Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:POR:TL-N-3759-01
JMDewey

date: September 20, 2001

to: LMSB Exam Team 1747
Attn: Chris Beach, Dennis Strieff

from: Associate Area Counsel
CC:LM:CTM:SEA:POR

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subject: **Accrual of Income and Expenses**

Taxpayer: [redacted]

You have requested our advice concerning the proper timing for the accrual (for tax purposes) of both income received and expenses incurred by the above-named taxpayer for the "wholesale" tours which it arranges and markets through travel agencies. Full payment for these tours is generally required of the traveler [redacted] days in advance of departure date. Payments made by the taxpayer for the different travel services (provided by third parties) which comprise a tour are required at different times--some when services are booked, some after services have been performed, depending on the taxpayer's contracts with service suppliers.

You have taken the position that the taxpayer should recognize advanced full-payments for tours as income at the time such payments are made by the traveler; and that the costs of the booked tour elements may be deducted at the time of booking. For the reasons discussed below, we concur with your analysis.

FACTUAL BACKGROUND:

In arranging its "wholesale" tours, [redacted], an accrual-basis taxpayer, contracts directly with airline companies, hotels, car rental firms, land tour companies, and other providers of travel services (its "suppliers") for blocks of seats, rooms, and other services at special rates, and under special terms. The tour products, which [redacted] then offers for sale through travel agencies, are travel arrangements which combine some or all on these different elements. Generally, [redacted] deals only with its customers--the travel agencies (in [redacted] and [redacted])--and not with the individual travelers who purchase the tours. Most of the tours sold are to

[redacted], but [redacted] also markets travel to destinations in California, Nevada, Australia and elsewhere. The company makes its profits on the volume of its sales and the special rates it is able to negotiate with suppliers. Its gross profit margin is not large; for example, in [redacted], [redacted] and [redacted] this was about [redacted]%.

When a traveler decides to purchase one of [redacted]'s travel arrangements from a travel agency, he can place a "hold" on the tour by making a $[redacted] deposit within [redacted] days. This deposit is completely refundable, and it guarantees nothing. Thus, if the itinerary or price for a prospective tour changes, the customer will bear the burden of any increased cost. These deposits are not at issue here, since you agree with the taxpayer that they do not represent accruable income when due or paid.

However, under the terms of the tour packages provided by [redacted], full payment for a tour is required of the traveler prior to travel. Such payment must be made [redacted] days prior to the date of departure, or, if a tour is purchased less than [redacted] days before departure, on the date of that purchase. Payment is made to the travel agent, in cash, by check or with a credit card, and such payment fixes a specific itinerary and guarantees the rates for the different elements of the tour--airfare, hotel rooms, car rentals, and so forth. A deposit previously paid may, at the traveler's option, be applied against the cost of a tour at the time of full payment. Also at the time full payment is made, [redacted] will book the different elements of a tour with its suppliers; thus, airline seats, rental cars, hotel rooms and other services are reserved. The traveler is provided, through the travel agency, with the itinerary, and will subsequently receive airline tickets and/or vouchers for different tour elements.

[redacted] pays its suppliers directly. Exactly when [redacted] must pay a supplier for services to be provided during booked tours will vary depending on the terms of [redacted]'s contract with the supplier. Generally, however, travel agent commissions are paid when the traveler full-pays for a tour and payment for air travel is made (at approximately the same time) when the seats are booked. Although other tour elements are booked at the time of full-payment, [redacted] generally does not pay the suppliers until after the contracted-for services are given to the traveler.

At the time specific tours are full-paid and the tour elements have been booked, the services provided by [redacted] are substantially completed. [redacted]'s business is to arrange travel, not to provide the actual travel services, and it has no agency relationship with the travel service suppliers. Thus, generally, after a tour has been purchased and booked, [redacted] has no further contact with the travel agency (or the traveler) regarding the

tour. However, until a tour is completed, the company will "trouble-shoot" if required, and does provide an element of flexibility regarding travel arrangements which have been sold. Thus, for example, it is expected that some changes may be required due to events outside the control of [redacted] or the traveler, such as mistakes in bookings, unanticipated changes in airline flight schedules or hotel closures or repairs.

In addition, a customer may request changes in tour elements, or may even cancel a tour. [redacted] will do its best to accommodate (through the travel agent) a traveler's request for a change, but certain additional fees[1] may be charged (at [redacted]'s discretion) for this service. If a tour is cancelled, the amount pre-paid by the traveler, less a "non-refundable" portion, will be returned. (It is our understanding that, under these circumstances, the non-refundable part is composed of a "cancellation fee" and any amount paid out by [redacted] for which it cannot get a refund under the terms of its contract with the supplier.) It should be noted that these refund policies are dictated by the consumer protection laws (both statutory and case law) of the states in which [redacted] operates.

[redacted] views its "flexibility" in accommodating needed or requested changes to tour packages as an important part of its services. It asserts that in certain months changes have been made for more than [redacted]% of its bookings. However, many of these changes are minor and include such things as the rescheduling of a flight, a change in name, or the purchase of additional items (like a rental car) which do not involve change fees or a change in the cost of basic tour elements.

[redacted] does collect significant revenue in the form of change (or cancellation) fees. For example, in [redacted], it recognized approximately $[redacted] in (gross) income from such fees. However, although outright cancellations do occur, [redacted] representatives admit that these are rare. Also [redacted] recommends and sells travel insurance packages which guard against various cancellations and changes that may affect travel. (In [redacted], it recognized over $[redacted] in commissions on such insurance.) It should be noted that, when a traveler purchases insurance, many of the events that would trigger change and/or cancellation fees are covered.

State laws do not require [redacted] to deposit the pre-payments it receives from its tour sales into client trust accounts. [redacted]

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[1] Some of which may be paid out, in turn, to the supplier who is impacted by the change.

does deposit some of these funds (amounts not required to meet current expenses) into bank accounts or other short term investments, from which it earns substantial income. For example, during the [redacted] period [redacted] reported income in excess of $[redacted] from the investment of such funds.

The taxpayer is a member of the U.S. Tour Operators Association, and, according to the taxpayer, it has posted a $[redacted] "letter of credit" with this professional association to secure the travel funds pre-paid to [redacted].

For the years at issue here ([redacted] and [redacted]), for both book and tax purposes, [redacted] did not recognize as income amounts paid for specific tours purchased until the date of departure. Prior to that time full-payments made for travel packages, termed "customer deposits," were recorded as liabilities. Travel costs for specific tour elements paid to suppliers prior to departure were recorded as "prepaid travel costs;" supplier costs incurred under contract but not yet paid were not accounted for until departure date, when both paid and unpaid supplier costs were booked (accrued) as expenses.

Your position is that [redacted] must recognize the full-payment made for a tour on the date of payment by the traveler, and, at approximately the same time, it may deduct the supplier costs incurred for that tour. Thus you have determined that [redacted] must accrue these items, for tax purposes, up to [redacted] day earlier than it reported on its federal income tax returns (Forms 1120-S) for the two years at issue. The adjustments to income resulting from this accounting change total approximately $[redacted].

LEGAL DISCUSSION:

A. Income Recognition.

Under the "all events" test, accrual-basis taxpayers, such as [redacted], are required to recognize income for Federal income tax purposes when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. §§1.446-1(c)(1)(ii) and 1.451-1(a). Under this test, a taxpayer's right to income is fixed either when the amount is unconditionally due or when he has performed. The rule is thus generally stated that income must be recognized when it is paid, due or earned, whichever occurs first.

Case law, based on a number of opinions of the U.S. Supreme Court, has established the principle that revenue paid to a

taxpayer prior to performance (that is, the provision of services or goods) by a taxpayer, must be recognized as income at the time payment is received. Some early case law applied the "claim of right doctrine" to reach this conclusion, even where it was possible that a taxpayer might later be required to refund all or a portion of the amount paid. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Any contingencies that might compel the return of such amounts received were to be ignored unless the receipt was subject to "substantial limitations or restrictions," or the amounts simply did not qualify as income--as would be the case for loans or fully-refundable "deposits." Moritz v. Commissioner, 21 T.C. 622 (1954).

Because this rule requiring income recognition for pre-payments represents a divergence between tax accounting and GAAP principles, accrual basis taxpayers have repeatedly challenged it, and several circuit court opinions have rejected the "claim or right" argument, allowing the deferral of recognition for such income. See Beacon Publishing Co. V. Commissioner, 218 F.2d 697 (10th Cir. 1955), rev'g 21 T.C. 610 (1954); Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956), rev'g 24 T.C. 247 (1955); and Bressner Radio v. Commissioner, 267 F.2d 520 (2d Cir. 1959), rev'g 28 T.C. 378 (1957). However, three decisions of the U.S. Supreme Court have essentially over-ruled these circuit court cases. See Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Automobile Association v. U.S., 367 U.S. 687 (1961); and Schlude v. Commissioner, 372 U.S. 128 (1963). In Schlude, for example, the Court found that all prepayments made to the taxpayer for dancing lessons, under contract to be provided subsequently, were immediately includible in income. The accrual of additional amounts later to be paid under the contract depended on the due dates for those payments, and not on the provision of services.

The Tax Court has applied Schlude to establish what amounts to a per se rule that pre-payments, so long as they comprise income, are taxable when paid, and are not deferrable under GAAP principles, even where there is a possibility that all or a portion of the payment might later have to be refunded. For example, in S. Garber, Inc. v. Commissioner, 51 T.C. 733, 736 (1969), the court stated its view that the possibility of a refund was "nothing more than a contingent liability which had no bearing" on the right to receive the payment in the first place. Also see, Hagen Advertising Displays v. Commissioner, 47 T.C. 139 (1966), aff'd 407 F.2d 1105 (6th Cir. 1969); Travis v. Commissioner, 47 T.C. 502 (1967), aff'd on this issue, rev'd on another, 406 F.2d 987 (6th Cir. 1969); Security Associates Agency Insurance Corp. v. Commissioner, 53 T.C.M. 1239 (1987), and many other cases.

A few circuit courts have declined to interpret Schlude as establishing a per se rule, and have allowed deferral of income received as prepayments in limited circumstances, involving future obligations to be performed on specific dates, or "demonstrably accurate projections of future expenses." See Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968) and RCA Corp. v. U.S., 664 F.2d 881 (2nd Cir. 1981). In response to these opinions, the Tax Court has stated, in dicta (in Handy Andy T.V. & Appliances v. Commissioner, 47 T.C.M. 478, 486 (1983)), that a taxpayer must accrue prepaid income when received "unless he can demonstrate that a particular amount of future performance of services under ...contract is assured with reasonable certainty....based on contract terms. However, the Tax Court has continued to apply a per se rule. See, for example, the Security Associate Agency Insurance Corp. case.

Thus, it is our opinion that case law has clearly established the tax principle that prepaid income must be recognized by accrual basis taxpayers at the time it is paid. The general income accrual rule, is thus correctly stated above: income must be accrued (if the amount can be reasonably estimated) at the earliest point in time when either the taxpayer has performed, a payment is due (without condition), or payment has been made. In [redacted]'s case, performance regarding a particular tour was substantively completed at the time [redacted] finished booking or reserving the different elements of a tour. This was done only after the traveler had full-paid the travel agency for the tour, and full-payment was unconditionally due at that time. Accordingly, we conclude that [redacted] should be required to recognize these full-payments as income at the time payment was made by the traveler.

[redacted] asserts, however, that the full-payments at issue are merely "deposits"--because they may be refundable under some circumstance--and therefore do not accrue as income until the date the traveler actually departs on his trip. We do agree that fully-refundable deposits, perhaps made to insure performance by a payer under an agreement or contract, are not recognizable as income, either by cash or accrual basis taxpayers. Of course, whether an amount paid represent a deposit and not pre-paid income does not depend on how it is characterized by the taxpayer. Rather, the question is whether the payer has some control over obtaining a refund of the "deposit" or whether, instead, the taxpayer has complete control and dominion over the fund, i.e., whether the taxpayer controls the conditions under which the "deposit" may have to be repaid and thus will have some guarantee that he will be allowed to retain it. See Oak Industries v. Commissioner, 96 T.C. 559 (1991) and TAM 9719005.

That refundable deposits do not comprise income, even where the holder has control over the funds during the time period in which he has possession of them, was established by the U.S. Supreme Court in Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). At issue in that case were deposits made to a utility company to secure subsequent payment of utility bills by customers with poor credit ratings. The utility's dominion over the funds was limited, however: It was required to pay interest on deposits held for more than one year and to refund a deposit (after off-setting, if necessary, any unpaid bills) upon termination of services, or earlier if the customer demonstrated an acceptable credit by making timely payments over a given period of time.

In its opinion, the Supreme Court observed that a deposit, like an advance payment, may confer (at least temporarily) the economic benefit of the use of the funds. However, the proper focus is not the existence of this economic benefit but, rather, the nature of the rights and obligations under the deposit agreement. (Thus, to determine this question, it is necessary to consider the expectations of and agreements between the parties at the time a "deposit" is made.) Because, in Indianapolis Power & Light, the utility company acquired the deposit subject to an express obligation to repay it at some future date, the Court analogized the deposit to a loan, which also confers economic benefit and an obligation to repay. The Court noted, in contrast, that a person making an advance payment retains no right to insist upon the return of funds, provided, of course, that the recipient complies with the terms of the contract.

We agree with your conclusion (and [redacted]'s position) that the fully-refundable $[redacted] "deposits" sometimes made by a traveler to "hold" a prospective tour, qualify as non-taxable deposits. In contrast, we think it clear that the full-payments required in order to fix travel rates and obtain booking for tour elements comprise advance payments of income. At the time of payment, [redacted] contracted to sell to the traveler, through the travel agency, a package of pre-arranged tour elements, and what was paid to [redacted], through the agency, was income received for this service. The fact that a purchased tour might later be modified, and that this might entail the charging of additional fees, had no impact on the original agreement, and the taxpayer's right to receive full payment. At best, the possibility of prospective changes represented a "conditional liability" which would not effect the initial recognition of income. Moreover, the fact that a purchased tour might later be cancelled, in whole or in part, and that this could result in a refund of some (but not all) of the funds originally paid, also represented merely a "condition subsequent," and would not negate the requirement, under case

law, that [redacted] must recognize the full-payments as income at the time when they were paid.

We do note that some special rules have been provided, by Congress and/or the Service. which permit income deferral for advanced payments of income under certain circumstances. For example, deferral is allowed regarding prepayment made for goods held for sale in the ordinary course of business. Treas. Reg. §1.1451.5. With regard to prepayment made for services, special rules have been provided, under limited circumstances, in Revenue Procedure 71-21, 1971-2 C.B. 549. This procedure allows an accrual basis taxpayer to defer income recognition for up to a year where he receives payments in one tax year, pursuant to an oral or written agreement, for services that are to be performed by him in the subsequent tax year. Under the permissible tax accounting methods set out in this revenue procedure, the income paid for services performed during the year of pre-payment are to be recognized in that year, and all of the remaining income paid under the contract must be recognized in the subsequent year, whether or not all of the contracted-for services have been performed. For example, where optional service contracts on property sold by a taxpayer are paid for at the time the property is sold, but the service contract covers more than one tax year, the seller will be allowed to defer recognition of some part of the service contract price until the subsequent tax year, when all the remaining income must be recognized.

This revenue procedure has been held by the courts to apply where a taxpayer receives an advance payment pursuant to an agreement requiring him to perform contingent services on a continuing basis in order to earn the payment. Signet Banking Corp. v. Commissioner, 106 T.C. 117 (1996). It was also deemed applicable to "annual membership fees" charged by a bank to credit card holders under circumstances where the payment of fees gave the holder continuing access to additional benefits and services not available to the banks's other customers, and, should the credit card be cancelled, these fees were to be ratably refunded based on the number of months remaining in the one-year period. Barnett Banks of Florida, Inc. v. Commissioner, 106 T.C. 103 (1996).

However, the special rules allowing deferral set out in this revenue procedure simply do no apply to the case at issue here. This is because, at the time the tours are paid for, [redacted] completes substantially all of its services in arranging the tour by booking the different elements of the tour which has been purchased. The services remaining to be performed for the traveler are those which will be provided by the suppliers of travel services, not by [redacted]. [redacted] is not an agent of these

suppliers, nor are they agents of [redacted]. [redacted] does have an obligation to pay for the travel services which it books, and some of these payments are made after travel is completed. When these payments are to be made is determined under the terms of [redacted]'s contracts with the suppliers; this is not determined under the terms of [redacted]'s agreements (through the travel agency) with the purchaser of a tour. Accordingly, the services [redacted] is required to render pursuant to a tour contract or agreement are completed almost immediately after full-payment has been made. Unless such payment is made on the last day of a taxable year and the tour elements are not booked until the first day(s) of the next year, this revenue proceeding would not be applicable.

This is so even though [redacted] may be required, or asked by the traveler (through the travel agency), to perform additional services in making changes to tour arrangements. Such services do not comprise a substantial part of the work [redacted] does in arranging and booking its tours, and they are not tasks which are specifically identified under the contract to be performed for a given price at a later date. Rather, they represent extra, contingent, services which may be required or requested, and which will then be paid for if they entail any significant additional expense for [redacted]. In the rare case where a traveler cancels a tour (and thus, essentially, does not perform under the tour contract), cancellation fees and other non-refundable amounts will be charged. Any fees charged for changes made by [redacted] should be recognized as income when they are due, and any amounts of income previously recognized which must be returned to a traveler should then be subtracted against (gross) income at the time the refund is made.

B. Accrual of Expenses.

The tax accounting rules which determine when an accrual basis taxpayer must recognize and claim deductions for expenses are similar but not identical to those for income accrual. They include the "all-events" test, which was first articulated for deductions by the U.S. Supreme Court in U.S. v. Anderson, 269 U.S. 422, 441 (1926), and which has long been incorporated into the Code and regulations. See Treas. Reg. §§ 1.446-1(c)(1)(ii)(B) and 1.461-1(a)(2). As with income recognition, this rule provides that a liability is incurred and must be taken into account for the taxable year in which (1) all the events have occurred which establish the fact of liability and (2) the amount can be established with reasonable accuracy.

For deductions, however, a third "prong" or requirement, that of "economic performance," was added to the Code with the enactment of I.R.C. § 461(h)(1) by section 91(a) of P.S.98-369,

July 18, 1984. This requirement is met either when services or property are provided to a taxpayer or a taxpayer provides services or property (i.e., makes payments) to another. See section 462(h)(2)(A) and (B). In addition, however, section 461(h)(3)(A) provides an exception to the "economic" performance" under circumstances where the first and second prongs of the "all-events" test are met during a taxable year and economic performance actually occurs within a "reasonable period" after the close of that tax year (or at least with 8 1/2 months after the close of the year). A taxpayer may adopt this exception for costs which are "recurring in nature" if they are accounted for in a consistent manner, and if the costs are either "immaterial" or comprise items for which accrual in the earlier tax year would result in a more proper matching of expenses against income.

The time when expenses should properly be recognized by an accrual basis taxpayer is not necessarily the time at which related income must be recognized, because the accrual rules are not identical for these items. The main distinction, of course, is the requirement of "economic performance" for expense deductions. In the present case, it is clear that [redacted] could properly claim expense deductions for the payments it makes, or which are unconditionally due, to travel agencies at the time a tour is sold, or to airline companies at the time that seats are booked, because payment of these costs was required at those times. However, the expenses [redacted] incurs when it books other travel services will generally not become deductible until "economic performance" occurs, that is, until the travel services are provided to the traveler and payment by [redacted] thus becomes due and payable.

However, it is our opinion that the "recurring items" exception to "economic performance" is applicable to these costs. The payments made to suppliers such as hotels and car rental agencies, are certainly "recurring" cost items for [redacted]. The first and second prongs of the "all-events" test are met at the time the tours are purchased and the hotel rooms and other services are booked at given rates. Even for tours purchased before the close of the tax year which do not commence until the beginning of the subsequent year, "economic performance," in the form of payment to suppliers, invariably occurs within 8 1/2 months after the close of the tax year. Although, these expenses, taken as a whole are undoubtedly not "immaterial," individual items may be viewed as such. More importantly, however, deduction of all the costs incurred in relation to a given tour in the same year the income from that tour is accrued, undoubtedly allows a better matching of expenses against income. Accordingly, we concur with your analysis that the exception may be applied to these expenses and that, if the taxpayer so elects,

the travel costs may be deducted at the time the tour elements are paid for and booked.

FINAL COMMENTS:

We have communicated informally with National Office Attorney Joyce C. Albro (CC:IT&A:Br3) concerning the facts of this case and the statutory and case law applicable to it. Ms. Albro is a technical expert on tax accrual and has dealt with other, similarly situated taxpayers (for example, tour companies and cruise lines) concerning the tax treatment of items such as "advance deposits" and "pre-paid travel costs." She has indicated that the analysis and advice contained in this memorandum is in accord with the position of the National Office on these issues.

If you have any questions or comments about this memorandum, please call the undersigned at (503) 326-3100, extension 248. Also, you should be aware that this advice may contain privileged information. Thus, any unauthorized disclosure of it may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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Attorney (LMSB)

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