

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:LM:FSH:BRK:TL-N-1969-01
TKerrigan

date:

to: Territory Manager (Communication, Technology & Media)
Attention: Group 1348-LMSB

from: Associate Area Counsel
CC:LM:FSH:BRK

subject: [REDACTED] - Deferred Income
Taxable year 1997
U.I.L. No. 0451.13-04

This memorandum responds to a March 26, 2001 request for assistance from Patricia Pignitore of your staff concerning the application of the income deferral provisions for advance payments set forth in Treas. Reg. § 1.451-5 to the facts set forth below. This memorandum should not be cited as precedent.

FACTS

The relevant facts, as we understand them, are as follows:
[REDACTED] (" [REDACTED] ") is a U.S. company located in [REDACTED] New York. The corporation is a wholly-owned subsidiary of a German corporation that manufactures a [REDACTED] equipment. This equipment includes [REDACTED].
[REDACTED]. The taxpayer is responsible for the sales and service of equipment in the United States.

Under the terms of [REDACTED]'s standard sales contract, purchasers are required to make a payment (up to [REDACTED]% of the purchase price) upon the execution of the contract. The standard agreement refers to these payments as deposits. Paragraph 3 of the contract states, in relevant part, that "[i]f the delivery date is postponed more than three months, Purchasers will have, as its full remedy the right to cancel the order with a full refund on any deposits advanced."

[REDACTED] uses the accrual method of accounting for financial and tax purposes. The taxpayer did not recognize payments received

at the time of contract execution as income until the product was shipped to the purchaser. For the taxable year [REDACTED], [REDACTED] reported gross receipts of approximately \$ [REDACTED] and deferred reporting approximately \$ [REDACTED].

The revenue agent believes that the payments received in [REDACTED] by the taxpayer for goods that were delivered in the following year were advance payments of income includable in the gross income of the taxpayer for [REDACTED]. The taxpayer contends that the payments were refundable deposits and thus did not constitute income to the corporation when received. Alternatively, the taxpayer asserts that if the payments are advance payments rather than refundable customer deposits, then the payments qualify for deferral under the relief provisions for accrual basis taxpayers contained in Treas. Reg. § 1.451-5.

ISSUES

1. Whether amounts received by the taxpayer upon the execution of sales contracts constitute refundable customer deposits or advance payments?

2. If the payments at issue are characterized as advance payments, whether the taxpayer may defer reporting of income under the provisions of Treas. Reg. § 1.451-5?

LEGAL ANALYSIS

I.R.C. § 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes income. A taxpayer's right to use a method of accounting is subject to the requirement that the method clearly reflect income. I.R.C. § 446(b).

1. Deposits v. Advance Payments

The first issue concerns the appropriate characterization of payments received by the taxpayer from its customers in [REDACTED] for the purchase and delivery of business equipment in the following year. The revenue agent contends that the payments received in [REDACTED] were advance payments of income includable in the gross income of the taxpayer for [REDACTED]. The taxpayer maintains that the payments were refundable deposits and thus did not constitute income to the corporation when received.

I.R.C. § 61(a) defines gross income to include "all income from whatever source derived," including gross income from business. Income must be reported in the taxable year in which the taxpayer receives it unless, under the taxpayer's method of

accounting, the item of income is properly accounted for in a different period. I.R.C. § 451(a). Accrual basis taxpayers generally must include in income in the year received advance payments for the sale of goods that are unrestricted as to their use, even though those payments may not be earned until later years. S. Garber, Inc. v. Commissioner, 51 T.C. 733, 735-736 (1969); Hagen Advertising Displays, Inc. v. Commissioner, 47 T.C. 139, 146-147 (1966), aff'd, 407 F.2d 1105, 1107 (6th Cir. 1969); Farrara v. Commissioner, 44 T.C. 189, 191 (1965). As an accrual method taxpayer, the taxpayer must recognize income when all the events have occurred which fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Schlude v. Commissioner, 372 U.S. 128, 137 (1963); I.R.C. § 1.446-1(c)(1)(ii); Treas. Reg. § 1.451-1(a). In general, an advance payment of income is includable in gross income in the year the advance payment is received. Schlude v. Commissioner, 372 U.S. 128 (1963); Oak Industries, Inc. v. Commissioner, 96 T.C. 559, 563-564 (1991). A deposit, however, is not includable in gross income when received. Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1165 (7th Cir. 1988), aff'g 88 T.C. 964 (1987), aff'd, 493 U.S. 203 (1990); Oak Industries, Inc. v. Commissioner, 372 U.S. at 564.

The controlling authority addressing the taxability of customer deposits is the Supreme Court opinion in Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). In that case, the Supreme Court applied the "complete dominion test" to determine whether customer deposits should be included in taxable income when received. Under the complete dominion test, the taxability of deposits "turns upon the nature of the rights and obligations" that the taxpayer assumed when the deposits were made. The Court held that deposits acquired by the taxpayer subject to an express obligation to repay were not within the complete dominion of the taxpayer and thus not taxable advance payments. Commissioner v. Indianapolis Power & Light Co., 493 U.S. at 209. The key to determining whether or not a taxpayer has "complete dominion" over deposits received is whether the taxpayer has some guarantee that it will be allowed to keep the funds. Commissioner v. Indianapolis Power & Light Co., 493 U.S. at 210.

In the present case, the sales agreement contained no express provision providing that deposits were refundable to the purchaser for any reason. The obligation to refund deposits was limited to instances where the delivery date was postponed more than three months. Moreover, even in cases where the taxpayer was unable to perform due to circumstances beyond its control, which included "embargo, hostility, war, civil disturbance, strike or other labor difficulty," refunds were not offered. Rather, the delivery time would be extended for a period of time equal to the time lost by reason of the delay. In this case,

when purchasers made deposits with the taxpayer, they had no right to demand refunds, and the corporation had no obligation to repay the deposits to the buyers unless the corporation was unable to deliver the equipment consistent with the terms of the agreement. Accordingly, the payments at issue are properly characterized as advance payments.

2. Treas. Reg. § 1.451-5 Deferral

Under Treas. Reg. § 1.451-5, accrual basis taxpayers that receive advance payments in one taxable year may, in certain circumstances, defer reporting the payments in gross income. Treas. Reg. § 1.451-5(a)(1)(i) defines the term "advance payment" as any amount, which is received in a tax year by a taxpayer using an accrual method of accounting for purchases and sales, pursuant to, and to be applied against an agreement for the sale or other disposition in a future tax year of goods held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business. In general, advance payments are includable in income in either (1) the taxable year of receipt, or (2) the taxable year in which the gross receipts from the contract are properly accruable under the taxpayer's method of accounting. Treas. Reg. § 1.451-5(b).

In the present case, the payments at issue represent advance payments as defined in Treas. Reg. § 1.451-5(a). First, the payments are amounts received pursuant to the sales contract for the sale in a future tax year of goods. Second, the payments are applied against such agreement. Third, the agreements are for the sale of goods held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business. We further note that Treas. Reg. § 1.451-5(b)(1) also contains the following example, which describes a situation similar to the facts of this case: An accrual method retailer who receives advance payments and accounts for its sales of goods when the goods are shipped must report the advance payment in gross receipts for tax purposes in either the tax year received or in the tax year such goods are shipped.

CONCLUSION

Based on the above, the payments received by the taxpayer upon the execution of sales contracts are properly characterized as advance payments under Treas. Reg. § 1.451-5(a). Accordingly, the taxpayer may defer the inclusion in income from the advance payments until the tax year in which the gross receipts from the contracts are properly includable under the taxpayer's method of accounting, i.e. the year in which the goods are shipped.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

ROLAND BARRAL
Area Counsel

By: _____
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