit to defray such expenses. By contrast, a customer's payment for a N is not a deposit at all. At the time a customer makes and pays for the N, the customer reserves the right to use a F for a specific period of time. The N equals the customer's cost of the F for the stated time. Thus, no part of the payment for the N is for a "customer's future decision to purchase services." The customer who makes the payment for the N has already purchased the service (*i.e.*, use of F for a specified time); the only decision the customer needs to make is whether to make actual use of the F for which he or she previously made a N.

We also note that the refundability of the deposit in *Indianapolis Power & Light* was a circumstance always present with the deposit unless the customer failed to make a payment or affirmatively requested the deposit be applied to future expenses. In other words, if the customer stayed current on its utility bills, the refund was virtually automatic. Refund of the N, however, requires the customer to act affirmatively by cancelling the N in a timely manner. Thus, refund of the N charge is dependent on a condition subsequent, meaning a subsequent action of the customer.

Therefore, the amounts paid by customers to Taxpayer to O the N are not deposits and are includible in gross income upon receipt unless appropriately deferrable under its method of accounting.

## ISSUE 2:

Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income is includible in gross income when all the events have

occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See *Schlude v. Commissioner*, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

Rev. Proc. 2004-34, 2004-1 C.B. 991 (the revenue procedure) allows a limited deferral of income with respect to certain amounts that otherwise would have been includible in income under § 1.451-1(a). Section 5.02(1)(a) of the revenue procedure provides that a taxpayer within the scope of the revenue procedure may use the Deferral Method for “advance payments”. Section 3 provides that a taxpayer is within the scope of the revenue procedure if the taxpayer uses or is changing to an overall accrual method of accounting and receives advance payments as defined in section 4.

Section 4.01 provides that, subject to certain exceptions not applicable here, a payment received by a taxpayer is an advance payment “if—(1) including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to this revenue procedure); (2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) for a subsequent taxable year (or, for taxpayers without an applicable financial statement as defined in section 4.06 of this revenue procedure, the payment is earned by the taxpayer (in whole or in part) in a subsequent taxable year); and (3) the payment is for—(a) services \* \* \* .”

Taxpayer and the field agree that the amounts at issue in this case are recognized by Taxpayer in revenues in its applicable financial statements, as that term is defined in section 4.06, in the taxable year following the year of receipt. Taxpayer argues that the amounts at issue fall within the definition of advance payment, while the field argues that the amounts at issue are not advance payments within the meaning of the revenue procedure.

The field argues that the amounts at issue are not advance payments within the meaning of the revenue procedure because the amounts are earned by Taxpayer in the same year that the payments are received by Taxpayer. As support for this argument, the field looks to an earlier definition of an advance payment found in Rev. Proc. 71-21, 1971-2 C.B. 549. Rev. Proc. 71-21 was modified and superseded by Rev. Proc. 2004-34. Section 3.02 of Rev. Proc. 71-21 provided the general rule that “An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services \* \* \* .” The field argues that Rev. Proc. 71-21 would have required the amounts at issue here to be

included in income upon receipt because Rev. Proc. 71-21 required inclusion no later than the year in which the income was earned.

We do not agree with the field's use of the definition of an advance payment found in Rev. Proc. 71-21, or in any source other than Rev. Proc. 2004-34. As defined in Rev. Proc. 2004-34, an amount is an advance payment if the payment is recognized by the taxpayer in revenues in its applicable financial statement for a subsequent taxable year. The time when an amount is earned is relevant to the definition of an advance payment only in situations in which a taxpayer lacks an applicable financial statement, as that term is defined in section 4.06 of the revenue procedure. Because Taxpayer and the field agree that Taxpayer recognizes the amounts at issue in revenues in its applicable financial statement for a subsequent year, the amounts at issue are advance payments and Taxpayer falls within the scope of the revenue procedure.

Section 5.02 of the revenue procedure provides that a taxpayer with an applicable financial statement generally must include advance payments in income in the taxable year of receipt to the extent recognized in revenues in its applicable financial statement for that taxable year. See sections 5.02(1)(a)(i) and 5.02(3)(a)(i) of Rev. Proc. 2004-34. Any remaining portion of the advance payment must be included in income in the next succeeding taxable year. See sections 5.02(1)(a)(ii) and 5.02(3)(a)(ii) of Rev. Proc. 2004-34. Notwithstanding this general rule, a taxpayer using the Deferral Method must include in income for the taxable year of receipt all advance payments not previously included in income "if, and to the extent that, in that taxable year, the taxpayer's obligation with respect to the advance payments is satisfied or otherwise ends other than in" certain circumstances which are not applicable in this case. See section 5.02(5)(b) of Rev. Proc. 2004-34. This provision is referred to as the "acceleration provision."

The field argues that, even if Taxpayer falls within the scope of the revenue procedure and is entitled to use the Deferral Method, the acceleration provision of section 5.02(5)(b) requires Taxpayer to include the amounts at issue in income no later than the time the N are O for its customers because Taxpayer's obligations with respect to the amounts are satisfied at that time. The field argues that the P requires only that Taxpayer O a N for a customer. At that time, any future obligations with respect to that customer are contingent and discretionary with Taxpayer. Thus, Taxpayer's obligations with respect to the amounts are satisfied at the time the N are O.

Taxpayer argues that the acceleration provision does not apply because Taxpayer continues to have obligations even after N are O. Namely, customers use Taxpayer to make changes to or cancel N, and Taxpayer continues to provide services to customers, as listed above. Furthermore, Taxpayer argues that, unlike a more traditional L, Taxpayer remains contractually obligated to provide the F, even after N are O. Taxpayer asserts that it is more like a M than a L, in the sense that Taxpayer has a primary obligation to its customers for managing its customers' N.

Taxpayer further argues that Example X of the revenue procedure is applicable to the facts in this case because (a) Taxpayer is more like a M than a L; and (b) Taxpayer, as in the example, has an applicable financial statement.

We agree with the field that the acceleration provision applies under these circumstances. The only obligation that Taxpayer has under its P is to C the O of a F. Any other services provided by Taxpayer are contingent, discretionary, and not required under the P.

We do not agree with Taxpayer that Example X is dispositive. Whether Taxpayer is more like a M or a L, and whether or not Taxpayer has an applicable financial statement, do not affect the application of the acceleration provision. Example X does not address when the relevant obligations were satisfied and it does not address the application of the acceleration provision. Furthermore, Taxpayer's obligation under its P to O the N involved only one obligation, whereas in Example X a number of separate obligations are involved which likely span a significantly longer period of time.

Because Taxpayer's contractual obligation to provide the N is satisfied at the time the payments are received, Taxpayer is required to include the amounts in income at the time the N are O for its customers.

**CAVEAT:**

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.