Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: , Team
(Large Business & International)

from: Associate Area Counsel
(Large Business & International)

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subject: Deferral of Income Recognition for Contracts for the Sale of Goods

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

<u>LEGEND</u>

Taxpayer =
Product(s) =
Year1 =
Year2 =
Year3 =
Year4 =
Year5 =
Year6 =
Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =
Date7 =
Date8 =
Date9 =
$v =

$w	=
$x	=
$y	=
$z	=
Customer1	=
Customer2	=
b	=
c	=
unit	=

ISSUE

Is Taxpayer properly using the method of accounting in Treas. Reg. § 1.451-5 for advance payments received pursuant to long-term agreements for the sale of goods?

CONCLUSIONS

No. Taxpayer's actions show that its liability under these agreements has ended, and it is required to immediately recognize as income all advance payments received in prior years. In the alternative, Taxpayer's method of accounting is not consistent with Treas. Reg. § 1.451-5 because it is not applying the advance payments to goods as they are shipped.

FACTS

Taxpayer manufactures Product for use in various industries. When the demand for Product grew rapidly a few years ago, Taxpayer developed a business model to exploit the increased demand and insulate itself from dramatic decreases in future demand or new competition that might affect prices. Taxpayer therefore negotiated long-term supply contracts with some of its customers that would ensure steady demand to justify a substantial increase in production. These supply contracts were take or pay, in that the customer agreed to pay for a certain quantity of Product, whether or not it actually took delivery. In return, Taxpayer agreed to stand ready to deliver the specified Product at specified times at set prices. Each customer also agreed to pay non-refundable advanced payments.

Original Long-Term Contracts

Taxpayer entered into long-term contracts with various customers beginning in Year1. The contracts specify minimum yearly quantities that the customer will purchase, and Taxpayer will deliver, at fixed prices over a term of years. The majority of the contracts are for b-year terms. All of the original contracts have the take or pay feature and an initial, non-refundable advanced payment ("IAP"). The contracts specify that the IAP is to be applied to purchases ratably over the contract period on a per-unit basis.

We have reviewed a number of Taxpayer's original long-term supply agreements and subsequent amendments, all of which follow the same general pattern.[1] The original agreement between Taxpayer and Customer1, for example, contains the following provisions:

The agreement goes on to describe, in detail, the terms under which Taxpayer agrees to sell, and Customer1 agrees to purchase, certain products. The agreement is for a term of b years and may not be terminated except for limited circumstances described in the contract. It requires an initial advance payment and contains take or pay provisions:

[1] In most cases, the language of the operative provisions is identical, and the only differences are customer-specific items such as names, prices, and quantities.

The agreement describes in detail the prices and quantities for the Product and states:

There are no other sections of the agreement, or any of its exhibits, that provide for changes to the price of the Product.

The agreement significantly limits the parties' ability to terminate the contract:

. Circumstances under which the agreement is terminated include:

The agreement, like all other similar long-term supply agreements that Taxpayer provided to the audit team, has choice of law provisions.

Accounting for Long-Term Contracts

For book and tax purposes, Taxpayer recognizes income from the sale of goods as the goods are shipped. It also recognizes income from long-term contracts at the average price over the term of each contract.[2] For tax purposes, Taxpayer adopted the method in Treas. Reg. § 1.451-5. Under Treas. Reg. § 1.451-5 as used by Taxpayer, advance payments are included in income in the taxable year in which they are recognized for book purposes. Therefore, because Taxpayer recognizes long-term contract income at the average contract price for book purposes, Taxpayer defers initial recognition of the IAP and includes the IAP in income ratably over the term of each agreement.

For book and tax purposes, Taxpayer records the IAP in a deferred revenue liability account. It also records an additional deferral for each sale based on a difference between the average contract price and the actual amount stated on the sales invoice. In the early years of each contract, when the price is higher, Taxpayer defers the excess between the invoice and average prices. The balances as of the end of the tax year for these liability accounts are:

	Year5	Year6
Initial Advanced Payment	$w	$x
Average Price Deferral	$y	$z

Contract Modifications

In Year5, the market for Product changed, and Taxpayer's long-term supply contracts were then charging customers more than the customers would otherwise pay on the open market. Taxpayer could have insisted on enforcing its existing contracts, but it instead made the business decision to negotiate contract modifications on a case-by-case basis. A few of the original contracts were terminated by mutual consent, for which Taxpayer received a settlement payment. In these cases, Taxpayer included both the settlement payment and the balance of any remaining deferred revenue balance for that contract (IAP plus the "average price adjustment") into current income.

For the remaining contracts, Taxpayer and its customers negotiated new prices, new quantities, or both, based on market prices and the customer's need for Product. Taxpayer also agreed to modify some of the other provisions of the contracts, including a change in the contract term (extending it from b to c years, or longer), a charge of a "deferral fee" in lieu of the customer's required purchase, or a partial refund of the IAP. The most important modification in Taxpayer's practice is that it no longer is applying the IAP on a ratable basis. Beginning in Year5 and continuing through Year6, Taxpayer does not report the IAP in income based on units sold for the majority of its contracts. In essence, Taxpayer is deferring the IAP indefinitely for many of its long-term contracts.[3]

[2] Taxpayer cites two sources of authority for its GAAP treatment of the long-term contracts: SEC Staff Accounting Bulletin No. 104 and EIFT 91-6. The average contract price is computed by dividing the total quantity to be delivered by the total contract price.
[3] See Exhibit A for an example of a contract, its modifications, and Taxpayer's tax treatment thereof.

The concept of a "deferral fee" is new to Taxpayer in the current exam cycle. For one particular long-term contract, Taxpayer and its customer agreed that the customer was not obligated to purchase any Product in one particular calendar quarter. In return for Taxpayer's agreement to not enforce the take or pay feature of the original agreement, the customer agreed to pay a "deferral fee" of $v and to take delivery of the originally-specified quantity of Product in a later year.

Because Taxpayer was not shipping any Product for this particular period, it did not recognize any portion of the IAP for that contract for that period. In addition, Taxpayer represents that it recognized as current taxable income only one half of the deferral fee. The other half of the deferral fee was classified as a liability and will not be recognized until Taxpayer knows whether or not the customer will purchase Product in the next calendar quarter.

The modifications to the Customer1 contract are representative: In a letter dated Date5, the parties amended the Year3 agreement by extending to 90 days the payment terms for product delivered and agreed that Customer1 could resell in Year4 any of the Products referenced in the agreement, notwithstanding the agreement's original prohibition on resale. On Date6, the parties executed another amendment that changed certain quantities and refunded a portion of Customer1's advance payment. In yet another amendment effective Date7, the parties again changed the quantity and prices for the Products.

You have asked whether the Taxpayer may continue to defer recognition of the IAPs given the modifications to the contracts, or whether Taxpayer has changed its method of accounting to an improper method.

LAW AND ANALYSIS

The Code specifies allowable methods of accounting: the cash method, an accrual method, any method specified elsewhere in the Code, or any combination thereof permitted in the regulations. I.R.C. § 446(c). A method of accounting includes a taxpayer's overall method and the accounting treatment of any material item. Treas. Reg. § 1.446-1(a)(1). A taxpayer is free to adopt any method of accounting in accordance with generally accepted accounting principles, but the method must clearly reflect income. Treas. Reg. § 1.446-1(a)(2); Thor Power Tool v. Commissioner, 439 U.S. 522, 538-44 (1979). The Commissioner has "broad discretion in determining whether an accounting method clearly reflects income." Peninsula Steel Products & Equipment Co. v. Commissioner, 78 T.C. 1029, 1044 (citing Commissioner v. Hansen, 360 U.S. 446, 467 (1959)). When a taxpayer's method of accounting does not clearly reflect income, the Commissioner may impose on the taxpayer a method that does clearly reflect income. I.R.C. § 446(b).

The amount of any item of gross income is included in the taxable year in which the taxpayer receives it, unless, under the taxpayer's method of accounting, such amount is properly accounted for in a different period. I.R.C. § 451(a). 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 (the "all events test"). Treas. Reg. § 1.451-1(a).

Treas. Reg. § 1.451-5 contains an exception to the all events test for advance payments for goods received under long-term contracts. An "advance payment" means, in relevant part, any amount that is received in a taxable year by a taxpayer using an accrual method of accounting for sales pursuant to, and to be applied against, an agreement for the sale or other disposition in a future year of goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Treas. Reg. § 1.451-5(a)(1).

Advance payments must be included in income in the taxable year of receipt, the taxable year properly accruable under the taxpayer's method of accounting for tax purposes if inclusion occurs no later than it does for book purposes, or in limited circumstances, no later than the second year following the receipt of the advance payment. Treas. Reg. § 1.451-5(b)(1).

If a taxpayer has adopted a method of accounting under which it defers including advance payments in income, and the taxpayer's liability under the agreement otherwise ends, all advance payments received under that agreement, and which the taxpayer has deferred, must be included in gross income in the year the taxpayer's liability ended. Treas. Reg. § 1.451-5(f).

When a taxpayer has adopted a method of accounting, it generally must receive the Commissioner's consent to change that method of accounting. I.R.C. § 446(e). A change of accounting method includes a change in the treatment of a material item. Treas. Reg. § 1.446-1(e)(2)(i). A material item is, in relevant part, any item that involves the proper time for the inclusion of the item in income. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A change in the taxpayer's method of accounting also includes any change involving the adoption, use, or discontinuance of any specialized method of computing income. Id. Finally, when a taxpayer has adopted a method of accounting specified in the regulations, such as Treas. Reg. § 1.451-5, and the taxpayer's accounting is inconsistent with those regulations, the Commissioner has the authority to change the taxpayer's method. Thor Power Tool, 439 U.S. at 533.

Deferral Fees

We see no legal basis for Taxpayer's failure to recognize as current taxable income any of the "deferral fees" it collects pursuant to contract amendments.[4] These deferral fees are not advance payments under Treas. Reg. § 1.451-5(a). An "advance

[4] Taxpayer indicated to you that it agrees the deferral fees cannot be deferred, but it has not signed an agreement to this change, so we address the issue here.

payment” is any amount to be applied against an agreement for the sale of goods in a future year. Treas. Reg. § 1.451-1(a)(1). We have studied one such contract at issue,[5] and the deferral fees are not applied to the sale of goods in a future year. Instead, the deferral fees are consideration for Taxpayer’s agreement to defer to a later year the customer’s required purchase of a specific volume of Product. We see nothing in the contract that states that this deferral fee is to be applied to reduce the price of Product shipped in the future, so Taxpayer’s deferral of any portion of the deferral fee is improper under Treas. Reg. § 1.451-5. Taxpayer simply has received consideration for a contract amendment, has dominion and control over such receipt, and cannot point to any provision of the Code or any regulation that would allow it to exclude any portion of the amount from current income. Taxpayer therefore must recognize the entire amount of any deferral fee in the year such fee was earned.[6]

Initial Advance Payments

Taxpayer adopted the Treas. Reg. § 1.451-5 Advance Payments for Goods method of accounting when it first began accruing and/or receiving IAPs in Year2. The question presented by the modifications to Taxpayer’s long-term contracts in Year4, Year5, and Year6 is whether those changes are so significant that Taxpayer’s liability under the original contracts “otherwise ended” (within the meaning of Treas. Reg. § 1.451-5(f)), which would require Taxpayer to recognize as current income the balance of its deferred IAPs. If Taxpayer’s liability did not “otherwise end” with respect to some or all of its contracts, we still must determine if Taxpayer’s method of accounting for the IAPs is consistent with Treas. Reg. § 1.451-5.

There is no guidance in Treas. Reg. § 1.451-5 regarding when a taxpayer’s liability under a long-term contract ends, other than when a taxpayer dies or ceases to exist in a transaction other than one to which I.R.C. § 381(a) applies, neither of which applies here. We therefore find it helpful to look to contract law to determine when a liability ends. There are no reported cases that address the specific issue in this case.

Michigan law provides that, in general, parties to a contract may agree to alter it, add to it, or remove provisions from it. See, e.g., Quality Prods. & Concepts Co. v. Nagel Precision, Inc., 469 Mich. 362, 364 (2003); see also Port Huron Educ. Ass'n MEA/NEA v. Port Huron Area Sch. Dist., 452 Mich. 309, 326 (1996). The parties may, for example, change the terms of performance, including the time performance is due, or the compensation due. Waller v. Sloan, 225 Mich. 600, 603 (1923); Soltys v. Soltys, 336 Mich. 693, 697 (1953); General Motors Corp. v. Enterprise Heat & Power Co., 350 Mich. 176, 178 (1957). Contracting parties even may amend or modify a contract

[5] “ ,” between Taxpayer and Customer2, effective Date8.

[6] For the Customer2 contract, the agreement was executed in Year6 and specifies that Customer2 agrees to pay the deferral fee by Date9, so Taxpayer must accrue the deferral fee income in Year6.

despite a provision in the original agreement contains an anti-modification clause. Quality Prods. & Concepts Co., 469 Mich. at 364.

Depending on the circumstances of the contract modifications, a contract that the parties have amended by mutual consent may be considered a new agreement, and the original contract may be considered abandoned. See, e.g., Fenner v. Bolema Const. Co., 330 Mich. 400 (1951). Like contract modifications, "[t]he abandonment of a contract is a matter of intention to be ascertained from the facts and circumstances surrounding the transaction from which the abandonment is claimed to have resulted. R.M. Taylor, Inc. v. General Motors Corp., 187 F.3d 809, 813 (8th Cir. 1999) (citing Dault v. Schulte, 31 Mich. App. 688 (1971). In Fenner, for example, a construction company agreed to pay a subcontractor $5 per hour for a bucket and crane and one operator to do excavating on the job. 330 Mich. at 401. After the subcontractor encountered difficulties at the site, the parties agreed to change the terms: The subcontractor would instead use a different method of excavating and would be paid $1 per foot for excavating and backfilling work with a bulldozer at the rate of 85 cents per foot. Id. The construction company denied that it had entered into any amended agreement and paid the subcontractor the amount it believed was due under the original contract. Id. at 402. The subcontractor sued to collect the additional amount he believed he was due under the amended agreement. Id.

The Michigan Supreme Court held that the issue of whether the parties modified the original agreement was a question of fact, and the jury reasonably found that the parties changed the original contract. Id. When it became clear it would become more expensive and take more time for the subcontractor to complete the work as required under the original agreement, the parties agreed to change both the manner in which the work was to be done and the amount the subcontractor would be paid. Id. at 403. Under these circumstances, the Court held, "It was a deliberate abandonment and extinction of the future obligations, if any, of the parties under the old agreement." Id. (emphasis added).

As evidence that contract abandonment is a highly factual issue, the U.S. Court of Appeals for the Eighth Circuit, applying Michigan law, held that a contract was not abandoned when a party issued a large number of emergency change orders. R.M. Taylor, Inc. v. General Motors Corp., 187 F.3d 809 (8th Cir. 1999). One of the keys to the Eighth Circuit's holding was that the contract at issue explicitly allowed emergency field orders (change orders). 187 F.3d at 813 (citing Fenner, in which the contract did not contain any change order clause). Because GM acted within the terms of the contract in issuing the field orders, the changes did not cause it to abandon the original contract. Id.

The facts of each contract we have examined show that Taxpayer and its customers abandoned the original long-term supply agreements with the subsequent amendments. Although the original agreements allowed mutually-agreed modifications, the substance of each of the modifications is that they created new agreements. The original agreements all contained take or pay provisions, under which Taxpayer agreed to sell and its customers agreed to buy certain minimum quantities at specified prices. The original agreements contained provisions specifying the quantity for each year during the contract term; the parties changed these amounts in subsequent amendments, some of which were yearly changes. The original agreements also provided that only very specific changes may be made to the price each customer agreed to pay, yet the parties agreed to lower prices in subsequent years. The original agreements also all required advance payments, which Taxpayer agreed to refund (in part) in at least one case. The subsequent amendments substituted new price, quantity, and performance terms that were so different from the original they rendered the original a nullity.

The amendments to Taxpayer's agreements are factually similar to the contract modifications in Fenner. Performance under the original long-term supply agreements "became infeasible and undesirable," Fenner, 330 Mich. at 403, for Taxpayer's customers because the market for Product was so changed that the contract prices were unreasonable. Taxpayer and its customers therefore agreed that Taxpayer "should be compensated in an amount to be arrived at by a different measure," id., or by different minimum quantities. The changes to Taxpayer's agreements therefore represented "a deliberate abandonment and extinction of the future obligations, if any, of the parties under the old agreement." Id. As the Michigan Supreme Court noted in Fenner, "Under such circumstances, the rights of [the] parties were thereafter fixed by the terms of the new agreement regardless of whether there was full performance, part performance or breach, and on no possible theory could they be held to be governed by the first agreement." Id. Here, the magnitude and frequency of the changes (in some cases, every year) to the long-term agreements, and the fact that the changes go to the very heart of the agreements (advance payments, price, and quantities), show that the parties intended that the original agreements be abandoned. Therefore, Taxpayer's liability under the original agreements has "otherwise ended" under Treas. Reg. § 1.451-5(f), and Taxpayer is required to immediately recognize any deferred revenue attributable to those agreements.

For these contracts where Taxpayer has stopped shipping goods, it appears Taxpayer has abandoned, often by mutual agreement, the contract obligation itself. The fact that Taxpayer argues this abandonment is temporary and that it will, at some future time, ship goods under the contract is not sufficient. As described above, these agreements all contained take or pay provisions; Taxpayer's forbearance changes critical terms of the agreements and represents a "deliberate abandonment and extinction of future obligations" under the agreements. Fenner, 330 Mich. at 403. This situation is rife with the potential for abuse in allowing the unlimited deferral of IAPs already received. Taxpayer cannot point to any specific provision in Treas. Reg. § 1.451-5 that allows this open-ended deferral of income recognition. Because the substance of these amendments is that Taxpayer's obligation to ship goods (and the customer's obligation to pay for the goods) under the take or pay agreements has ended, Taxpayer is required to immediately recognize all IAPs otherwise deferred for those. Treas. Reg. § 1.451-5(f).

Improper Method of Accounting

Even if Taxpayer's liability under the contracts did not end, its method of accounting for the advance payments no longer is consistent with Treas. Reg. § 1.451-5. We recommend you propose in the alternative that Taxpayer has improperly changed its method of accounting, or is not properly using the advance payment method, for advance payments under Treas. Reg. § 1.451-5. Taxpayer received IAPs, applied them to shipments in the early years of each agreement, and then stopped, even as it continued to ship goods under those contracts.[7]

Treas. Reg. § 1.451-5(b) provides that the IAP is includible in income either in the taxable year of receipt or in the taxable year that income is accrued for book purposes. In general, Taxpayer recognizes income from the sale of goods as it ships those goods. Yet Taxpayer continued to ship goods under some contracts beginning November Year5 and did not recognize any of the IAPs associated with those contracts. This is a change in method of accounting and is improper.

Taxpayer's failure to recognize any IAP when it ships goods is an accounting method change because it has changed the time when it recognizes the IAP as taxable income. This change is not a mere change in fact, because none of the underlying facts have changed; Taxpayer received IAPs in earlier years and only has changed how it recognizes those advance payments.

Taxpayer's failure to recognize any IAP when it ships goods is improper because this method does not comport with Treas. Reg. § 1.451-5(b). Treas. Reg. § 1.451-5(b) allows a taxpayer to defer recognizing advance payments to the time when it would otherwise recognize income under its method of accounting. Here, Taxpayer recognizes income for both book and tax purposes when it ships goods. Therefore, the failure to recognize any IAP when goods are shipped violates Treas. Reg. § 1.451-5(b).

Because Taxpayer's failure to recognize any IAP when goods are shipped violates the rule in Treas. Reg. § 1.451-5(b), and because Taxpayer changed how it accounts for the IAP without securing the consent of the Commissioner, as required by I.R.C. § 446(e), Taxpayer's method of deferring the IAP even when goods are shipped is improper, and its change to that method also was improper.

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[7] Taxpayer indicated informally that it was prepared to file amended returns to recognize a portion of the IAP as it shipped goods. Although it appears Taxpayer has conceded its original returns were incorrect in not recognizing any IAP even when goods were shipped, we address this issue here because Taxpayer has not yet filed any amended returns, and because the law regarding changes in methods of accounting is relevant to the other issues you have raised.

You also could propose that Taxpayer is no longer allowed to use the advance payment method of accounting because the nature of the contract amendments makes Treas. Reg. § 1.451-5 inapplicable in the first instance, and because it impossible to test if the IAPs fall within the "inventoriable goods" rules in Treas. Reg. § 1.451-5(c).

The frequent amendments to Taxpayer's agreements establish that the price, quantity, and types of Product are highly variable, often subject to multiple changes within a single year. This variation makes it impossible to compute the average contract price. Taxpayer has argued that GAAP rules require it to recognize income on long-term contracts at the average contract price, but if it cannot compute an average price, we question whether Taxpayer is using a proper method of accounting for book purposes. It appears that Taxpayer should revert to recognizing income for all purposes – at invoice price – when it ships goods. In this instance, it is not clear why Taxpayer would be allowed to continue deferring the IAPs under Treas. Reg. § 1.451-5.

The frequent amendments also make it impossible to test whether the "inventoriable goods" exception in Treas. Reg. § 1.451-5(c) applies. The inventoriable goods exception states:

> If a taxpayer receives an advance payment in a taxable year with respect to an agreement for the sale of inventory goods, and on the last day of such taxable year the taxpayer—
>
> (a) Is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes;
>
> (b) Has received "substantial advance payments" . . . with respect to such agreement; and
>
> (c) Has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year;

Then all advance payments received with respect to such agreement by the last day of the second taxable year after they are received must be included in income in that second taxable year. A taxpayer has received "substantial advance payments" when all advance payments received with respect to an agreement equal or exceed the total costs and expenditures reasonably estimated as includible in inventory with respect to such agreement. Treas. Reg. § 1.451-5(c)(3).

In this case, we know the goods to be delivered, because the agreements specify the type of Product (although the parties may later change that type by mutual agreement, as shown in the subsequent amendments). We also know the amount of the IAP for each agreement. And the original contracts specify the total quantity that Taxpayer must deliver. Therefore, sufficient information exists in each of the <u>original agreements</u> to make the "substantial advance payments" computation.

When Taxpayer amended its agreements, however, it became impossible to calculate whether it had received substantial advance payments for any particular contract. Or, calculations have to be done so frequently as to render the exception moot. Taxpayer has, in fact, stopped computing the average price for each contract and the deferral of the excess invoice price over the average price. We take that change as Taxpayer's admission that it also could not calculate whether it has received "substantial advance payments." Therefore, because it cannot do so, it should not be allowed to use Treas. Reg. § 1.451-5 as an accounting method.

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Please call if you have any further questions.

Associate Area Counsel
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By: ______________________________

Attorney
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