

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:MCT:CLE:TL-N-4360-00  
CAFisher

date: November 17, 2000

to: LM:MCT:1707:CLH  
Independence, OH Attn: Carlton L. Hill, Team Manager

from: Associate Area Counsel, LM:MCT, Cleveland, Ohio

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subject: [REDACTED]  
Accrual of Residual Commission Income  
U.I.L. Number 451.19-00

This responds to your request for advice regarding [REDACTED]. Our advice is provided pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as the issues herein involve primarily well-settled principles of law. We are required under these procedures to forward a copy of this memorandum to Office of Chief Counsel for review. We will inform you of their response, if any, as soon as it is received.

Disclosure Statement

This document may contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Service, including taxpayer(s) involved, and its use within the Service should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document also contains tax information of the instant taxpayer which is subject to section 6103 of the Internal Revenue Code<sup>1</sup>.

Issues

1. Whether the book-tax conformity requirement of section 446(a) requires [REDACTED] to accrue all of the Residual Payment commission income for tax purposes in the same year that it accrues such income for financial accounting purposes.

2. When is [REDACTED]'s right to the Residual Payment commission income at issue fixed for purposes of the "all events"

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<sup>1</sup> All section references hereinafter refer to the Internal Revenue Code of 1986, unless stated otherwise.

test of Treas. Reg. Sec. 1.451-1(a).

Conclusions

1. The book-tax conformity rule of section 446(a) is not a basis for requiring [redacted] to accrue the Residual Payment commissions in the year [redacted] accepts a customer's contract, if [redacted] can establish that it maintains adequate records which allow it to reconcile its book treatment to its tax treatment of this item.

2. Acceptance of the contract by [redacted] is not an event which fixes [redacted]'s right to the Residual Payments. Rather, we believe that it does not have a fixed right to the Residual Payment income until: 1) [redacted] provides the customer with the products or services contracted for during the prior month; and 2) [redacted] bills the customer for such.

Facts

[redacted] is a [redacted] distributor. An [redacted] distributor markets and sells [redacted] products and services of an [redacted]. [redacted] one of the [redacted] and [redacted] executed the Authorized Distributor Agreement in [redacted] ("Agreement") replacing the prior Authorized Distributor ("AD") agreement and extending [redacted]'s status as an AD of [redacted] for an additional [redacted] years<sup>3</sup>. The Agreement gave [redacted], subject to certain terms and conditions, the nonexclusive right to promote, market and solicit orders from prospective customers for [redacted] products and services, within a designated sales territory<sup>4</sup>. The Agreement provided that [redacted] would hold itself out to be an independent contractor, and not an agent, partner or employee of [redacted]. (Agreement, [redacted]) [redacted] and not [redacted] entered into sales agreements with the customers. [redacted] had

<sup>2</sup> [redacted] were formed as a result of [redacted] [redacted] are authorized [redacted] The [redacted]

<sup>3</sup> A copy of the Agreement is included herewith.

<sup>4</sup> [redacted]'s sales territory under the Agreement was limited to certain area codes within [redacted], [redacted] and [redacted].

no authority to bind [REDACTED] to any sales agreement or order from a customer. (Agreement, [REDACTED])

[REDACTED] of the Agreement sets forth the general rules governing the compensation to be paid [REDACTED] for arranging these sales for [REDACTED]. [REDACTED] establishes that [REDACTED] would be paid on a commission basis. Commissions were not to awarded on any sale or order until accepted by [REDACTED]. [REDACTED] had the right to refuse any sale or order for any reason which it deemed sufficient, and [REDACTED] was not entitled to any commission on any order so refused. However, [REDACTED] also agreed that it would not unreasonably withhold acceptance. (Agreement, [REDACTED])

[REDACTED] of the Agreement contains specific rules for determining the amount and timing of the commissions payable for each of the products and services [REDACTED] was authorized to market. Each product or service provided for a basic commission. Many of the products and services also allowed for incentive bonuses, payable if certain sales goals were met.

When commissions were paid depended upon whether they were payable as an Upfront Payment commission or a Residual Payment commission<sup>5</sup>. Upfront Payments were payable upon the acceptance of the sale and verification of the order<sup>6</sup>. [REDACTED] an accrual basis taxpayer, reported commission income payable as an Upfront Payment in the year the sales were accepted by [REDACTED] for both tax and financial accounting purposes. Bonus commissions were generally payable as an Upfront Payment.

Residual Payments were payable over the life of the contract between [REDACTED] and its customer. The Residual Payment was

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<sup>5</sup> Some products and services, e.g., [REDACTED] and [REDACTED] products, earned both Upfront Payment and Residual Payment commissions for [REDACTED]. Some only provided for Upfront Payment commissions, e.g., [REDACTED] and [REDACTED] [REDACTED] and others provided for only Residual Payment commissions, e.g., [REDACTED].

<sup>6</sup> The commission amount payable as an Upfront Payment is equal: 1) to a percentage of the Life Cycle Revenue ("LCR"); 2) a multiplier of the first month's bill; or 3) a published payment. The LCR is defined as the total of the non-recurring charges plus the monthly recurring charges multiplied by contract length. The percentage applied to the LCR, the multiplier and the published payment, if any, are specified for each product or service in [REDACTED].

computed as a percentage of the Recurring Revenue<sup>7</sup> charged the customer during the month preceding payment. (Agreement, [REDACTED]) The percentage applied to the Recurring Revenue amount depended upon the product or service sold. See, e.g., Agreement, [REDACTED].

For tax reporting purposes, but not financial accounting purposes, [REDACTED] reported the Residual Payments as income in the year they were paid to [REDACTED]. The examining revenue agent estimates that this treatment of Residual Payment commissions resulted in the deferral of approximately [REDACTED] % of [REDACTED]'s total annual commission income, over periods of up to [REDACTED] months.

The examining agent has requested advice regarding whether [REDACTED] should report all of the Residual Payment commission income in the year [REDACTED] accepts the customer's sales agreement or order. The agent observes that section 446(a) provides 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. The agent proposes to accrue all of the Residual Payments for tax purposes in the same year they are accrued for financial purposes - the year [REDACTED] accepts the customer's sales agreement - pursuant to the book-tax conformity rule of section 446(a).

[REDACTED] disagrees, contending that it is properly accruing the Residual Payments for tax purposes as well as financial accounting purposes. For tax purposes, [REDACTED] contends that the accrual of the Residual Payments is dictated by the "all events" test of Treas. Reg. Sec. 1.451-1(a). [REDACTED] contends that the "all events" test is not met with respect to the Residual Payments at the time [REDACTED] accepts the customer's sales order because its right thereto is not fixed under the Agreement at that time. Rather, [REDACTED] contends that its right to the Residual Payments is not fixed under the Agreement until [REDACTED] pays the Residual Payment. [REDACTED]'s position relies upon the definition of Residual Payment in [REDACTED] which states in part, that the commission is "earned" by [REDACTED] at the time it is paid. [REDACTED] also suggests that the right to the Residual Payment is contingent upon [REDACTED]'s billing the customer for the services and products used during the prior month<sup>8</sup>.

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<sup>7</sup> Recurring Revenue is defined as those monthly charges resulting from installed products and services. (Agreement, [REDACTED])

<sup>8</sup> [REDACTED] relies on the definition of Residual Payment set forth in [REDACTED] of the Agreement, for support. The

In response, the examining revenue agent alleges that the sales contracts between [REDACTED] and its customers provide that in the event of termination or default by the customer, the customer is nonetheless obligated to make full payment of the balance which would have been otherwise due [REDACTED] under the contract had no termination or default occurred. The examining agent contends that this provision assures [REDACTED] of payment, thus rendering moot any conditions precedent to accrual of the Residual Payment which [REDACTED] may claim under the Agreement.

Finally, we note that neither the examining agent nor [REDACTED] addressed the "reasonably determinable" requirement of the "all events" test of Treas. Reg. Sec. 1.451-1(a). Based upon our review of the documents provided, it appears that the "reasonably determinable" requirement may be satisfied with respect to the Residual Payments. Given this and the absence of dispute between on the parties, we will not address the "reasonably determinable" requirement of the "all events" test.

#### Discussion

Issue 1. Section 446(a) is not available as a basis for accruing the Residual Payments as income in the year [REDACTED] accepts the customer's sales order if [REDACTED] can establish that it maintains accurate, reliable records, e.g., adjusting journal entries, which reconcile the tax versus book treatment of the Residual Payments. We suspect that [REDACTED] can do so. In PLR 9103001, the Service ruled that a taxpayer could properly use the cash method of accounting to compute its taxable income while at the same time maintaining its books and records on the accrual method of accounting, if it maintained records which allowed it to reconcile the two methods. PLR 9103001 acknowledged that "... no deviation from strict book-tax conformity [of section 446(a)] is sanctioned by the Code or regulations..." but nonetheless ruled in favor of the taxpayer, finding that "[c]ase law ...provide[s] little support for the enforcement of a strict book-tax conformity." The legal analysis provided therein in support of this assessment of the law included the following statement from the legislative history of section 448:

Under present law, a taxpayer generally may elect (on its first income tax return) to use any method of accounting that clearly reflects income and that is regularly used in keeping the taxpayer's books and records (sec. 446). The latter requirement is

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definition provides, in part, that the Residual Payment "... is calculated as a percentage of Recurring Revenue billed to a customer in the month preceding payment."

considered satisfied even if the tax accounting method differs from that used by the taxpayer in keeping its books and records so long as sufficient records are maintained to allow reconciliation of the results obtained under the two methods.

H.R. Rep. No. 496, 99th Cong., 1st Sess., at 604 (1985). We recommend that you review PLR 9103001.

Issue 2. [REDACTED]'s position that the Residual Payments are not accruable until paid rests primarily upon the definition of Residual Payment in [REDACTED] of the Agreement. The definition states, in part, that a Residual Payment is "...that portion of the total commission paid over time and earned by [REDACTED] at the time it is paid." (Emphasis supplied). We agree with [REDACTED] that its right to the monthly Residual Payment commissions was not fixed under the terms of the Agreement immediately upon the acceptance of the customer's sales order by [REDACTED]. However, we do not agree that its right to these monthly commissions did not become fixed until payment. We believe that under the terms of the Agreement, [REDACTED]'s obligation to pay [REDACTED] a monthly commission arose before actual payment. We believe that [REDACTED] had a fixed right to receive, and [REDACTED] was obligated to pay, a monthly Residual Payment after: 1) [REDACTED] provided the customer with the products or services contracted for during the prior month; and 2) [REDACTED] billed the customer for such. It is our position that these are conditions precedent to [REDACTED]'s right to payment. We recognize, however, that the monthly Residual Payment commissions are probably paid shortly after these two conditions precedent are satisfied, and as such, there is likely little practical difference between date of accrual under [REDACTED]'s position and the date of accrual under our position.

An analogous situation is found in Schneer v. Commissioner, 97 T.C. 643 (1991), wherein the court had to determine, in part, when percentage fees payable by a law firm and assigned to another law firm became "fixed" under the "all events" test of Treas. Reg. Sec. 1.451-1(a). Schneer involved an attorney who was initially employed as an associate by law firm A. While there, the attorney brought new clients to the firm, and was paid a percentage of the fees generated by these clients in addition to his regular salary. The attorney subsequently left law firm A and became a partner with two other law firms, referred to hereinafter collectively as law firm B. The attorney agreed to turn over to law firm B any income that he earned from the practice of law after joining law firm B.

The attorney left law firm A with an understanding that he would continue to receive a percentage of the fees generated by the clients that he had referred to law firm A while an associate, even though they remained clients of law firm A. It was expected that petitioner would be available to consult regarding these clients. However, petitioner would have become entitled to his percentage of the fees even if he had not been called upon to consult. After joining law firm B, petitioner was paid a percentage of fees by law firm A for services rendered to the clients he had previously referred to law firm A. Essentially, these fees were composed of three types: 1) fees which were generated while the attorney was employed as an associate of law firm ("Type I"); 2) fees which were generated after he left law firm A and for which he provided consultation services ("Type II"); and 3) fees which were generated after he left law firm A but did not provide any consultation services ("Type III"). Pursuant to his agreement with his partners at law firm B, the attorney turned over all of these fees to the law firm B.

The attorney did not include these fees in his individual income in the years received, contending that they were instead income of law firm B. The Service disagreed, arguing primarily that all of the fees were income of the attorney under the assignment of income doctrine of Lucas v. Earl, 281 U.S. 111 (1930). In order to resolve the assignment of income issue, the court found it necessary to first determine when, under principles of the accrual method, the percentage fees were "earned," i.e., the right thereto became "fixed," relative to the date the attorney assigned them to law firm B. The court ruled that the Type I fees were "earned," i.e., the right thereto was fixed, prior to the attorney's departure from law firm A because the services giving rise to the client's obligation to pay the fees had been rendered prior to his departure. However, the Type II and Type III percentage fees were not "earned," i.e., the right thereto was not fixed, until after the attorney became a partner with law firm B because the services rendered to the referred clients giving rise to these obligations had not been performed until after that date. It was the rendition of the services to the client, without regard to whether the attorney provided consultation services to law firm A, which "fixed" the right to the percentage fees. We believe that, as with percentage fees in the Schneer case, [REDACTED]'s right to the Residual Payments is conditioned, in part, upon the contracted products and services having been provided to the customer by [REDACTED].

Finally, the examining agent argues in the alternative that [REDACTED]'s right to the Residual Payments is fixed at the time

