INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 23, 1999

Number: **200001006**
Release Date: 1/7/2000
Index (UIL) No.: 446.03-00, 446.04-02, 451.13-01, 7121.00-00
CASE MIS No.: TAM-100867-99/CC:DOM:IT&A

District Director,

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer	=
Type A	=
Type B	=
Type C	=
Type D	=
Type E	=
Month/Day	=
Date	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
y	=
z	=

ISSUES:

(1) Is Taxpayer using acceptable methods of accounting for income from market area studies?

(2) If any of Taxpayer's methods of accounting are not acceptable, does the closing agreement preclude the Service from changing those methods of accounting?

CONCLUSIONS:

(1) Taxpayer is not using an acceptable method of accounting for income from Type A, D, and E market area studies. Taxpayer is using an acceptable method of accounting for income from Type B and C market area studies.

(2) The closing agreement does not preclude the Service from changing Taxpayer's unacceptable methods of accounting.

FACTS:

Taxpayer is the common parent of an affiliated group of corporations that file federal income tax returns on the basis of a Month/Day fiscal year. Taxpayer provides decision support systems and services to clients in retail environments to assist them with their business planning requirements, such as retail site location, retail network operations, and short-term pricing. These include proprietary computer software, market area studies, and consulting services.

The Purpose of Market Area Studies

Market area studies provide supply and demand information related to a specific geographical retail market. Supply data consist of retail outlet sales volume information. Demand data include census information (e.g., population and housing density, income levels, and number of automobiles), traffic counts, and other demographic information. Except for information provided by a client, the data base information belongs to Taxpayer and the client is permitted to use it only on a nonexclusive basis.

Clients use the market area studies to assist them in determining how customers in a specific market area make their retail purchase decisions. The data from the studies are also used in evaluating alternative scenarios. The data can help clients resolve business "what if" questions through the use of computer generated models of certain geographic markets. By running various scenarios through the model, clients can predict (with a high degree of accuracy) the effect of their management decisions on retail business. The models are operated or generated by a combination of two different computer software programs, one generally available and the other one specially developed by Taxpayer.

The Specific Types of Market Area Studies

Since about Year 4, Taxpayer has been offering the following five types of market area studies:

> Type A -- These studies are used by clients who possess a large number of retail sites and who wish to analyze market conditions and evaluate site locations in metropolitan areas on a continuous basis. The supply and demand data used in this type of study are collected by Taxpayer. This type of study provides clients with a series of consecutive data base updates over a specific time period, generally five years. Clients agree to pay in periodic installments. This type of study is tailored to individual client needs, and pricing is determined in part by the number of subscribers to a particular market during the commitment period and the discounts for multi-year commitments.
>
> Type B -- These studies are similar to Type A except that the clients do not commit to a series of consecutive data base updates over a specific time period. These studies are usually scheduled by one client and offered to additional clients on a subscription basis. (Sometimes the study is initiated by Taxpayer and then offered to clients on a subscription basis.) While each study uses a single demand-side data base, the final data base provided to each client is unique.
>
> Type C -- These studies are similar to Type B except they are sold to a single client. Portions of the demographic data can generally be used as a major part of other studies in the same market for clients in the same or comparable retail industries.
>
> Type D -- These studies are similar to Type C except the area studied does not contain more than 75 outlets. Likewise, the accompanying study deliverables are scaled down.
>
> Type E -- These studies are used to evaluate market conditions or the effects of various operating decisions at a single site within a specified geographic area.

Prior to about Year 4, Taxpayer offered only three of the five types of market area studies described above. These were Type B, Type C, and Type E.

The Sale of Market Area Studies

Market area studies are ordered, and paid for, separately from the license for Taxpayer's specially developed software. Clients are not required to license the software in order to obtain a market area study from Taxpayer. Similarly, a licensee of Taxpayer's software is not required to order a market area study as a condition of the license. They can obtain the information from others or develop the data base information themselves.

Clients order a market area study by executing a letter agreement describing the type of study and geographic location. For clients who are licensees of Taxpayer's software, the rights and obligations of each party relative to the market area study are contained within the license agreement. Due to its clients' budgeting schedules, Taxpayer generally receives a concentration of orders in December through February and May through June. The process of completing a market area study is labor intensive.

With respect to Type A studies, the contract period is generally five years, and Taxpayer provides a full study every odd numbered year and a partial study every even numbered year. The letter agreement specifies the total price for the series of annual studies and provides that the client will pay an equal amount in each year for which there is an annual study. In other words, the portion of the total contract price allocated to each annual study is the same, regardless of whether Taxpayer provides a full study or just a partial study in that year. During each year of the contract, Taxpayer generally receives a payment of 70% of the annual study price before it commences work on the annual study. The remaining amount of the annual study price is usually paid upon delivery of the annual study. Taxpayer treats each annual study as a separate transaction and, as discussed below under Financial and Tax Reporting, recognizes income with respect to each annual study based on the amount of work completed on the annual study.

With respect to Type B and Type C studies, the process of completing a market area study averages three to four months, but could be as long as nine months. Taxpayer receives advance payments ranging from 35% to 70% of the total contract price.

With respect to Type D studies, the process of completing a market area study averages several months. Taxpayer does not receive substantial advance payments of the total contract price.

With respect to Type E studies, the process of completing a market area study averages about one month. Taxpayer generally receives advance payments of 70% of the total contract price. The remaining amount is usually paid upon delivery.

Financial and Tax Reporting for Revenue From Market Area Studies

Prior to about Year 4, Taxpayer offered only Type B, Type C, and Type E studies. Taxpayer's Year 1 Form 10-K (at page y) indicates that, for financial reporting purposes, Taxpayer recognized revenues and costs related to Type B and Type C studies using the cost-to-cost percentage of completion method, but charged off anticipated losses against earnings when a loss was identified. For purposes of applying this method, market studies of an area that were performed concurrently for more than one customer were grouped together and accounted for as one contract. In addition, Taxpayer's Year 1 Form 10-K also states that revenues from Type E studies, which are generally short-term in nature, were recognized using the completed contract method.

In its federal income tax returns for taxable years through the year ended Month/Day, Year 3, Taxpayer originally reported income and expenses related to the market area studies in the month completed, regardless of when cash was received (a completed contract method of accounting). This method was changed as a result of a previous examination, which included the taxable year ended Month/Day, Year 3. The examiner concluded that Taxpayer's method of accounting was in error and, therefore, proposed a change in Taxpayer's method of accounting. This change was agreed to by the parties in a closing agreement.

During or about Date, Taxpayer and the Service entered into a Form 906 (Closing Agreement on Final Determination Covering Specific Matters). The closing agreement contained seven determination paragraphs. Paragraph number one provides that Taxpayer and its subsidiaries will amend the income tax returns for the taxable years ended Month/Day, Year 2, and Month/Day, Year 3, to reflect a new method of accounting. Paragraph number two provides that the change in method of accounting is treated as a change from a Category B method[1] initiated in the tax period ended Month/Day, Year 1. Paragraph number three provides that Taxpayer and its subsidiaries will change the method of accounting for reporting income from "market-area surveys" to the accrual basis of accounting, recognizing revenue when services are performed and expenses when incurred. Paragraph number four provides that the amount of revenue recognized from "market-area surveys" under the method of accounting that Taxpayer uses for financial purposes, the percentage of completion method, approximates most clearly the amount of revenues that would be recognized as services are performed. Paragraphs five through seven address the § 481(a) adjustment, the increase in income attributable to that adjustment, and the amount of the net operating loss deduction.

Taxpayer's Year 5 Annual Report (at page z) indicates that, for financial reporting purposes, Taxpayer recognized revenues and costs related to Type A through Type C studies using the cost-to-cost percentage of completion method, but charged off

---

[1]Apparently, this reference is to section 6.03 of Rev. Proc. 84-74, 1984-2 C.B. 736, 748, which was superseded later. <u>See generally</u> Rev. Proc. 97-27, 1997-1 C.B. 680, <u>modified by</u> Rev. Proc. 97-30, 1997-1 C.B. 702; Notice 98-31, 1998-22 I.R.B. 10.

anticipated losses against earnings when a loss was identified.[2] In addition, Taxpayer's Year 5 Annual Report also states that revenues and costs related to Type E studies, Type D studies, and other projects that are completed in a short time period were recognized at completion.

Taxpayer states that it has filed all subsequent year returns, including those that are involved in this technical advice memorandum, in accordance with the accounting method prescribed in the closing agreement. With respect to Type B and Type C studies, Taxpayer uses the accrual method of accounting, and determines the amount of income that is accruable by using the percentage of completion method, which is the method Taxpayer uses for financial purposes. Taxpayer defers cash advances to the extent they exceed income under this method. With respect to Type E studies, Taxpayer continues to use the completed contract method for both financial and federal income tax purposes. With respect to Type D studies, which Taxpayer began offering around Year 4, Taxpayer uses the completed contract method for both financial and federal income tax purposes. With respect to Type A studies, which Taxpayer also began offering around Year 4, Taxpayer accounts for each annual study in the same manner as Type B and Type C studies.

LAW AND ANALYSIS:

This request for technical advice raises two issues. The first issue is whether or not Taxpayer is using acceptable methods of accounting for income from performing its various market area studies. The second issue is whether the closing agreement precludes the Service from changing Taxpayer's unacceptable methods of accounting, if any. As explained below, Taxpayer's methods of accounting for income from Type A, D, and E market area studies are not acceptable methods of accounting, and the closing agreement does not preclude the Service from changing Taxpayer's methods of accounting for these market area studies.

Issue #1: Taxpayer's Methods of Accounting

The first issue is whether or not Taxpayer is using acceptable methods of accounting. Taxpayer asserts that its method of accounting for income from each type of market area study is an acceptable method of accounting because it clearly reflects income and it complies with the requirements of Rev. Proc. 71-21, 1971-2 C.B. 549, as well as relevant case law for the deferral of income. In contrast, the field asserts that Taxpayer's methods of accounting do not clearly reflect income because they do not meet the requirements of § 460 or Rev. Proc. 71-21, and in some situations they improperly delay the time at which Taxpayer takes income from the provision of market area studies into account. For the reasons described below, Taxpayer's method of

---

[2]Taxpayer does not charge off such losses for federal income tax purposes.

accounting for income from Type B and C market area studies satisfies the requirements of Rev. Proc. 71-21 and, therefore, is an acceptable method of accounting. However, Taxpayer's methods of accounting for income from Type A, D, and E market area studies satisfy neither § 460 nor Rev. Proc. 71-21 and are not acceptable methods of accounting. The following analysis first examines the general rules for determining whether a method of accounting clearly reflects income and then applies those rules to Taxpayer.

I. General Rules

Section 446(a) provides the general rule that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. See also § 1.446-1(a)(1).

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also §§ 1.446-1(a)(2) and 1.446-1(c)(1)(ii)(C).

Section 451(a) provides the general rule that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) provides, in part, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. 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 occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128 (1963); Commissioner v. Hansen, 360 U.S. 446 (1959); Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 83-106, 1983-2 C.B. 77; Rev. Rul. 81-176, 1981-2 C.B. 112; Rev. Rul. 79-195, 1979-1 C.B. 177.

Section 1.446-1(a)(2) provides in part that a method of accounting that reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.

Section 1.446-1(c)(1)(ii)(C) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

Section 1.446-1(c)(2)(ii) provides, in part, that the Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.

The Commissioner is vested with broad discretion in determining whether a particular method of accounting employed by a taxpayer clearly reflects the taxpayer's income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979). The Commissioner's determination that a taxpayer's method of accounting does not clearly reflect income is entitled to more than the usual presumption of correctness. RLC Industries Co. v. Commissioner, 98 T.C. 457, 491 (1992). The taxpayer bears a "heavy burden of [proof]" to show that the Commissioner abused his discretion. Thor Power Tool Co., 439 U.S. at 532-533. Thus in order to prevail, a taxpayer must establish that the Commissioner's determination is "clearly unlawful" or "plainly arbitrary." Thor Power Tool Co., 439 U.S. at 532-533.

Although the Commissioner does enjoy broad discretion under § 446, he cannot require a taxpayer to change from an accounting method that clearly reflects income to an alternate method that more clearly reflects income. Molsen v. Commissioner, 85 T.C. 485, 498 (1985); Peninsula Steel Products & Equip. v. Commissioner, 78 T.C. 1029, 1045 (1982). Whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis. Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 371 (1995). In general, however, a method of accounting clearly reflects income when it results in accurately reported taxable income under a recognized method of accounting. RLC Industries Co., 98 T.C. at 490.

Many cases have held that a taxpayer's method of accounting clearly reflected the taxpayer's income where the taxpayer utilized a method of accounting provided in the Code, the regulations, a revenue ruling, or a revenue procedure. See, e.g., United States v. Hughes Properties, 476 U.S. 593 (1986); Frysinger v. Commissioner, 645 F.2d 523 (5th Cir. 1981); Barnett Banks of Florida, Inc. v. Commissioner, 106 T.C. 103 (1996); RLC Industries Co., 98 T.C. 457; Packard v. Commissioner, 85 T.C. 397 (1985); Van Raden v. Commissioner, 71 T.C. 1083 (1979), aff'd, 650 F.2d 1046 (9th Cir. 1981); Galedrige Construction, Inc. v. Commissioner, T.C. Memo. 1997-240; Hospital

Corp. of America v. Commissioner, T.C. Memo. 1996-105. In all of the above cited cases, the courts have noted that (1) the taxpayer did not manipulate the method of accounting, (2) the taxpayer did not have a tax avoidance purpose in utilizing the method of accounting, or (3) the taxpayer's method did not result in a purposeful or material distortion of income. Although a taxpayer's method of accounting may be in compliance with the Code or regulations it is still subject to the clear reflection of income standard. See, e.g., Hughes Properties, 476 U.S. 593; Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995).[3]

Beyond compliance with the Code and regulations, courts have identified other factors in determining whether a method of accounting clearly reflects income, including the following: (1) Whether the taxpayer consistently used its method of accounting. See, e.g., Ansley-Sheppard-Burgess Co., 104 T.C. at 375; Molsen, 85 T.C. at 506; (2) Whether taxpayer's method of accounting conforms to the industry practice. See, e.g., Molsen, 85 T.C. at 506; and (3) Whether the taxpayer made an attempt to unreasonably prepay expenses or defer the recognition of income (i.e., whether the taxpayer made an attempt to manipulate the method of accounting). See, e.g., Ansley-Sheppard-Burgess Co., 104 T.C. at 375.

Another element that courts may consider in determining whether a taxpayer's method of accounting clearly reflects income is whether such accounting method creates a mismatch of income and expense, such as in the case where a taxpayer may prepay expenses or defer the recognition of income. Many cases have held that the

---

[3]There may be instances, however, where a taxpayer's use of an acceptable method of accounting may not clearly reflect income because there exists a gross distortion between the economic results and the tax results. One such case is Ford Motor Co.. In Ford Motor Co., the taxpayer, an accrual basis taxpayer, settled numerous tort claims by entering into settlement agreements with the tort claimants. Under the terms of the settlement agreement, the taxpayer was to make annuity payments to the each of the tort claimants over differing periods, the longest of which was 58 years. In order to fund these payments, Ford purchased single premium annuity contracts during 1980. Ford claimed a deduction for its 1980 taxable year for the entire amount of all future payments it was required to make to all tort claimants in full accord and satisfaction of the settlement agreements. For financial accounting purposes, Ford expensed only the actual cost of the annuity contracts.

The Sixth Circuit held that Ford's method of accounting for tax purposes did not clearly reflect income because the economic results of the transactions were grossly different from the tax results, even though the court found that Ford's deductions were in compliance with the regulations promulgated under § 461. The court found that allowing Ford a full deduction could result in the tax benefit derived from the deduction funding the full amounts due in future periods, leaving Ford with a profit.

Commissioner's concern about matching income and expense is insufficient by itself to support a finding that the taxpayer's method fails to clearly reflect income. See, e.g., RLC Industries Co., 98 T.C. 457. Furthermore, some courts have held that a taxpayer's method of accounting, which deferred unearned income to a subsequent tax year beyond the year of receipt, clearly reflected income partly because there was a matching of income with related expenses. See Artnell Company v. Commissioner, 400 F.2d 981 (1968); Boise Cascade Corp. v. United States, 530 F.2d 1367, 1377 (Ct. Cl. 1976), cert. denied, 429 U.S. 867 (1976), AOD CC-1986-014 (Feb. 19, 1986); Collegiate Cap and Gown Co. v. Commissioner, T.C. Memo. 1978-226. However, should there be a material or gross distortion of income and related expenses it is more likely that the taxpayer's method of accounting will fail to clearly reflect income. See, e.g., Gold-Pak Meat Co. v. Commissioner, 522 F.2d 1055 (9th Cir. 1975).

On the other hand, if a taxpayer's method of accounting is inconsistent with the Code or regulations, it is more likely that the Commissioner's determination that a method of accounting fails to clearly reflect income can be sustained. Thor Power Tool Co., 439 U.S. at 533. See also Sam Goldberger, Inc. v. Commissioner, 88 T.C. 1532 (1987). In Thor Power Tool, the taxpayer wrote down certain excess inventory, in accordance with GAAP, to its net realizable value. However, the taxpayer continued to offer the inventory for sale at full price, despite writing it down. The Court, applying the appropriate regulations to the facts, held that the Commissioner properly disallowed the taxpayer's write-down of excess inventory as not clearly reflecting income because the taxpayer's method of accounting "was plainly inconsistent with the Regulations." Thor Power Tool Co., 439 U.S. at 538.

II. Application to Taxpayer's Methods of Accounting

As noted above, the field asserts that Taxpayer's methods of accounting for income do not clearly reflect income because they do not meet the requirements of § 460 or Rev. Proc. 71-21, and in some situations they improperly delay the time at which Taxpayer takes income from the provision of market area studies into account.[4]

---

[4]The field has observed that the closing agreement does not expressly mention that advance payments may be deferred under Rev. Proc. 71-21. However, that fact is not dispositive because the ultimate issue is whether the method specifically authorized by the closing agreement, without regard to how that method is labeled, satisfies the requirements of Rev. Proc. 71-21. In this regard, it is important to note that the closing agreement (1) required Taxpayer to account for income from "market-area surveys" on the accrual basis of accounting, recognizing revenue when services are performed, and (2) provided that the amount of revenue recognized from "market-area surveys" under the method of accounting that Taxpayer uses for financial purposes, the percentage of completion method, approximates most clearly the amount of revenues that would be recognized as services are performed. Taxpayer changed its methods of accounting in

In contrast, Taxpayer claims that its method of accounting for income from each type of market area study is an acceptable method of accounting because it clearly reflects income and it complies with the requirements of Rev. Proc. 71-21 as well as relevant case law for the deferral of income. For the reasons set forth below, the long-term contract rules do not apply to Taxpayer’s methods of accounting. Accordingly, Taxpayer’s methods of accounting are not authorized or prohibited by the rules applicable to long-term contracts. Taxpayer’s deferral of advance payments from Type B and C market area studies satisfies the requirements of Rev. Proc. 71-21 and, therefore, is an acceptable method of accounting. Further, Taxpayer's methods of accounting for income from Type A, D, and E market area studies do not comply with the requirements of Rev. Proc. 71-21, are not proper under case law, and are not acceptable methods of accounting under the facts of this technical advice.

A. Long-term Contracts

Section 1.451-3(a)(1) provides generally that the income from a long-term contract may be included in gross income in accordance with one of the two long-term contract methods, namely, the percentage of completion method (as described in paragraph (c) of this section) or the completed contract method (as described in paragraph (d) of this section), or any other method. Whichever method is chosen must, in the opinion of the Commissioner, clearly reflect income.

Section 1.451-3(b)(1)(i) provides generally that the term "long-term contract" means a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into.

Section 1.451-3(c) provides generally that under the percentage of completion method, the portion of the gross contract price that corresponds to the percentage of the entire contract that has been completed during the taxable year must be included in gross income for that taxable year.

Section 1.451-3(d)(1) provides generally that under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which that contract is completed.

Section 460(a) provides that in the case of any long-term contract, the taxable income from such contract shall be determined under the percentage-of-completion method (as modified by subsection (b)).

---

accordance with the closing agreement and has consistently used the new methods since the change.

Section 460(b)(1) provides generally that in the case of any long-term contract with respect to which the percentage of completion method is used, the percentage of completion shall be determined by comparing costs allocated to the contract under subsection (c) and incurred before the close of the taxable year with the estimated total contract costs, and upon completion of the contract (or, with respect to any amount properly taken into account after completion of the contract, when such amount is so properly taken into account), the taxpayer shall pay (or shall be entitled to receive) interest computed under the look-back method of paragraph (2).

Section 460(f)(1) provides that the term "long-term contract" means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.

Section 460(e)(4) provides that for purposes of this subsection, the term "construction contract" means any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property.

Rev. Rul. 70-67, 1970-1 C.B. 117, holds that an architect, who does not build or construct anything but simply draws the plans and supervises the work of construction, is not entitled to report income from the contracts as a long-term contract. The ruling reasons that drawing plans and supervising construction in accordance with the plans is not building, installation, or construction as the terms are used for long-term contracts. The ruling does not discuss the possibility that the taxpayer is manufacturing plans, but concludes that the taxpayer's activities are in the nature of personal services.

Rev. Rul. 80-18, 1980-1 C.B. 103, and Rev. Rul. 82-134, 1982-2 C.B. 88, provide that a taxpayer engaged in the business of providing engineering and related services was not performing long-term contract activities even though they were functionally related to activities that may be long-term contract activities. In both rulings, the taxpayer was not required to actually build, install, or construct anything.

By definition, a long-term contract must be a building, installation, construction or manufacturing obligation. Taxpayer's market area studies contracts do not contain any such obligation. Like the rulings concerning architectural and engineering services, the market area studies contracts are service contracts. Recording the results of these services on paper or magnetic media is not a manufacturing, building, installation, or construction activity for purposes of classifying a contract as a long-term contract, just as providing architectural drawings is not a long-term contract activity. Consequently, the market area studies contracts are not long-term contracts. Accordingly, Taxpayer's methods of accounting are not authorized or prohibited by the rules applicable to long-term contracts.

B. Rev. Proc. 71-21

Rev. Proc. 71-21, 1971-2 C.B. 549, implements an administrative decision by the Commissioner under § 446 to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Section 3.02 provides that an accrual method taxpayer who, pursuant to an agreement, 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, subject to the limitations provided in sections 3.07, 3.08, and 3.11. Section 3.11 provides that the amount of any advance payment includible as gross receipts in gross income in the taxable year of receipt by a taxpayer shall be no less than the amount of such payment included as gross receipts in gross income for purposes of his books and records and all reports (including consolidated financial statements) to shareholders, partners, other proprietors or beneficiaries and for credit purposes.

Section 3.03 of Rev. Proc. 71-21 provides that, with certain limited exceptions not relevant here, a payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year: (a) any portion of the services is to be performed by him after the end of the taxable year immediately succeeding the year of receipt or (b) any portion of the services is to be performed by him at an unspecified future date that may be after the end of the taxable year immediately succeeding the year of receipt.

Section 3.09 of Rev. Proc. 71-21 provides that the term “agreement” includes other agreements between the taxpayer and the person for whose benefit the performance under the first agreement is to be rendered if such other agreements provide for rendition of substantially similar performance over a period of time that is substantially consecutive to that of the first agreement.

Section 3.14 of Rev. Proc. 71-21 provides in part that the deferral of the inclusion in gross income of amounts in accordance with the revenue procedure will be treated as an acceptable method of accounting under § 446 as long as the method is consistently used by the taxpayer.

In Rev. Rul. 72-207, 1972-1 C.B. 126, the taxpayer reported its income on the basis of the calendar year and used an accrual method of accounting. On March 31, 1969, the taxpayer contracted with the Department of Labor to hire and train underemployed, low-income persons. The taxpayer received an installment of 50x at that time. The contract provided, in part, that over a two-year period beginning on

July 1, 1969, the taxpayer must hire a specified number of low-income persons for full-time employment for a minimum period. As part of its obligations, the taxpayer was required to implement a structured training program, which required the construction of a training facility. The government agreed to pay the taxpayer 500x dollars in installments according to a specified payment schedule in the contract. The revenue ruling states that, because the performance of services will continue after 1970, the amount received in 1969 is not subject to deferral under Rev. Proc. 71-21.

1. Type A Studies

With respect to Type A studies, the contract period is generally five years, and Taxpayer provides a full study every odd numbered year and a partial study every even numbered year. Accordingly, all of the services under the agreement for a Type A study, as it exists at the end of the year of the receipt of the advance payment, will not be performed before the end of the year following the year of receipt of the advance payment. Consequently, we conclude that Type A studies do not meet the criteria for deferral of advance payments for services under Rev. Proc. 71-21.

2. Type B Studies

With respect to Type B studies, the process of completing a market area study averages three to four months, but could be as long as nine months. Taxpayer receives advance payments for these studies. For financial and tax accounting purposes, Taxpayer determines the amount of income that is accruable for the current tax year for Type B studies by using a percentage of completion calculation. In this case, Taxpayer's calculation has the effect of requiring Taxpayer to include its advance payments in gross income as services are performed, which is consistent with the closing agreement and is not disputed by the field. This complies with the requirements of § 3.02 of Rev. Proc. 71-21.[5] Accordingly, Taxpayer's method of accounting for Type B studies is an acceptable method of accounting under § 446. See § 3.14 of Rev. Proc. 71-21.

3. Type C Studies

With respect to Type C studies, the process of completing a market area study averages three to four months, but could be as long as nine months. Taxpayer receives advance payments for these studies. For financial and tax accounting purposes, Taxpayer determines the amount of income that is accruable for the current tax year for Type C studies by using a percentage of completion calculation. In this

---

[5] The other requirements of Rev. Proc. 71-21 are not discussed as they have not been raised as an issue in this request for technical advice with respect to any of the market area studies.

case, Taxpayer's calculation has the effect of requiring Taxpayer to include its advance payments in gross income as services are performed, which is consistent with the closing agreement and is not disputed by the field. This complies with the requirements of § 3.02 of Rev. Proc. 71-21. Accordingly, Taxpayer's method of accounting for Type C studies is an acceptable method of accounting under § 446. See § 3.14 of Rev. Proc. 71-21.

4. Type D Studies

The process of completing a Type D market area study averages several months. Although Taxpayer does not receive substantial advance payments of the total contract price, advance payments are received. Under its method of accounting for Type D studies, Taxpayer includes the gross contract price in income and total costs incurred in expenses for the taxable year in which the contract is completed. As a result, where a Type D study spans two tax years, Taxpayer performs services in the first tax year without including any advance payments actually received in income in that tax year. Accordingly, Taxpayer's method of accounting for Type D studies does not comply with § 3.02 of Rev. Proc. 71-21, which requires that advance payments be included in gross income as earned through the provision of services.

5. Type E Studies

The process of completing a Type E market area study averages about one month. Taxpayer generally receives substantial advance payments for these studies. Under Taxpayer's method of accounting for Type E studies it includes the gross contract price in income and total costs incurred in expenses for the taxable year in which the contract is completed. As a result, where a Type E study spans two tax years, Taxpayer performs services in the first tax year without including any of the advance payments in income in that tax year. Accordingly, Taxpayer's method of accounting for Type E studies does not comply with § 3.02 of Rev. Proc. 71-21, which requires that advance payments be included in gross income as earned through the provision of services.

C. Case Law

Taxpayer asserts that its methods of accounting for income from Type A studies, Type D studies, and Type E studies are acceptable methods of accounting even though the requirements of Rev. Proc. 71-21 are not satisfied. Taxpayer's position is that its methods are proper under case law supporting deferral of service income, including Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968), and Boise Cascade Corp. v. United States, 530 F.2d 1367, 1377 (Ct. Cl. 1976), cert. denied, 429 U.S. 867 (1976), AOD CC-1986-014 (Feb. 19, 1986). For the reasons described below, Taxpayer's position is not persuasive.

In a trilogy of cases, the Supreme Court considered the proper income tax treatment of prepaid income received for services by an accrual method taxpayer. See Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Automobile Association v. United States, 367 U.S. 687 (1961); and Schlude v. Commissioner, 372 U.S. 128 (1963). In these cases, the Supreme Court held that the Commissioner did not abuse his discretion by rejecting any deferral of income by the taxpayer and requiring that the entire prepaid income be included in income when received. As interpreted by the Service, these cases (along with Commissioner v. Hansen, 360 U.S. 446 (1959)) establish that all the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. See Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 83-106, 1983-2 C.B. 77; Rev. Rul. 81-176, 1981-2 C.B. 112; Rev. Rul. 79-292, 1979-2 C.B. 287, clarified by Rev. Rul. 89-122, 1989-2 C.B. 200; Rev. Rul. 79-195, 1979-1 C.B. 177. Taxpayer's methods of accounting for income from Type A studies, Type D studies, and Type E studies do not satisfy this standard and, therefore, are not acceptable methods of accounting. The Artnell and Boise Cascade cases are distinguishable and do not change this analysis.

Issue #2: Closing Agreement

The general rules applicable to closing agreements.

Section 7121(a) provides that the Secretary is authorized to enter into a written agreement with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period. Section 7121(b) provides that when such an agreement is approved by the Secretary it is final and conclusive. Except upon a showing of fraud or malfeasance, or misrepresentation of a material fact, a case shall not be reopened as to the matters agreed upon. Further, the agreement shall not be annulled, modified, set aside, or disregarded in a suit, action, or proceeding.

Section 301.7121-1(a) of the Regulations on Procedure and Administration provides, in part, that the Commissioner may enter into a written agreement with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period ending prior or subsequent to the date of such agreement.

Section 301.7121-1(b)(2) provides, in part, that closing agreements with respect to taxable periods ended prior to the date of the agreement may relate to the total tax liability of the taxpayer or to one or more separate items affecting the tax liability of the taxpayer. Section 301.7121-1(b)(3) provides that closing agreements with respect to taxable periods ending subsequent to the date of the agreement may relate to one or more separate items affecting the tax liability of the taxpayer. See also § 601.202(a)(2).

Section 301.7121-1(b)(4) provides the following example to illustrate the provisions of § 301.7121-1(b):

> A owns 500 shares in the XYZ Corporation which he purchased prior to March 1, 1913. A is considering selling 200 shares of such stock but is uncertain as to the basis of the stock for the purpose of computing gain. Either prior or subsequent to the sale, a closing agreement may be entered into determining the market value of such stock as of March 1, 1913, which represents the basis for determining gain if it exceeds the adjusted basis otherwise determined as of such date. Not only may the closing agreement determine the basis for computing gain on the sale of the 200 shares of stock, but such an agreement may also determine the basis (unless or until the law is changed to require the use of some other factor to determine basis) of the remaining 300 shares of stock upon which gain will be computed in a subsequent sale.

Section 301.7121-1(c) provides, in part, that a closing agreement with respect to a taxable period ending subsequent to the date of the agreement is subject to any change in, or modification of, the law enacted subsequent to the date of the agreement and made applicable to such taxable period, and each closing agreement shall so recite.

The rules applicable to interpretation of the closing agreement.

In general, court opinions hold that the ordinary principles of contract law govern the interpretation of closing agreements.[6] If the essential terms of an agreement are deemed unambiguous, a court will not look beyond the four corners of the document to determine the parties' intent. Rink v. Commissioner, 100 T.C. 319 (1993), aff'd, 47 F.3d 168 (6th Cir. 1995). See also Lamson v. Commissioner, T.C. Memo. 1994-383.

A Form 906 closing agreement is a final and conclusive agreement that is binding only as to matters agreed upon for the taxable period stated in the agreement. Qureshi v. Commissioner, T.C. Memo. 1996-169 (citing Estate of Magarian v. Commissioner, 97 T.C. 1 (1991) and Zaentz v. Commissioner, 90 T.C. 753 (1988)). Although the premises in a closing agreement are helpful for interpreting the agreement, § 7121 does not bind

---

[6] It is the position of the Service that a closing agreement is an agreement entered into pursuant to statute, rather than a contract. Because a closing agreement is not a contract, its enforceability does not depend on mutual consideration. Perry v. Page, 67 F.2d 635 (1st Cir. 1933), cited with approval in Rink v. Commissioner, 100 T.C. 319, 325 n.4 (1993). See also IRM 8(13)10, text 712 and 121:(1). Although a closing agreement is not a contract, certain principles of contract law may be relevant in dealing with closing agreements, e.g., principles related to offer and acceptance. See Rev. Rul. 73-514, 1973-2 C.B. 416.

the parties as to those premises; rather, the parties are bound only as to the specific matters agreed upon. Estate of Magarian and Zaentz.

In Qureshi, the closing agreement was ambiguous as to the taxable years covered. Portions of the closing agreement supported the position of the Service that the closing agreement governed the tax treatment of the taxpayer's investment in a tax shelter for all taxable years. However, other portions of the agreement supported the taxpayer's position that the closing agreement applied only to specific taxable years referred to in the agreement. The Tax Court resolved this issue in the taxpayer's favor. The rationale was, first, that the ambiguity in the closing agreement should be resolved against the drafter (the Service) and, second, that each year is a separate matter. With regard to the latter rationale, the court stated:

> If the parties had intended 1984 to be included in their closing agreement, they could have done so. But they did not. Accordingly, we hold that the closing agreement per se does not preclude petitioners from entitlement to the claimed depreciation deduction, investment tax credit, and loss for 1984.

We believe the closing agreement covers only Type B and Type C studies.

Paragraph number three of the closing agreement provides that Taxpayer and its subsidiaries will change the method of accounting for reporting income from "market-area surveys" to the accrual basis of accounting, recognizing revenue when services are performed and expenses when incurred. The term "market-area surveys" is ambiguous. However, we believe the intent can be determined from paragraph number four.

Paragraph number four provides that the amount of revenue recognized from "market-area surveys" under the method of accounting that Taxpayer uses for financial purposes, the percentage of completion method, approximates most clearly the amount of revenues that would be recognized as services are performed. At the time Taxpayer and the Service entered into the closing agreement, Taxpayer offered only three of the five types of market area studies described above. These were Type B, Type C, and Type E. Also at the time Taxpayer and the Service entered into the closing agreement, for financial reporting purposes, Taxpayer recognized revenues and costs related to Type B and Type C studies using the cost-to-cost percentage of completion method. However, revenues from Type E studies were recognized using the completed contract method. Since the closing agreement was executed, Taxpayer has continued to use the completed contract method for both financial and federal income tax purposes for Type E studies. Accordingly, we conclude that the closing agreement covers only Type B and Type C studies, which are the only studies that used the percentage of completion method for financial reporting purposes at the time the closing agreement was executed.

<u>We believe the closing agreement does not make determinations for future years.</u>

Similar to the case of <u>Qureshi</u>, there is an issue regarding what years are covered by the closing agreement. To resolve this issue, the various paragraphs in the closing agreement should be read in connection with each other, rather than in isolation. Thus, paragraph number one provides that Taxpayer will amend the income tax returns for the taxable years ended Month/Day, Year 2, and Month/Day, Year 3, to reflect a new method of accounting. However, paragraph number one does not describe the new method of accounting. Thus, paragraph number one cannot be read in isolation from the other paragraphs. More specifically, paragraph number one must be read in connection with paragraph number three, which provides that Taxpayer will change the method of accounting for reporting income from market-area surveys to the accrual basis of accounting, recognizing revenue when services are performed and expenses when incurred. Further, the meaning of paragraph number three is clarified by paragraph number four, which provides that the amount of revenue recognized from market-area surveys under the method of accounting that Taxpayer uses for financial purposes, the percentage of completion method, approximates most clearly the amount of revenues that would be recognized as services are performed.

By reading paragraph number one in connection with paragraph number three, we conclude that the closing agreement's requirement of a change in method of accounting for reporting income from market-area surveys is applicable only to the taxable years ended Month/Day, Year 2, and Month/Day, Year 3. These are the years specifically at issue in the closing agreement. As was pointed out in <u>Qureshi</u>, each year is a separate matter and if the parties had intended that the change in method of accounting would be applicable to all years, the parties could have easily provided for this result.

<u>If the closing agreement purports to make a determination for future years, it is not binding.</u>

Delegation Order No. 97 (Rev. 27) (effective October 31, 1987) provides that the authority to enter into and approve closing agreements is delegated by the Commissioner to various officials. In particular, paragraph 4 provides that:

> The Assistant Commissioner (International); Regional Commissioners; Regional Counsel; Assistant Regional Commissioners (Examination); Service Center Directors; District Directors; Chiefs and Associate Chiefs of Appeals Offices; and Appeals Team Chiefs with respect to his/her team cases, are hereby authorized in cases under their jurisdiction (but excluding cases docketed before the United States Tax Court) to enter into and approve a <u>written agreement with any person relating to the Internal Revenue tax liability of such person (or of the person or estate for whom he/she acts) for a taxable period or periods ended prior to the date of</u>

> agreement and related specific items affecting other taxable periods. [Emphasis added.]

The delegation order does not define "related specific items affecting other taxable periods." However, the Closing Agreement Handbook, IRM 8(13)10, provides a description of the limits of the authority delegated under paragraph 4. The text of 131.4:(4), which was last revised on January 4, 1988, provides in part as follows:

> There are two general limitations on the closing agreement authority of Regional Commissioners and other field officials stated in paragraph 4 of the Delegation Order. The first is that the agreements must be with respect to cases under their jurisdiction. The second is that such agreements must pertain to taxable periods ended before the dates of such agreements or to specific items related to such periods and affecting other taxable periods. These officials are not authorized to sign closing agreements pertaining to prospective transactions. Such agreements are handled by the National Office.

Emphasis added. See also section 5.03 of Rev. Proc. 68-16, 1968-1 C.B. 770, 774-775; IRM 8(13)10, text 121:(5). Cf. Rev. Proc. 94-67, 1994-2 C.B. 800 (Accelerated Issue Resolution closing agreements subject to the same limitations).

A complete analysis of the limits of the authority delegated to field officials under paragraph 4 of Delegation Order No. 97 is beyond the scope of this technical advice memorandum. Nevertheless, the authority delegated under paragraph 4 would not extend to determinations pertaining to transactions that have not yet occurred in a taxable period ended prior to the date of the agreement. The following two examples illustrate this limit by showing determinations that are within the delegated authority.

The first example illustrates a matter that relates to the tax liability for a taxable period ended prior to the date of the agreement.

> ABC Corporation purchased an asset and placed it into service during its 1987 taxable year. That return was examined during 1988.

During the examination, the field and ABC Corporation could enter into a closing agreement that determines the basis of the asset as well as the depreciation method and period. Such a determination affects the calculation of depreciation deductions in future years. It is important to recognize that this type of determination made with respect to a taxable period ended prior to the date of agreement both (1) relates to the tax liability for that period and (2) affects future taxable periods. However, because the determination relates to the tax liability for a period ended prior to the date of the agreement, there is no need to resolve whether it is also a "related specific item affecting other taxable periods."

The second example illustrates a matter that is solely a related specific item that affects other taxable periods. The facts are a variation of the example in § 301.7121-1(b)(4).

> A purchased 500 shares of stock of the XYZ Corporation (a closely held company) during the 1986 taxable year. A sold 200 shares of such stock during the 1987 taxable year, which was later examined during 1988.

During the examination, the field and A could enter into a closing agreement that determines the basis of the 200 shares of stock and the resulting gain to be recognized during 1987. Additionally, the closing agreement may also determine the basis of the remaining 300 shares of stock as of a date in a taxable period ended prior to the date of the closing agreement for purposes of computing gain or loss in a subsequent sale. With respect to the 300 shares, it is important to note that the determination does not relate to the tax liability for a taxable period ended prior to the date of agreement, but instead the determination concerns a related specific item affecting other taxable periods. It is also important to note that the 300 shares of stock were already acquired by the taxpayer. As in the first example, the transaction which is the subject of the closing agreement occurred in a taxable period ended prior to the date of the closing agreement.

In this technical advice, the years involved in the current examination are the taxable years Year 4, Year 5, and Year 6. Also, the closing agreement was executed during or about Date. Consequently, all of the contracts for market area studies that were executed before that time were completed long before the start of the taxable years involved in the current examination because such market area studies took no longer than nine months to complete. Accordingly, we believe the field did not have the authority under paragraph number four of the delegation order to make a determination with respect to the method of accounting to be used for contracts for market area studies for the taxable years involved in the current examination.[7] Such a determination is beyond the authority delegated to field officials under paragraph four because that determination pertains to prospective transactions, i.e., market area studies to be entered into after the execution of the closing agreement. If a closing agreement is approved by employees of the Service lacking authority to do so under the delegation order, a question necessarily arises as to whether the closing agreement is binding on the parties. At least two cases hold that such a closing agreement is not binding.

In Webb v. Commissioner, T.C. Memo. 1994-549, the closing agreement was signed by a revenue agent and a section chief on behalf of the Commissioner. The closing agreement related to a taxable year at issue in a docketed Tax Court case.

---

[7]Of course, the provisions of § 446(e) apply with respect to the valid determinations made in a closing agreement.

Because the case was docketed before the Tax Court at the time the agreement was signed, the employees of the Service lacked authority under Delegation Order No. 97 to bind the Service. The Court specifically rejected the argument that the Service employees had “apparent authority” to enter into the closing agreement. Even if the taxpayer assumed that the revenue agent and section chief had apparent authority to enter into the closing agreement, such apparent authority does not translate into actual authority and cannot bind the Service. A similar result was reached in Stiskin v. Commissioner, T.C. Memo. 1996-306, in which the closing agreement was signed by an Associate Chief of Appeals and related to a case docketed before the Tax Court. Again, the court held that the Service was not bound by the unauthorized acts of its agents and was not estopped to assert their lack of authority as a defense.

Based on the reasoning of those cases, we conclude that the closing agreement does not bind the Service with respect to the years currently under examination if the agreement purports to make determinations for those years.

CAVEAT(S):

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