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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL,

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL, FIELD SERVICE
CC:DOM:FS

SUBJECT: Mutual Fund Distributor's 12b-1 Fee Income and Commission Expenses

This Field Service Advice responds to your memorandum dated October 12, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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ISSUES

1. Whether a mutual fund distributor using the accrual method of accounting should include the fees earned with respect to mutual fund shares in the year that the shares are issued or in the year the fees are received.

2. Whether a mutual fund distributor using the accrual method of accounting may deduct commissions paid to broker dealers with respect to the issuance of mutual fund shares in the year the commissions are paid or incurred.

CONCLUSIONS

1. The 12b-1 fees at issue cannot be reasonably estimated at the time the shares are sold; thus, they cannot be accrued into income until actually paid to the distributor.

2. Further factual development is necessary to answer this question.

FACTS

We ask that you further develop the facts in this case. Further factual development may establish that the "facts" used herein are incorrect.

A, the taxpayer, is the distributor of approximately g mutual funds sponsored and advised by various banks and investment advisors. The taxpayer is a registered broker-dealer pursuant to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq., and is a member of the National Association of Securities Dealers.

B is registered as an open-end management investment company pursuant to the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. (the "40 Act"), and is the sponsor of approximately f different series of mutual funds. As a registered investment company, B is not permitted to directly or indirectly finance the distribution of its mutual funds except under a plan adopted pursuant to 17 C.F.R. § 270.12b-1 ("Rule 12b-1"), promulgated pursuant to section 12(b) of the 40 Act. Furthermore, as a p, C, the parent of B, for regulatory purposes may not act as the distributor of mutual funds.

B and the taxpayer entered into a Distribution Services Agreement (“Agreement”), a plan adopted pursuant to Rule 12b-1 (a “Rule 12b-1 Plan”). Under the Agreement, B appointed the taxpayer as the distributor of the mutual funds to sell the shares to the public. The taxpayer markets and merchandises the shares, trains and supervises its registered representatives, reviews advertisements and sales literature for compliance with various securities laws, and qualifies the shares for sale under the securities laws of the various states. As distributor, the taxpayer is required to use its “best efforts” to sell the shares and to conform with the requirements of all federal and state laws. Under the Agreement, the taxpayer receives fees (“12b-1 fees”) to help finance the costs of marketing the shares. B calculates the 12b-1 fees and distributes the fees to the taxpayer on a monthly basis. Because a mutual fund’s net asset value (“NAV”) changes daily, the 12b-1 fees cannot be precisely calculated at the time the shares are sold. The 12b-1 fees reduce B’s earnings.

B offers Class A and Class B mutual fund shares for sale to, and issues the shares directly to, investors. The only commission expenses at issue are those relating to the Class B shares. To purchase the Class B shares, the investor can either contact B directly or can purchase the shares through an independent broker-dealer or other financial institution. When the investor contacts B directly, the investor is referred to a broker-dealer associated with B, usually E, which will be the investor’s broker-dealer.

An investor who purchases shares directly from B can either mail a check to E, payable to B, or he may wire money to D, the transfer agent (“Transfer Agent”). The investor never writes a check payable to the taxpayer. The investor must also send to B a completed account application. The shareholder of record will be the investor if he purchases shares directly from B. When an investor contacts B directly by calling the B telephone number, the investor will speak with an individual who is identified as a registered representative of the taxpayer. This individual is actually an employee of the Transfer Agent.

An investor who purchases shares from an independent broker-dealer pays for the shares by sending a check to the broker-dealer payable to the broker-dealer. An investor also may use a bank or other financial institution to purchase shares. Either the investor or the broker-dealer may be the shareholder of record.

The broker-dealer completes all of the investor’s paperwork and informs the Transfer Agent of the purchase. The Transfer Agent records the trade in B’s records and informs the taxpayer of the trade. E or an independent broker-dealer forwards the payment to the Transfer Agent, and the Transfer Agent sends the money to the B custodian account. The Transfer Agent issues a confirmation sheet to the investor for the purchase. B then issues the Class B shares to the investor.

Pursuant to the terms of the Agreement, "Shares purchased by [the taxpayer] are to be resold by [the taxpayer] to investors at the public offering price. . . ." The taxpayer has the following rights:

> to buy from the Trust [B] the Shares needed to fill unconditional orders for unsold Shares of the Funds as shall then be effectively registered under the Securities Act placed with [the taxpayer] by investors or securities dealers or depository institutions or other financial intermediaries acting as agent for their customers. Alternatively, [the taxpayer] may act as the Trust's [B's] agent, to offer, and to solicit offers to subscribe to, unsold Shares of the Funds. . . .

The investor must pay the following to purchase the Class A shares: (1) an amount equal to the average daily NAV of the shares of the mutual fund; (2) an initial sales charge; and (3) a 12b-1 fee. The broker-dealer receives the initial sales charge, and the taxpayer receives the 12b-1 fees. Typically, the 12b-1 fee equals h% of the NAV of the mutual fund attributable to those shares. The fees are not calculated based upon the taxpayer's actual costs incurred in marketing and distributing the mutual fund shares.

To purchase the Class B shares, the investor must pay: (1) an amount equal to the NAV of the shares and (2) a 12b-1 fee. The investor pays no upfront sales charge, but upon redemption of the shares, he will be subject to a contingent deferred sales charge ("CDSC") if he held the shares fewer than seven years. The 12b-1 fee for the Class B shares, typically j% of the average daily NAV attributable to those shares, consists of a distribution servicing fee equal to i% of the average daily NAV and a maintenance fee equal to h% of the average daily NAV. Upon redemption of Class A or Class B shares, the investor must either send the Transfer Agent the redemption order or call the Transfer Agent; the Transfer Agent redeems the shares for the investor.

The CDSC is equal to a percentage of the lesser of either the original purchase price of the Class B shares, or the NAV of the Class B shares at the time of redemption. The percentage of the CDSC declines from k% in the first two years after the purchase of the Class B shares to l% in the seventh year after the purchase of the shares. After seven years, the Class B shares automatically convert to Class A shares, and the investor is no longer liable for the CDSC.

The aggregate amount of fees and CDSCs received by the taxpayer for any class of shares of any mutual fund is limited by the Agreement, and cannot exceed m% of the total issue price, plus interest, plus an additional n% per year.

Both B and the taxpayer can terminate the Agreement at any time upon 60 days' written notice. The Rule 12b-1 Plan can also be terminated. If the Rule 12b-1 Plan is terminated (other than by a "complete termination"), the taxpayer will continue to receive its allocable portion of the 12b-1 fees and the CDSCs until the earlier of either four years after the date of the contract cancellation, or such time as there exist no outstanding amounts due to the taxpayer. A complete termination occurs when the directors have determined it is in the best interests of the shareholders and of the mutual fund. Upon complete termination, the CDSC is not altered, the mutual fund does not pay the 12b-1 fee to another party, and the fund does not adopt another Rule 12b-1 Plan for a similar class of shares. If there is a complete termination of the taxpayer's contracts, the taxpayer will be paid only the CDSCs.

The taxpayer uses the accrual method of accounting. The taxpayer treats the 12b-1 fees as income in the year the taxpayer receives them. The taxpayer treats the commissions it pays to the broker-dealer as ordinary and necessary business expenses and currently deducts them.

LAW AND ANALYSIS

1. Timing of Income for Fees Earned

The 12b-1 fees are paid to the taxpayer monthly and are computed and accrued daily as a percentage of the average daily NAV of the mutual fund. The taxpayer in some instances also receives CDSCs. The Agreement provides that the taxpayer will be deemed to have fully earned its distribution fees upon the sale of shares. For tax purposes both of these sources of income are included in income in the year received. The request for assistance focuses only on the timing of income for the 12b-1 fees.

I.R.C. § 451(a) provides that the amount of any item of gross income shall be included in 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.

Treas. Reg. § 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"). See also Treas. Reg. § 1.446-

1(c)(1)(ii)(A). 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. Commissioner, 372 U.S. 128, 133 (1963); Rev. Ruls. 84-31, 1984-1 C.B. 127, and 80-308, 1980-2 C.B. 162.

In this case, because the taxpayer is deemed to have earned the distribution fee upon the sale of the shares, all events fixing the taxpayer's right to receive the distribution fee income occurs when the shares are sold notwithstanding that distribution services may be performed after the sale occurs. A case involving a similar issue is Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996), aff'd, 161 F.3d 1231 (9th Cir. 1998), cert. denied, 120 S. Ct. 67 (1999).

In Schwab, the issue was the timing of commission income for stock sales. The trade date is the day a trade occurs, and is the day on which a customer's order is executed by locating a seller or purchaser for securities. Subsequent to trade execution, taxpayer performs functions of recording, figuration, confirmation, comparison, and booking. The settlement occurs on the date that payment is transferred from buyer to seller and certificates from seller to buyer.

Taxpayer argued that its commission was earned upon delivery of the securities and payment of the purchase price, which is the settlement date. It argued that the acts performed subsequent to the trade date were integral parts of the service for which it is paid a commission and represents a substantial percentage of the brokerage services provided. Respondent argued that the execution of the order on the trade date was the essential service and marks the time at which taxpayer's right to receive and the customer's obligation to pay the commission arose. Actions remaining to be performed after the trade date are ministerial and effectuate the mechanics of the transfer and merely confirm the trade executed. The court agreed that the income fixing event was the execution of a trade and the subsequent functions effectuating the mechanics of the transfer and confirmation of the trade were ministerial acts. 107 T.C. at 282. The possibility that a trade might not be settled was a condition subsequent to the trade execution, which was the event fixing the right to commission income. Id., citing Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 217-18 (2d Cir. 1952), aff'g in part and rev'g in part, 16 T.C. 882 (1951).

The second prong of the all events test requires that the amount of the income be determined with reasonable accuracy. That is, estimates for purposes of the all events test must be made with facts and procedures available to the taxpayer at the end of the taxable year, and whether the estimate is reasonably accurate depends on the validity and reliability of the methodology used in making the estimate. Esco

Corp. v. United States, 750 F.2d 1466, 1468 (9th Cir. 1985) (discussing the all events test for accrued deductions under section 461).

Accrual of income is not required (and is prohibited for deductions) if the full amount cannot be determined with reasonable accuracy. Thus, where it is obvious that some amount will be paid to the taxpayer as a result of a transaction, but the full amount has yet to be determined, accrual of some arbitrarily determined amount is not required. For example, if an accrual method taxpayer using a calendar year provides services to his client during December and January, with the charge to be determined after all services have been rendered, no amount of income will be accrued at the end of the first year even though it is obvious that the December services alone entitle the taxpayer to some amount of income. Stephen F. Gertzman, Federal Tax Accounting 4-16 (2d ed. 1993). See also Kinkead v. Commissioner, 35 T.C. 152 (1960), acq. 1961-2 C.B. 4 (No amount of service income accruable at end of taxpayer's taxable year where amount to be paid was to be determined by payor two months later based on what was fair and reasonable for the services rendered; the measure of income depended upon future events and contingencies). Similarly, a reasonably accurate determination of the amount can not be made where the amount is determined by reference to the value of stock that fluctuates significantly. See Rev. Rul. 72-32, 1972-1 C.B. 48.

In this case, the FSA request states that 12b-1 fees are based on daily NAV and how long shares will be outstanding, neither of which are determinable in advance. Yet, it is suggested that the taxpayer may have in its own books and records data that will permit it to predict changes in the net asset value of its mutual funds and to predict how long shares will be outstanding. This view is based on Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 296 (1932) (income to be received can be determined with reasonable accuracy when the taxpayer has in its own books and accounts, data to which it can apply the calculations required to make a reasonable estimate of the amount).

But, the books and records at issue in Continental Tie were needed to calculate operating income for two periods of time. The Court recognized that "some degree of exercise of opinion and judgment was involved," Id. at 296, ". . . [b]ut in spite of these inherent difficulties we think it was possible for a carrier to ascertain with reasonable accuracy the amount of the award to be paid by the Government." Id. at 297. The petitioner had instructions issued by the "Commission, of the method to be followed in allocating charges to operation during periods under inquiry. It does not appear that a proper effort would not have obtained a result approximately in accord with what the Commission ultimately found. . . . The books and accounts fixed the maximum amount of any probable award, and if petitioner had endeavored to make reasonable adjustments of book figures it could have arrived at a figure to be accrued for the year 1920." Id. at 297-98.

We believe that the estimate required in Continental Tie is far more predictable than attempting to predict the NAV of mutual funds, based on the stock market, which obviously fluctuates greatly based on many types of worldwide social and economic events which are entirely unpredictable. We do not view Continental Tie as authority for requiring income accrual under the facts of this case.

2. Deduction of Sales Commissions

a. Is the Distributor a Dealer in Securities; Is Capitalization Required

The first issue to be resolved is whether the distributor is a dealer in securities within the meaning of Treas. Reg. § 1.263(a)-2(e). If the distributor is a dealer then the commissions may be deducted in the year paid or incurred. Otherwise, the deductibility of those expenditures is dependent upon whether the expenditures result in the creation or enhancement of a separate and distinct asset or whether they result in a long-term future benefit.

Special rules govern the treatment of commissions paid by securities dealers. Treas. Reg. § 1.162-1(a) provides that commissions are among the items included in business expenses. For dealers in securities, section 263 of the Code does not otherwise require capitalization of those expenses. Treas. Reg. § 1.263(a)-2(e) provides that commissions paid in selling securities are an offset against the selling price, except that dealers in securities may treat selling commissions as an ordinary and necessary business expense. Under this latter regulation, dealers in securities may deduct the commissions paid to sell securities.

A dealer in securities is not defined in sections 162 and 263 or in regulations under either of those sections. Treas. Reg. § 1.471-5, which provides a definition of a dealer in securities, is relied upon by the courts to determine if a taxpayer is treated as a dealer in securities for purposes of section 263. See, e.g., Helvering v. Fried, 299 U.S. 175 (1936); Stephens, Inc. v. United States, 464 F.2d 53 (8th Cir. 1972). Under this regulation a dealer is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is one who as a merchant buys securities and resells them to customers for the gains and profits derived therefrom. Treas. Reg. § 1.471-5. Similarly, the 40 Act, 15 U.S.C. § 80a-2(a)(11), provides that a dealer is any person regularly engaged in the business of buying and selling securities for his own account. Whether a particular person is a dealer is a factual question and the courts examine various factors to determine dealer status. Higgins v. Commissioner, 312 U.S. 212, 217 (1941); Kemon v. Commissioner, 16 T.C. 1026, 1032 (1951), acq. 1951-2 C.B. 3.

The incoming advice request discusses various cases analyzing the factual question of the definition of a dealer in securities and supporting the view that the taxpayer at issue should not be treated as a dealer because it does not and cannot buy and sell mutual fund shares as a principal but acts merely as an agent.

The most important factor in determining if a person is a dealer is whether that person, as a principal, purchases securities and resells them to customers. This addresses the central requirement that a dealer act as a merchant. A dealer buys and sells on his own account, not as an agent for another, and earns a profit from the mark-up on the sale or other dealer concession. Helvering v. Fried, 299 U.S. at 176. See also Securities Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 207, 217-218, n.17-18 (1983). In Fried, the dealer at issue regularly and consistently engaged in purchases and resales of the securities and always had the securities it specialized in on hand; that is, they were actually received and delivered. Also, in Seeley v. Commissioner, 77 F.2d 323 (2d Cir. 1935), the court held that a floor trader was not a dealer because he purchased for customers of a firm with which he was associated, and not for himself. See also Securities Indus. Ass'n, supra. A person who purchases and sells securities, but does not transact business with customers, is not a dealer. Customers are important because dealers are viewed as profiting from bringing sellers and buyers together and not from changes in the value of securities. Without customers a person cannot act as a middleman and, therefore, cannot be a dealer.

If the distributor is not a dealer, whether the commissions require capitalization must be addressed. As noted in the request for FSA, section 162(a) provides a deduction for an accrual method taxpayer only when an expenditure is an ordinary and necessary expense incurred during the taxable year and made to carry on a trade or business. See Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971). There is no dispute that the commission expenses were incurred in the taxable years at issue, nor is it disputed that the expenditures were "necessary" in the accepted sense of "appropriate and helpful" in the carrying on of the taxpayer's business as distributor. The resolution of this issue turns on whether the commissions were "ordinary." The principal function of the term "ordinary" in section 162(a) is to clarify the distinction between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the life of the asset. FMR Corp. & Subsid. v. Commissioner, 110 T.C. 402 (1998), appeal docketed, No. 99-1073 (1st Cir. Dec. 15, 1998).

An expenditure that creates or enhances a separate and distinct asset or generates a significant long-term benefit is a capital expenditure, not an "ordinary" expense. See INDOPCO v. Commissioner, 503 U.S. 79, 87-88 (1992); Lincoln Savings & Loan, 403 U.S. 345; FMR Corp, 110 T.C. 402. An appropriate inquiry in deciding issues of capitalization is "the duration and extent of any benefits that the taxpayer received from its expenditures." FMR Corp., supra; Connecticut Mut. Life Ins. Co. & Consol. Subs. v. Commissioner, 106 T.C. 445, 453 (1996).

In FMR, supra, the court decided the capitalization issue on whether the expenditure provided the taxpayer with a significant long-term benefit. In that case, the taxpayer was the sole distributor of the shares of Fidelity mutual funds (Fidelity's Regulated Investment Companies or RICs). The majority of the RICs managed by the taxpayer were "open-end" mutual funds, like in the instant case. Each of the mutual funds followed a distinct investment approach. As in the instant case, the taxpayer's activities in creating and managing the various RICs were governed by the 40 Act, which requires that the management contracts between an adviser and a mutual fund have an initial term of 2 years, be renewable annually thereafter, and be terminable at will by the mutual fund's board of trustees upon 60 days notice without penalty. The 40 Act also requires that the initial management contract and all annual renewals be approved by a majority of independent directors/trustees.

The principal issue in FMR was whether the taxpayer was entitled to a section 162(a) deduction for expenditures incurred in launching 82 RICs in the years in issue. These expenditures included costs to develop the concept for each RIC, to develop the initial marketing plan, to draft the management contract, to form the RICs, to obtain the board of trustees' approval of the contract, and to register the new RICs with the Securities and Exchange Commission ("SEC"). The court refused to determine whether the management contract with each mutual fund represented a separate and distinct asset (the contracts were signed prior to the sale of any fund share and, thus, prior to the fund having any value), but focused its examination of the duration and extent of any benefits the taxpayer received from its expenditures. Despite the termination provision contained in the 40 Act, the court found that in the experience of the mutual fund industry, it is highly unusual for a management contract to be either terminated or not renewed; contracts are only canceled upon a finding of fraud or continued mismanagement.

In examining whether the taxpayer derived a long-term benefit from the start-up expenditures, the court looked to whether those expenditures "secured an advantage to the taxpayer which has a life of more than one year." The court found that the start-up expenses incurred by the taxpayer resulted in a benefit to the taxpayer which could be expected to produce returns for many years in the future and, therefore, were not deductible.

Expenditures that benefit current operations generally are deductible. In this regard, benefits such as repeat business, increased market share or the expansion of an existing business are not sufficient to require capitalization. See Rev. Rul. 2000-4, 2000-4 I.R.B. __.

In Lykes Energy, Inc. & Subs. v. Commissioner, T.C. Memo. 1999-77, the taxpayer was a public utility that distributed natural gas in Florida and was subject to regulation by the Florida Public Service Commission ("PSC"). Pursuant to the Energy Efficiency and Conservation Act ("FEECA") the PSC required the taxpayer to design and administer programs that would reduce consumption of high cost petroleum and lower electrical energy consumption.

The taxpayer operated several programs generally designed to accomplish these goals. The programs at issue increased the taxpayer's rate base, number of customers and sales. A portion of the costs of each such program consisted of subsidies for people who bought gas appliances for the taxpayer or an affiliate while the remaining portion of the costs of each program were promotional or selling expenses unrelated to a specific sale. The future benefits resulting from the programs were the same regardless of the portion of the cost that constituted a subsidy for current sales of appliances. In either event, future benefits resulted from the cost of the program being included in the taxpayer's rate base, the increase in the number of customers. In allowing a current deduction for the portion of each program related to sales of appliances, the court reasoned that the amounts at issue benefitted the taxpayer currently by inducing customers to purchase appliances. Accordingly, an immediate deduction was allowed even though the amounts at issue also resulted in future benefits such as repeat business and sales of related products or commodities. In contrast, the court required capitalization of the portion of the cost of each program that was not related to sales of appliances. In reaching this result, the court reasoned that the increase in the number of customers and the resulting revenue from these customers was a significant future benefit.

In order to determine whether the taxpayer is a dealer and in order to evaluate whether the commissions must be capitalized, we recommend that you verify certain facts discussed below.

b. Must Commission Expenses Be Amortized over the Same Period that Related Fees are Taken into Income

For purposes of discussion, we will assume that commission expenses are deductible in order to consider the argument that the doctrine of clear reflection of income requires that related items of income and expense be taken into income and deducted at the same time.

The incoming memorandum takes the position that in order to clearly reflect income, the commission expenses must be amortized over the period that the 12b-1 fees are earned and reported as income. Specifically, the memorandum focuses on the mismatch of the accrual of 12b-1 income and the accrual of immediate deductions for the related commission expenses.

Under GAAP, costs and expenses are generally required to be deducted in the same period as the revenues to which those costs and expenses relate. R. Wixon, Accountants' Handbook, 1.17 (4th ed. 1965). The objective of matching is thus that costs and expenses directly identifiable with particular revenues be deducted in the same period or periods in which those revenues are recognized. Although some cases may suggest that the matching principle of financial accounting (requiring related items of income and expense to be recorded in the same taxable year), is also a dominant element of accrual tax accounting in order for income to be clearly reflected, this is not true. Gertzman at 4-51. The matching principle is certainly relevant in testing whether a particular method clearly reflects income for tax purposes, but matching is not of itself the determinative test for finding a fixed liability or for permitting a deduction. Id. That is, a goal of matching income and expenses does not defeat the proper timing for income and deductions under the all events test. Thus, an accrued deduction should be taken even though related to an income item not yet recognized.

Under American Automobile Assn. v. United States, 367 U.S. 687 (1961), a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenue contrary to generally accepted commercial accounting principles. American Auto., 367 U.S. at 690. Furthermore, the Court indicated that to say that an accounting method used by a taxpayer "is in accord with generally accepted accounting principles and practices...is not to hold that for income tax purposes it so clearly reflects income to be binding on the Treasury." Id. at 693. This concept was expanded upon by the Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979), when it discussed the vastly different objectives that financial and tax accounting have (financial: useful information to management, shareholders, etc.; tax: equitable collection of revenue) and given "this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable."

"Accrual of an item as income in a particular year is not required merely because the expenses attributable to that item were deducted from gross income in that year. . . . As a practical matter, the income tax laws must operate on an annual basis, and there is no assurance under either an accrual or cash basis of accounting that there will be complete correlation between items of income and deductions pertinent thereto." Marquardt Corp. v. Commissioner, 39 T.C. 443, 453 (1962), acq. as to this issue, 1965-2 C.B. 6. See also Irby v. Commissioner, 30 T.C. 1166, 1175 (1958), corrected & aff'd, 274 F.2d 208 (5th Cir. 1960) ("Under either the cash or the accrual method, it is possible that expenses, paid or accruable, may be deductible in a year that is either prior or subsequent to the year in which the income related to such expenses is includible. . . . This is simply the result of the facts that taxable income must be computed on an annual basis, and that the computation of taxable income does not necessarily follow business accounting practices.")

Similarly, in Marcor, Inc. v. Commissioner, 89 T.C. 181 (1987), nonacq., 1990-2 C.B. 1, the taxpayer sold certain goods that required preparation and installation. The costs of such preparation and installation were deducted currently while the income from the sales was deferred under the installment method. The Commissioner sought to have the court deny the current deduction on the basis that the resulting mismatch of related items of income and expense did not clearly reflect income. The court disagreed, stating that taxpayer complied with all requirements relating to inventory costing and use of the installment method, and that clear reflection of income implements and does not contradict statutory and case law.

Also, in Koebig & Koebig, Inc. v. Commissioner, T.C. Memo. 1964-32, taxpayer accrued as income amounts billed during the year, but it deducted expenses actually incurred, even when expenses were incurred after the last billing date. The Commissioner sought to disallow the deduction of expenses incurred after the period to which the bill related. The court rejected a precise matching argument and found the taxpayer's income was clearly reflected.

> The fact that an accrual method of reporting income does not always give a precise matching of income and expenses does not mean that it does not clearly reflect the income. . . . the Commissioner is not empowered to reconstruct income on some other system to secure more favorable tax results. . . . It is immaterial that the method used by the Commissioner

> in recomputing income . . . would also clearly reflect income or would result in a more precise matching of income with expenses.

Id.

In Fidelity Assoc., Inc. v. Commissioner, T.C. Memo. 1992-142, the Tax Court rejected the Commissioner's attempt to require an accrual method taxpayer to defer its deduction of selling expenses and commissions on the basis of the clear reflection of income standard. The court held that the deductions in question satisfied the all events test, did not create an asset having a useful life extending substantially beyond the end of the taxable year, and could not be deferred on the basis of any asserted mismatching.

Lastly, we will comment on two cases cited in the incoming memorandum. In Shelby Salesbook Co. v. United States, 104 F. Supp. 237 (N.D. Ohio 1952), we are unable to determine from the facts discussed in the opinion when all the events occurred to fix the fact of the taxpayer's liability for commissions paid to its salesmen. If, as seems possible, the fact of liability for "commissions paid or credited to salesmen's accounts on orders not shipped until the following year" was fixed as of the end of the taxable years in question, we would currently take the position that such year end commissions are deductible, notwithstanding that the related income is not accruable until the succeeding year. Under the facts of this case, though, the taxpayer was seeking a change in method of accounting which requires approval by the Commissioner; a change in method of accounting may not be made retroactively, as sought by this taxpayer. See Diebold, Inc. v. United States, 891 F.2d 1579, 1583 (Fed. Cir. 1989).

We agree with the Tax Court's opinion in Johnson v. Commissioner, 108 T.C. 448 (1997), aff'd in part, rev'd in part, 184 F.3d 786 (8th Cir. 1999). With respect to the payments to the VSC administrator, the Tax Court allowed amortization (fees may be recognized in equal annual increments over the maximum time period provided for in the contract to which they relate). 108 T.C. at 491. In contrast, the 8th Circuit sanctioned an immediate deduction. 184 F.3d 786.

We note that the 8th Circuit's discussion of this issue is devoid of analysis, cites no case law, and resulted in an unvarnished beneficial result for the taxpayer ("matter of fairness"; "It is not fair. . . ." Id.). We strongly disagree with the 8th Circuit's approach in allowing a deduction for the administrators' fee.

In conclusion, we strongly recommend against pursuing a mismatch of income and expense/clear reflection of income argument as an alternative argument to either the income or deduction side of this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We have had many discussions and meetings during which additional factual development was discussed, much of which was memorialized, resulting in a comprehensive list of questions and additional facts to develop. We shall not repeat all of the questions and additional facts to develop here, but shall only emphasize the more significant ones.

In order to determine whether the taxpayer is a dealer and in order to evaluate whether the commissions must be capitalized, we recommend addressing the following:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Please call if you have any further questions.

CAROL P. NACHMAN
Acting Technical Assistant
Field Service Division