Office of Chief Counsel
Internal Revenue Service

memorandum

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date: JAN 30 2001

to: Frank Sherrod, Team Coordinator

from: Associate Area Counsel (LMSB)
Detroit, Michigan

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ubject: [redacted]
Settlement Agreement with Suppliers

This memorandum is in response to your recent request for our advice with regard to the above subject. Our advice is subject to post-review by our National Office and should not be relied upon for a period of 30 days.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to the taxpayer(s) involved or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether [redacted] is required to report as income amounts it received in settlement of certain patent infringement claims during the year the settlement was reached, even though the amounts are payable over several years.

2. If [redacted] is required to report the above amounts in the year the settlement was reached, then whether [redacted] is entitled to discount to present value the amounts reported.

CONCLUSIONS

1. As an accrual basis taxpayer, [redacted], is required to report the amounts received pursuant to the settlement in the year the settlement was reached rather than ratably over the years of the settlement; the amounts were determinable and [redacted]'s right to the amounts became fixed during that year. I.R.C. § 451(a) and Treas. Reg. § 1.451-1(a).

2. In the absence of any provision in the Internal Revenue Code allowing it to do so, [redacted], cannot discount to present value amounts reported as income pursuant to the settlement mentioned in 1. above.

FACTS

The facts are as discussed during our meeting of December 11, 2000, and as set forth in the "Settlement Agreement," (hereinafter referred to as settlement agreement), entered into on [redacted]

[redacted], is an accrual basis taxpayer with a fiscal year ending [redacted].

In [redacted] of [redacted], [redacted] was sued by [redacted] for patent infringement. To settle that lawsuit, [redacted] entered into a settlement agreement on [redacted], wherein it agreed to pay [redacted] $[redacted], and exchanged covenants with [redacted], with each agreeing to refrain from any further infringement in the future.

The lawsuit filed by [redacted] apparently gave [redacted] the right to assert certain claims against some of its suppliers. To settle those claims, [redacted] entered into a settlement agreement with these suppliers on [redacted]. Pursuant

to this settlement agreement, [redacted] was to receive $[redacted] payable over a [redacted]-year period. Specifically, paragraph 1 of the settlement agreement provided as follows:

> On or before the close of business on [redacted] the [suppliers] shall pay the amount of [redacted] dollars ($[redacted]) by certified check or electronic wire transfer to [redacted]. The [suppliers] shall make [redacted] additional payments, each in the amount of [redacted] Dollars ($[redacted] by certified check or electronic wire transfer to [redacted]. Those payments shall be made on or before the last business day of [redacted] in each of the [redacted] years subsequent to the initial payment, beginning [redacted]. The last of these [redacted] payments shall be due on or before [redacted]. The total amount of the [redacted] payments required by this paragraph is [redacted] Dollars ($[redacted]).

In addition, paragraph 4 of the settlement agreement obligated [redacted] to purchase [redacted]% of certain parts from two of the suppliers involved. This obligation, however, was conditioned on the suppliers' meeting [redacted]'s "reasonable and good faith price, quality and delivery terms . . . " Paragraph 4 further provided the supplier's obligation to make the payments required by paragraph 1 will be suspended if an arbitrator determines [redacted] failed to meet its obligations under paragraph 4 of the agreement.[1]

On its income tax return for the fiscal year ending [redacted],[2] [redacted] took a deduction in the amount of $[redacted] in relation to the settlements reached on [redacted]. This amount was computed by taking the $[redacted] paid to [redacted],[3] and then reducing it by $[redacted] the $[redacted] received from the

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[1] It is our understanding that, to date, all payments required by paragraph 1 have been made timely, and no violations have occurred.

[2] The fiscal year end for [redacted] was actually [redacted].

[3] Based on our discussions, an issue may exist as to whether a portion of this amount should be attributable to the covenant(s) obtained by [redacted] as part of the settlement and, thus, should be amortized. This issue will be addressed at a later time when all the information requested in our meeting of December 11, 2000, has been provided. As far as we are aware, there is no issue regarding [redacted] being the

suppliers reduced to present value.

As a result of the $[redacted] deduction, exam requested our assistance. Specifically, exam asked us to consider whether [redacted] correctly reduced to present value the $[redacted] required to be paid by the suppliers. In discussing the discounting issue with exam, it became apparent the timing of reporting the $[redacted] was also worthy of consideration.

DISCUSSION AND ANALYSIS

Issue 1

As a general rule, an accrual basis taxpayer is required to report income when all the events to fix the taxpayer's right to that income have occurred, and the amount of such income can be determined with reasonable accuracy. I.R.C. § 451(a); Treas. Reg. § 1.451-1(a). For income to be accruable, all that is required is the existence of a fixed right to receive the income rather than actual receipt. Schlude v. Commissioner, 372 U.S. 128 (1963); and Commissioner v. Hansen, 360 U.S. 446 (1959).

An exception to the general rule usually exists when, during the year the taxpayer's right to the income arises, collection and receipt of the income become doubtful. Clifton Manufacturing Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943). Similarly, if the right to receive the income is contingent upon the occurrence of a future event, accrual is not required. Lucas v. North Texas Co., 281 U.S. 11 (1930); and Guarantee Title & Trust Co. v. Commissioner, 313 F.2d 225 (6th Cir. 1963).

Based on the facts presented here, it is evident [redacted]'s right to the settlement amounts became fixed when the settlement agreement was executed in [redacted] of [redacted]. Although [redacted]'s receipt of the settlement amount was arguably contingent upon its obligations under paragraph 4 of the agreement, such obligations were not conditions precedent to the suppliers' payment of the amounts. At a minimum, any arguably existing contingency would not rise to the "dignity of what has hitherto been recognized as a contingency sufficient to vitiate the 'fixed' requirement of section 451(a)." Harmont Plaza, Inc. v. Commissioner, 64 T.C. 632 (1975), affd., 549 F.2d 414 (6th Cir. 1977), citing, Lucas v. North Texas Co., 281 U.S. 11 (1930) and Guarantee Title & Trust Co., 313 F.2d 225 (6th Cir. 1963). In Harmont, the Tax Court held the taxpayer was required to accrue payments required under an indemnification arrangement, even though the payments were contingent upon the payer's realization

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proper year for deduction. Please let us know if that is incorrect.

of sufficient cash flow, and even though the taxpayer did not actually receive the payments during the years at issue.

Based on the above, and considering the amounts required by the settlement agreement were certain, we conclude [redacted] is required to include the $[redacted] in its income during the [redacted] tax year.[4]

Issue 2

Although time value of money concepts exist in the Internal Revenue Code, see for example I.R.C. §§ 483 and 1272 through 1275, the Code is devoid of any provisions allowing for application of such concepts to income required to be accrued pursuant to I.R.C. § 451(a).

Time value of money principles can only be applied when they are either implicitly or explicitly provided for by statute. City of New York v. Commissioner, 103 T.C. 481 (1994); and Follender v. Commissioner, 89 T.C. 943 (1987). In Follender, the Tax Court held that the taxpayer was not entitled to apply time value of money principles to borrowed amounts to reduce his "at risk" amount under I.R.C. § 465. In City of New York, the Tax Court held the taxpayer was not entitled to apply time value of money principles to its bonds for purposes of meeting the requirements of I.R.C. § 141(c). Citing Follender, the Tax Court stated that "time value of money concepts can be applied only in the presence of a legislative directive to do so." In discussing Dickman v. Commissioner, 465 U.S. 330 (1984), where time value of money principles were applied to taxable gifts, the Tax Court further stated "that, absent specific statutory authorization, the use of time value of money principles is appropriate when necessary to effectuate a clearly legislative purpose."

Similarly, in Burnham Corporation v. Commissioner, 90 T.C. 953 (1988), affd., 878 F.2d 86 (2nd Cir. 1989), the Tax Court held that the accrual basis taxpayer was not required to reduce to present value its liability pursuant to a settlement agreement. We note the Tax Court's holding was based, in part, on the concession by the Internal Revenue Service that "no statutory authority or case law exists that would require

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[4] [redacted] may have conceded the proper year for accrual by including the income on its tax return for the [redacted] tax year.

accrual basis taxpayers to discount current deductions of long-term liabilities."[5]

In light of the fact I.R.C. § 451(a) lacks any provisions regarding reducing the accrued, or accruable income to present value, and based on the above, it is our conclusion [redacted] cannot reduce to present value the payments due from the suppliers under the settlement agreement.

We coordinated this issue with our National Office, and it concurs with our conclusion.

We hope the foregoing fully addresses your concerns regarding the issues. Should you have any questions or require any additional assistance, please feel free to contact the undersigned at (313) 237-6432.

Phoebe Nearing
Associate Area Counsel
(Large and Mid-Size Business)

BY: _____
MESO T. HAMMOUD
Attorney (LMSB)

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[5] Compare Ford Motor Company and Affiliated Companies v. Commissioner, 102 T.C. 87 (1994), where the Internal Revenue Service took the position that the taxpayer's deduction for liabilities arising from the settlement of tort claims was limited to the amount paid for annuity contracts to pay those liabilities, and not the actual liabilities. Pursuant to the settlement agreement, the taxpayer was obligated to make payments to the tort claimants over several years, the longest being 58 years. The amount paid for the annuity contracts did not exceed the present value of the taxpayer's obligations to the tort claimants, and the Tax Court upheld the Service's position.

CC: Sarolta Ficsor, Team Manager