INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-143011-02/CC:ITA:B6

Director, Field Operations
Natural Resources & Construction, LMSB

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Fiscal Year Involved:

Date of Conference:

LEGEND:

Taxpayer =
Date 1 =
Year 1 =

ISSUES:

(1) Whether Taxpayer’s change of reporting income from the sale of certain products is a change in accounting method requiring the Commissioner’s consent or a change in underlying fact.

(2) Whether Taxpayer’s present treatment of reporting income from the sale of certain products clearly reflects income for federal income tax purposes.

CONCLUSIONS:

(1) Taxpayer’s change of reporting income from the sale of certain products is a change in accounting method requiring the Commissioner’s consent and not a change in underlying fact.

(2) Taxpayer’s present treatment of reporting income from the sale of certain products does not clearly reflect income for federal income tax purposes.

FACTS:

Taxpayer, a publicly-held corporation, provides telecommunications systems and related products and services to its customers. Taxpayer uses an overall accrual method of accounting. A majority of the sales agreements entered into by Taxpayer for its systems and related products and services are completed within twelve months, however, some of the agreements entered into at the end of its taxable year are not completed within that taxable year. Generally, Taxpayer has three types of systems: (1) small systems that do not require customization; (2) complex systems that require significant customization and an extended period of time to complete; and (3) small systems that require limited customization and take typically a couple of months to complete. This technical advice memorandum addresses the method of recognizing income only with respect to the third type of system, i.e., small systems that require limited customization.

Prior to Date 1, for small systems that require limited customization, Taxpayer recognized income as soon as it completed a material amount of its obligations, e.g., after the testing and certifying by it of the system. Taxpayer asserts that this method of recognizing income was consistent with generally accepted accounting principles ("GAAP"), and noted that it was not raised as an issue in previous examinations by the Internal Revenue Service.

Effective Date 1, Taxpayer, for both financial reporting and federal income tax purposes, changed its procedures for recognizing income with respect to small systems that require limited customization in accordance with Securities and Exchange Commission (SEC) regulations for income recognition by publicly traded companies. Specifically, Taxpayer adopted Staff Accounting Bulletin No. 101, 17 C.F.R. pt. 211 (1999) ("SEC SAB 101"). Under SEC SAB 101, income should not be recognized until it is realized or realizable and earned. Id. (citing Recognition and Measurement in Financial Statements of Business Enterprises, Statement of Financial Accounting Concepts No. 5 (Financial Accounting Standards Bd. 1985).

SEC SAB 101 provides that income generally is realized or realizable and earned when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable, and (4) collectibility is reasonably assured. Id. Accordingly, Taxpayer now recognizes income for small systems that require limited customization when there is persuasive evidence that an arrangement exits, when the related hardware and software are delivered and any installation or post-delivery obligation has been fulfilled, when the fee is fixed or determinable and when collection is reasonable assured. In applying this standard, Taxpayer recognizes income upon "formal acceptance" from the customer, i.e., the customer accepts the product and agrees that all post-delivery obligations have been fulfilled. At that time, often an acceptance form is completed by the customer. Taxpayer believes that formal acceptance from the customer provides a more objective point in which to recognize income. However, as a consequence of implementing SEC SAB 101, the point at which Taxpayer recognizes income for small systems that require limited customization has changed, although the contractual terms used by Taxpayer for its sales have not changed. Taxpayer represents that SEC SAB 101 is in accord with GAAP.

In materials submitted by Taxpayer, Taxpayer indicated that at approximately the same time it adopted SEC SAB 101 for financial reporting and federal income tax purposes, the circumstances of its business changed. These changes included a significant increase in sales of telecommunication systems as a result of the acquisition of a competitor in Year 1; the sales of more complex telecommunication systems; a greater emphasis on customer-testing of systems; and a higher degree of tuning the systems to meet customer satisfaction.

Taxpayer also submitted a representative copy of its sales agreement and related documents for review and consideration. The sales agreement submitted by Taxpayer provides that delivery of a system will be made F.O.B. Taxpayer's place of business, and explicitly provides that title and risk of loss pass to the customer upon delivery to the carrier. Insurance is paid by the customer. It also provides that final payment is due upon the "installation date" of the system. The sales agreement defines "installation date" as the time when Taxpayer's employees test and certify the functionality of the system, or when the customer uses the system.

The sales agreement further provides that within 10 days of such certification customer agrees to provide written notice if the system is non-conforming. In such a case Taxpayer has 90 days to re-certify the functionality of the system. If Taxpayer cannot do so the customer may return the system and receive a refund of any amounts paid. However, if an order is cancelled at the customer's request, Taxpayer is entitled to reasonable cancellation charges which shall not exceed the price of the items cancelled, but which shall include expenses incurred prior to the cancellation date including direct charges, properly allowed indirect charges, and a reasonable profit. Cancellation shall not affect customer's obligation to pay for items shipped prior to the cancellation date.

In addition to a sales agreement, Taxpayer submitted copies of the certification form, and a letter for customers whose systems are in the "final stage of acceptance testing." Both documents request that the customer formally accept the system and that the project manager be alerted if there are issues that prevent acceptance of the system.

Based on the foregoing facts, the director contends that Taxpayer changed its method of accounting under section 446 of the Internal Revenue Code when it changed from its former income recognition method to its present standards for recognizing income in accordance with SEC SAB 101 for small systems that require limited customization. Taxpayer contends, however, that there was no change in method of accounting and that any change in the treatment of income recognition resulted from a change in underlying facts, including the changes in the circumstances of its business as indicated above. Further, Taxpayer represents that it changed its method of recognizing income for book purposes to comply with SEC SAB 101 (which it contends is consistent with GAAP), and therefore, changed its method for federal income tax purposes to conform to book purposes during the same period.

APPLICABLE LAW:

Section 446(e) sets forth the requirement respecting a change of accounting method, which is that except as otherwise expressly provided in chapter 1, a taxpayer who changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(2)(i) of the Income Tax Regulations provides that except as otherwise provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping its books shall, before computing its income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Code or the regulations thereunder.

Section 1.446-1(e)(2)(ii)(a) provides, in part, that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of an item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(b) provides, in part, that a change in the method of accounting does not include a change in treatment resulting from a change in underlying facts.

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.

Section 1.446-1(a)(2) provides, in part, that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily by regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy (the "all-events test"). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Comm’r, 372 U.S. 128, 133 (1963).

ANALYSIS:

(1) Whether Taxpayer’s change of reporting income from the sale of certain

> products is a change in accounting method requiring the Commissioner's consent or a change in underlying fact.

It is well established that for federal income tax purposes a change in a method of accounting involves changing a reporting result by the application of a different rule to the same facts, rather than the application of the same rule to different facts. See e.g., Federated Dept. Stores v. Comm'r, 51 T.C. 500 (1968), nonacq. on other grounds, 1971-2 C.B. 4, aff'd, 426 F.2d 417 (6th Cir. 1970). There, the Tax Court noted that

> [a] change of accounting must be with respect to a 'material item....' Fundamentally, the item itself must be basically the same as an item previously accounted for with the present method of accounting differing from the prior treatment. Unless the transactions are basically the same, the accounting treatment would not be a 'change' of accounting but only a 'new' accounting method for a different transaction.

Id. at 513-14. An example of a change in underlying facts is provided in the regulations and involves a change in accruing liability for vacation pay due to the adoption of a vested vacation pay plan. See section 1.446-1(e)(2)(iii)(Ex. 3). There, an accrual basis taxpayer deducted vacation pay in the year in which paid because it did not have a completely vested plan, hence, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed. Id. Similarly, in Decision, Inc. v. Comm'r, 47 T.C. 58 (1966), acq., 1967-7 C.B. 2, the Tax Court refused to consider the taxpayer's change in billing policy and practice as a change in accounting method. The court found that although the change had consequences in the annual determination of income, such consequences were not produced by the accounting system. Id. at 64. Moreover, the court noted that the "kind of business policy change was no different from a decision to lower prices or halt production for a year" and to hold that the taxpayer changed its method of accounting as a result of that "would have the effect of denying a business the right to determine the terms of sale of its product without clearing the matter with the Commissioner..., clearly an odious propagation of the tentacles of the Government anemone." Id.

Unlike the taxpayers in Example 3 of the regulation and Decision, Inc., supra, in this case Taxpayer changed the way it recognizes income from the sale of small systems that require limited customization as a result of employing a completely different and new accounting income recognition rule (i.e., SEC SAB 101) to the same set of facts. Taxpayer even acknowledged in its submissions that the contractual terms used for the sale of the small systems prior to the application of SEC SAB 101 are the same as the terms used for the sale of such systems after implementing SEC SAB 101. In fact, the only change was the method in which Taxpayer recognizes income from the sale of small systems that require limited customization. Moreover, the fact that Taxpayer's business picked up as a result of increased sales resulting from the acquisition of a competitor and greater focus on customer satisfaction, also did not cause the shifting of income recognition. The sale of telecommunication systems was basically the same after the acquisition as it was previously, with the present method of accounting differing from the prior treatment. The fact Taxpayer sold more and focused on customer satisfaction is of no consequence. In this case, the application of the present accounting system (i.e., SEC SAB 101) affects the annual determination of income by causing a deferral of sales revenues. Therefore, the change to SEC SAB 101 for purposes of reporting such income constituted a change in method of accounting and not a change in underlying fact.

Taxpayer also argues that because its present method of accounting accords with GAAP, it should be proper for federal income tax purposes. Courts have steadfastly held that GAAP is not conclusive in this regard. See Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) (a method consistent with generally accepted accounting principles does not necessarily clearly reflect income). Moreover, Taxpayer's changing of its procedures for recognizing income with respect to small systems that require limited customization for financial reporting purposes does not excuse its failure to obtain the Commissioner's consent prior to changing its procedures for federal income tax purposes. See section 446(e) and the regulations thereunder.

(2) Whether Taxpayer's present treatment of reporting income from the sale of certain products clearly reflects income for federal income tax purposes.

The Commissioner is vested with broad discretion in determining whether a particular method of accounting employed by a taxpayer clearly reflects the taxpayer's income. Thor Power Tool Co., 439 U.S. at 532. Whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis. Ansley-Sheppard-Burgess Co. v. Comm'r, 104 T.C. 367, 371 (1995). In general, however, a method of accounting clearly reflects income when it results in accurately reported taxable income under a recognized method of accounting. RLC Industries Co. v. Comm'r, 98 T.C. 457, 490 (1992).

Under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Section 1.451-1(a). For accrual method taxpayers, it is the right to receive an amount and not the actual receipt that determines the inclusion of the amount in gross income. Spring City Foundry Co. v. Comm'r, 292 U.S. 182 (1934). In the case of a taxpayer selling goods, the taxpayer's inventory is reduced and a claim for the purchase price arises at the time the sale is made. Id. at 185. Until a sale occurs, the required performance has not occurred to fix a taxpayer's right to receive income under the first part of the all-events test of section 1.451-1(a). Therefore, a taxpayer selling goods generally accrues income from the sale of goods at the time of the sale.

An accrual basis taxpayer must report income in the year the right to such income accrues, despite the necessity for mathematical computations or ministerial acts. The Charles Schwab Corp. & Includible Subsidiaries v. Comm'r, 107 T.C. 282 (1996) aff'd. 161 F.3d 1231 (9th Cir. 1998); Continental Tie & Lumber Co. v. United

States, 286 U.S. 290, 295-297 (1932). The fact that a taxpayer cannot presently compel payment of the money is not controlling. Hansen v. Comm'r, 360 U.S. 446 (1959). In applying the all-events test, courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income. Charles Schwab Corp., 107 T.C. 282.

The terms of a taxpayer's sales agreement are relevant in determining when the all-events test is met. Rev. Rul 98-39 1998-2 C.B. 198. See also Decision, Inc. 47 T.C. at 63; Hallmark Cards Inc. v. Comm'r, 90 T.C. 26 (1988). Taxpayer's sales agreements relating to sales of small systems that require limited customization provide that payment is due upon the "installation date," i.e., when Taxpayer's employees test and certify that the system meets the functionality requirements, or when the customer uses the system. Under Taxpayer's former method of accounting for these sales, income was recognized when these additional services (i.e., test and certify) were performed. Under Taxpayer's present method of accounting for these sales, income is recognized when the customer formally accepts Taxpayer's system. This technical advice memorandum addresses whether Taxpayer's present method clearly reflects income, and this analysis is limited to this issue. Thus, we assume that although the goods have been shipped and title and other indicia of ownership have passed, additional substantial performance is required of Taxpayer under the specific agreements in question.

Under Taxpayer's sales agreement acceptance of a system is assumed when a designated number of days pass after Taxpayer's testing and certifying of the system. It is clear that Taxpayer's right to the income under sales agreements that require certification of functionality is fixed no later than the "installation date" as defined by the agreement; when the system is tested and certified by Taxpayer, or used by the customer. At this point the sale is complete, Taxpayer has performed its obligations under the agreement, and the right to bill arises. Additionally, the amount due can be determined with reasonable accuracy.

Taxpayer asserts that formal acceptance of the system by the customer is a condition precedent to the right to the income. In support of this position Taxpayer cites cases holding that customer acceptance was a condition precedent to the accrual of income. However, the contracts of sale at issue in these cases support the courts' conclusion in each of these cases. See Ringmaster, Inc. v. Comm'r, 21 T.C.M. 1024 (1962), dismissed per curiam, 319 F.2d 860 (8th Cir. 1963); Webb Press Co. Ltd. v. Comm'r, 3 B.T.A. 247 (1925), acq. 1927-1 C.B. 6.

In Ringmaster, Inc., 24 T.C.M. 1024, the taxpayer contracted for the sale of ring binders to the United States. The contract in question provided that all supplies shall be subject to inspection and testing by the Government prior to final acceptance. The Government also expressly reserved the right to terminate the contract. The court held that these provisions operated to create a condition precedent which prevented a completed sales transaction from arising until inspection and tests had been made. In contrast, Taxpayer's sales agreements pass title, risk of loss, and the benefits and burdens of ownership when the goods are shipped, not when the customer accepts the goods, and the customer's right to terminate the agreement or reject the goods is limited.

In Webb Press, 3 B.T.A. 247, the taxpayer contracted for the sale of a cotton press. "The contract for the sale of the cotton compress reserved the title in the taxpayer, provided for substantial cash payments, and made provision for payments by notes after a test and acceptance by the purchaser." Id. at 253. The court held that the income from the sale did not accrue until the cotton press was accepted by the purchaser. However, the terms of the contract in this case, unlike the sales agreement under consideration presently, reserved title in the seller until the purchaser accepted the machine.

The determination of when a sale occurs requires consideration of all the facts and circumstances of a particular situation. Clodfelter v. Comm'r, 426 F.2d 1391 (9th Cir. 1970); Commissioner v. Segall, 114 F.2d 706 (6th Cir. 1940); Baird v. Comm'r, 68 T.C. 115, 124 (1977). The courts have consistently held that the transfer of ownership is completed upon the passage of title or passage of the benefits and burdens of ownership, whichever occurs first. See Dettmers v. Comm'r, 430 F.2d 1019 (6th Cir. 1970). Taxpayer points out that an important factor to consider in determining whether a sale of property has occurred is whether under the applicable sales agreement the seller has an unqualified right to receive the contract price. Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930). In North Texas Lumber Co., the Supreme Court held that a sale of timber land was not complete when the buyer notified the seller of its intent to exercise an option since an unqualified right to the contract price had not vested in the seller. Again, in this case title and the right of possession had not been tendered to the buyer, thus the sale was not complete. Id at 13. See also Hallmark Cards, 90 T.C. 26 (possession tendered, but title and risk of loss remained with the seller).

When Taxpayer's employee has completed any required testing and certifying Taxpayer has performed the last act necessary to earn the income under the sales agreement. Although the customer is entitled to test the system for 10 days, this is not a condition of the completion of the sale. The sales agreement provides that the customer agrees to notify Taxpayer if the system does not conform. There is only a chance that additional services will be required. If the system is found not to meet the agreed upon functionality requirements Taxpayer has 90 days to re-certify the system. The sales agreement limits the customer's right to cancel the agreement. Under the terms of the sales agreement the customer may only reject the system if Taxpayer cannot certify the functionality of the system within 90 days. Thus, only Taxpayer's extended inability to cure a non-conforming system will result in the extinguishment of Taxpayer's right to receive the income.

Even if the terms of the sales agreement made acceptance of the system a condition precedent to the right to receive the income, formal acceptance would generally not be required for the right to the income to attach. See Dally v. Comm'r, 227 F.2d 724 (9th Cir. 1955) (contractor's right to income was in the year it delivered a house, not in a later year when a properly certified invoice was submitted, even though the contract specifically provided for payment upon the submission of a properly certified invoice); Rev. Rul. 98-39, (accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year the services are performed, not when the required claim form is submitted). The return of an acceptance form by the customer is merely a ministerial act, and is not required to establish Taxpayer's right to the income under the all-events test. See also Continental Tie and Lumber Co., 286 U.S. 290.

Taxpayer also raises the application of section 1.451-5. The director and Taxpayer agreed in a pre-submission conference that the application of section 1.451-5 was not at issue and would not be addressed in this technical advice memorandum. However, this argument is merely a recasting of Taxpayer's argument that it's obligations under the sales agreement are not performed, and the sale is not complete until the customer formally accepts the system. As discussed above, this interpretation is not supported by the express terms of Taxpayer's sales agreement.

In a further attempt to bolster its contention that the sale is not complete until the customer accepts the system, Taxpayer submits that the "intent of the parties" is that the sale is only complete upon customer acceptance. Also, it is Taxpayer's practice to invoice the final payment only after notification of the customer's acceptance is received. The sales agreement submitted is Taxpayer's standard sales agreement, and we consider its terms to represent the legal rights and obligations of the parties. See Danielson v. Comm'r, 378 F.2d 771 (3rd Cir. 1967), cert. denied, 389 U.S. 858 (1967), on remand, 50 T. C. 782 (1968), ("a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, fraud, duress, etc."). In the absence of such proof, Taxpayer is held to the specific terms of its sales agreement.

It is not proper for Taxpayer to recognize income from the sale of small systems that require limited customization when the customer formally accepts the system. Under the terms of the sales agreement submitted, Taxpayer's right to the income is not dependent on formal acceptance by the customer. Pursuant to section 1.451-1(a), the right to the income is fixed when the system is tested and certified by Taxpayer or used by the customer. Taxpayer's present method of accounting defers the inclusion of income that Taxpayer has a fixed right to receive, and the amount of the income can be determined with reasonable accuracy. Therefore, Taxpayer's present method of reporting sales income for small systems that require limited customization does not clearly reflect income.

CAVEAT:

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.