



That's Not Income, That's a Discount—The Ninth Circuit Corrects the Tax Court  
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## **Advance Payments of Discounts**

The Ninth Circuit Court of Appeals recently reversed the Tax Court in its holding in *Westpac Pacific Foods v. Commissioner*, (TC Memo 2001-175), holding that payments received by Westpac as advance payment of purchase discounts were not income in the year received, but only would come into income via inventory as the goods were purchased to satisfy the organization's obligations to various suppliers.

This case is interesting to compare with the holding we discussed in *Karns Prime and Fancy Food* (TC Memo 2005-233). Note that Karns is another Tax Court case, but unfortunately for Karns their appeal would not go to the Ninth Circuit.

## **WestPac Facts**

Westpac was a partnership of three grocery chains (Raley's, Save Mart and Bel Air) that was to purchase and warehouse inventory. The partnership entered into supply agreement

with GTE Sylvania (for light bulbs), Ambassador (for Hallmark cards), American Greetings (for bows, wrapping paper, etc.), and McCormick (spices). In each case, the vendor advanced Westpac funds in exchange for supply agreements that, among other things, obligated Westpac to purchase certain amounts of goods from each supplier and if they failed to meet those purchase commitments that a prorata portion of the prepayment had to be repaid.

In reality, in two cases (GTE Sylvania and American Greetings) Westpac failed to meet the goals, terminated the agreement and paid back a prorata share of income.

## **IRS Position and Original Tax Court Decision**

The IRS believed that the taxpayer had income in the amount of the advances. The Tax Court initially agreed with them, and summarized the position in its opinion:

Section 61 broadly defines gross income as "all income from whatever source derived". See also sec. 1.61-1(a), Income Tax Regs. In interpreting a predecessor to section 61, the Supreme Court determined that the broad statutory language evidenced congressional intent to tax all gains except those specifically exempted. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). The Court concluded that the payments in dispute in *Glenshaw Glass Co.* constituted gross income, describing them as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 431.

Section 451 sets forth the general rule that an item of income shall be included in the taxpayer's gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used by the taxpayer in computing taxable income, such amount is to be properly accounted for in a different period. Westpac was an accrual method taxpayer. Under the accrual method of accounting, income is included in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. See sec. 1.451-1(a), Income Tax Regs. The right to receive income becomes fixed at the earliest of (1) required performance, (2) the date payment becomes due, or (3) the date payment is made. See *Schlude v. Commissioner*, 372 U.S. 128, 133, 137 (1963); *Charles Schwab Corp. v. Commissioner*, 107 T.C. 282, 292 (1996), *affd.* 116 F.3d 1231 (9th Cir. 1998); *Cox v. Commissioner*, 43 T.C. 448, 456-457 (1965).

Pursuant to the above-described principles, Westpac was required to include the advance trade discounts in income for the taxable year in which such discounts were received. Westpac had unfettered use of the cash payments in the years in which respondent seeks to include them in income. Accordingly, Westpac had "actual command over the property taxed -- the actual benefit for which the tax is

paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

The Tax Court, as in *Karns*, rejected the application of the *Indianapolis Power and Light* case (493 U.S. 203) arguing that in this case the amounts were not similar to the customer deposits in that case, rather arguing the key issue was whether or not the taxpayer now had income in line with the Supreme Court's holding in a different case, that of *Glenshaw Glass Co.* (348 U.S. 426).

Westpac appealed the case to the Ninth Circuit.

## A Different View

The Ninth Circuit views the matter a bit differently, as becomes clear in the introductory paragraph of the decision written by Judge Kleinfeld. He writes:

It is hard to think of a way to make money by buying things. A child may think buying things is how one makes money: he sees his father give a clerk a single piece of paper money, and receive in exchange the goods purchased, several pieces of paper money, and a number of coins. And a person may jokingly say to a spouse "I made \$100 today" after buying something on sale for \$100 off. But everyone knows these are merely amusing remarks, not real ways to make money.<sup>1</sup>

The facts outlined below sound more complicated than they are, so imagine a simple hypothetical. Harry Homeowner goes to the furniture store, spots just the right dining room chairs for \$500 each, and says "I'll take four, if you give me a discount." Negotiating a 25% discount, he pays only \$1,500 for the chairs. He has not made \$500, he has spent \$1,500. Now suppose Harry Homeowner is short on cash, and negotiates a deal where the furniture store gives him a 20% discount as a cash advance instead of the 25% off. This means the store gives him \$400 "cash back" today, and he pays \$2,000 for the four chairs when they are delivered shortly after the first of the year. Harry cannot go home and say "I made \$400 today" unless he plans to skip out on his obligation to pay for the four chairs. Even though he receives the cash, he has not made money by buying the chairs. He has to sell the chairs for more than \$1,600 if he wants to make money on them. The reason why the \$400 "cash back" is not income is that, like a loan, the money is encumbered with a repayment obligation to the furniture store and the "cash back" must be repaid if Harry does not perform his obligation.

This case is that simple, except that it involves a little more math and a lot more money. The taxpayer promised to buy a lot of items and received cash in advance as its discount on its future, high-volume purchases. Using accrual accounting, the taxpayer treated the up front cash discount as a liability when it was received, just like a loan. As goods were sold, the taxpayer applied the discount pro rata to

the full purchase price it paid.<sup>2</sup> The net effect was that Westpac reduced its cost of goods sold and increased its reported profit (and thus its taxable income). The taxpayer reported pro rata amounts without matching sales as miscellaneous or other income.

<sup>1</sup>About the only obvious way to make money by buying things is to buy back one's own debt at a discounted rate, as when a corporation purchases its outstanding bonds at less than par. See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 2 (1931).

<sup>2</sup>The government argues that there is no evidence that Westpac was actually purchasing the goods at the full list price. We give this argument very little credence. The Tax Court -- and each party to the various contracts -- consistently treated the advance "payments" as discounts on the volume Westpac agreed to purchase. Further, Westpac actually repaid the pro rata portion of the advance discount on the contracts for which it did not meet the volume requirement. In short, nothing in the record supports the government's argument that the up front money was a payment for entering into the contracts or anything other than an advance discount.

While the outcome of the decision is telegraphed very clearly from this introduction, the analysis is what we are interested in, especially since at first glance this case doesn't appear radically different from the *Karns* case we discussed earlier.<sup>1</sup>

The Ninth Circuit panel starts from the following basic outline of the relevant provisions of the law to start their analysis:

The statutory definition of gross income is expansive.<sup>9</sup> *Commissioner v. Glenshaw Glass Co.* held that punitive damages received by a successful litigant were "income" because they were "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."<sup>10</sup> The government argues that the cash advances in this case fit that definition because Westpac had "complete dominion" over the money. It did not have to put the cash in a trust account and could spend the money as it chose. But that leaves out sine qua non of income: that it be an "accession to wealth." One may have "complete dominion" over money but it does not become income until it is an "accession to wealth." That is why borrowed money is not income, even though the borrower has "complete dominion" over the cash.<sup>11</sup> "Because of this [repayment] obligation, the loan proceeds do not qualify as income to the taxpayer."<sup>12</sup>

<sup>1</sup> Note that the *Karns* decision would have to be appealed to the Third Circuit, so even if *Karns* is appealing the case in question, this decision doesn't necessarily mean it's a closed case that the Tax Court will be reversed on appeal.

<sup>9</sup> 26 U.S.C.A. § 61(a).

<sup>10</sup> See *Glenshaw Glass*, 348 U.S. at 431.

<sup>11</sup> See *CIR v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207 (1990) (Explaining that "it is well settled that receipt of a loan is not income to the borrower.").

<sup>12</sup> *CIR v. Tufts*, 461 U.S. 300, 307 (1983).

To the Ninth Circuit, there were three key Supreme Court cases that differentiate between items that would count as income vs. items that would not count when we have “unearned revenue” from an accounting view. Those cases were *Indianapolis Power and Light* (493 U.S. 203 (1990)) on one hand and *Automobile Club of Michigan v. CIR*, 353 U.S. 180 (1957) and *Schulde* (372 U.S. 128 (1963)) on the other.

In *Indianapolis Power and Light* the Supreme Court held that security deposits received by the utility from customers were not income, but rather more like loans. The Court noted that the deposits were required to be paid back when service ended. So even though Indiana Power and Light had full dominion and control of the funds when received, the transaction was more like a loan than income.

On the other side was the *Automobile Club of Michigan* case which involved prepaid membership dues received by the club. There the Supreme Court held the amounts received were income, despite the fact that the prepayment had to be recorded as unearned revenue under generally accepted accounting principles. The Court emphasized that although the organization was obligated to provide services over the next year, the prorata application of the deferred revenue to income bore no relationship to the services actually performed—members did not each ratably demand the services.

Similarly, the Supreme Court held in *Schulde* that payments for ballroom dancing lessons were required to be counted as income when received. In the *Schulde* case, the payments were not refundable and the studio was allowed to keep the fees for the lessons even if the student didn't show up for the lessons.

The Ninth Circuit had to decide whether *Westpac* more closely matched the facts in *Indianapolis Power and Light* or those in *Automobile Club of Michigan* and *Schulde*. The Ninth Circuit determined that the case more closely approximated the facts in *Indianapolis Power and Light* and therefore decided the amounts could be excluded from income.

How did they arrive at this conclusion. Well, it's best to first look at the facts for one of the four contracts as the Ninth Circuit noted in its decision. The GTE Sylvania contract was analyzed as follows:

In July of 1990, Westpac made a deal with the Sylvania Lighting division of GTE Products Corp. to (1) make GTE Sylvania its exclusive lightbulb supplier

for Westpac and its member stores for four years; (2) "aggressively and regularly" advertise and promote GTE Sylvania's products; (3) dedicate on average at least 12 lineal feet of shelf space to GTE Sylvania's products in its member stores; and (4) purchase \$17 million in lightbulbs during the term of the agreement. Given Westpac's volume purchase commitment, GTE Sylvania agreed to pay Westpac \$1.1 million as an "unearned advance allowance." GTE Sylvania paid this to Westpac by check, and agreed to pay Westpac another \$200,000 on the first, second, and third anniversaries of the agreement, provided that GTE Sylvania was satisfied with Westpac's warehouse distribution arrangement. The contract refers to the total \$1.7 million in payments as the "Westpac Allowance" and contains the following clause:

Upon termination of this Agreement, Westpac will reimburse GTE Sylvania on a pro-rated basis for any portion of the Westpac Allowance advanced to Westpac but not earned due to the failure by Westpac to purchase at least \$17.0 million in lamps.

During Westpac's 1991 tax year, GTE Sylvania paid the first \$200,000 to Westpac.

Westpac could not resell enough lightbulbs to meet the minimum volume the contract called for, so it terminated the arrangement in October of 1994.

Westpac's termination letter acknowledged its obligation to pay back a pro-rated portion of the Westpac Allowance, and it repaid \$861,857 to GTE Sylvania in December.

A similar analysis is performed for the other contracts. While arguably the result did not depend on the fact that Westpac actually repaid part of the fees, it certainly did not hurt the "smell" of their case on appeal and the Ninth Circuit did point out that fees were actually repaid.

The Ninth Circuit gives their conclusion in the following paragraph:

This case is like *Indianapolis Power*, not *Automobile Club of Michigan* or *Schlude*. The cash advance trade discounts are like the security deposits in that they are subject to repayment, and unlike the membership dues in that the recipient cannot keep the money regardless of what happens after receipt. Westpac could only retain the full, up front trade discount if it met the volume requirements. Like the security deposit, the cash advance is subject to repayment. The only difference is that the repayment amount in this case may not be the full amount advanced by the vendor, but that is because the repayment amount is reduced pro rata to the extent Westpac fails to fulfill its volume commitment.

Because the taxpayer here has to pay the money back if the volume commitments are not met, it is not an "accession to wealth" as required by *Glenshaw Glass*.

Westpac either has to buy a specified volume of goods for more than it would otherwise pay or pay back the money, just like Harry Homeowner. Thus the cash advance discounts are, like a loan or customer security deposit, liabilities rather than income when received.

The Ninth Circuit also noted that it felt it needed to apply its prior decision in a case involving the NFL's Oakland Raiders, *Milenbach v. CIR*, 318 F.3d 924 (9th Cir. 2003). In that case, the court held that the Raiders did not have to immediately recognize as income a \$6.7 million loan it received, the terms of which provided that the loan would only be paid out of revenue from luxury suites to be built in the future, suites that never were actually built by the Raiders. The court held that the obligation was real even if, in fact, it never ended up being actually paid. The court pointed out that *Westpac* not only had an actual obligation, but they in fact actually did repay part of that obligation.

## Reconciling to Karns

The Tax Court also considered *Indianapolis Power and Light* in the *Karns*. To the Tax Court the key lesson from *Indianapolis Power of Light* involved whether the taxpayer or a third party was in control of whether the amount would need to be repaid. As the court noted in its opinion in the *Karns* case (TC Memo 2005-233):

We turn now to petitioner's reliance on the statement in *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 210 (1990), that "In determining whether a taxpayer enjoys 'complete dominion' over a given sum, \* \* \* The key is whether the taxpayer has some guarantee that he will be allowed to keep the money." According to petitioner,

There was no guarantee in April of 1999 that the Petitioner would meet the purchase obligations or other obligations under the Supply and Requirements Agreements for the ensuing six years. Accordingly, there was no guarantee that future debt service payments would be forgiven. \* \* \*

\* \* \* \* \*

Even if one assumes that on the anniversary date the Petitioner had met the purchase requirements under the Supply and Requirements Agreement, there was still no guarantee that the debt service payment would be forgiven because the Note required "that the borrower is in compliance with, and shall not have materially breached or then be an uncured default, under the Supply Agreement" \* \* \*.

Petitioner's contentions in reliance on *Commissioner v. Indianapolis Power &*

*Light Co.*, supra, miss the point that the Supreme Court established in that case. The issue presented in *Indianapolis Power & Light Co.* was whether certain deposits that the taxpayer, a power company, received from its customers were income. In resolving that issue, the Supreme Court analyzed whether the taxpayer enjoyed "complete dominion" over such deposits. The Supreme Court held that the taxpayer did not have "complete dominion" over the deposits in question because it did not have "some guarantee" that it would be allowed to keep them. *Id.* According to the Supreme Court, by making timely payments of their respective utility bills, the customers, and not the taxpayer, controlled whether the taxpayer would be required to return the deposits that it received from such customers. *Id.* at 209. In contrast to the situation presented in *Indianapolis Power & Light Co.*, Super Rite did not have control over the events that petitioner asserts would have constituted a material breach by it of the April 16, 1999 supply agreement and that would have required petitioner to repay a portion or all of the \$1.5 million at issue that it received from Super Rite. See *id.*; see also *Herbel v. Commissioner*, 106 T.C. 392, 416-417 (1996), *affd.* 129 F.3d 788 (5th Cir. 1997). On the record before us, we find that petitioner had "some guarantee" that, for each annual period covered by the April 16, 1999 supply agreement and the corresponding April 15, 1999 note, it would be allowed to keep the amount of the annual payment set forth in that note as long as, for each such period, it lived up to its end of the bargain by not materially breaching the April 16, 1999 supply agreement. See *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. at 209, 212; *Herbel v. Commissioner*, supra.

Based on that analysis, Westpac would be in a similar position to Karns—it had the ability to control the repayment since it was the entity that had to perform (by purchasing product) in order to avoid having to repay the advances. Similarly, had the Ninth Circuit's view of *Indianapolis Power* been applied to Karns, it seems clear the result would be different. So we have a clearly different view of what the true implications of *Indianapolis Power and Light* decision are with regard to prepayments of purchase discounts that have an obligation to repay if volume goals are not met.

## IRS View

The IRS position in this area became more "hard line" this week, as the IRS announced that they would not follow the Tax Court's holding in *Erickson Post Acquisition v. Commissioner* (TC Memo 2003-218) where cash payments received from a wholesaler to a retailer that were stated as a loan, but which were expected to be repaid via future discounts.

In that case, the Tax Court did not require the taxpayer to pick up the amount in income, in fact differentiating the case from the original *Westpac* decision against the taxpayer as follows:

The focus is on the obligation created at the time of the transaction. In *Westpac Pac. Foods v. Commissioner*, supra, and *Colombo v. Commissioner*, supra, when the payments were made, the recipient of the funds had no obligation to repay the funds. That obligation would arise later if and when the recipient breached its underlying obligation to purchase the products. Here, when Amoco paid the \$175,000 to petitioner, petitioner had an unconditional obligation to repay the full amount of the advance.

It's important to note in *Erickson Post* that the agreements, even presuming that the taxpayer was in full control of keeping the agreement in force (something not absolutely clear from the opinion), would not have paid off the advance—the taxpayer was obligated to 10 annual principal payments, but had only a five year initial supply agreement with Amoco. The facts in this case caused the Tax Court to view the transaction as a loan rather than income.

However, as noted, the IRS does not agree with this position. Therefore, it is safe to presume that in virtually any advance payment situation the IRS is going to assert taxable income to the taxpayer on the date of payment. While that position now appears less than solid in the Ninth Circuit, outside their jurisdiction it seems likely that taxpayers are not going to find the IRS willing to give on this issue without the taxpayer being required to litigate it. As well, it seems highly unlikely that the IRS will follow *Westpac* other than for cases that would be appealed to the Ninth Circuit.

An interesting aside is to be found in TAM 200605010 where the IRS allows a taxpayer to offset rebates from suppliers against inventory, pointing out in a footnote that so long as the payments are not made in advance the taxpayer doesn't trip over the inclusion of income required in the initial *Westpac* Tax Court decision. *Westpac* held for the immediate inclusion into income of the amounts received, which the TAM indirectly notes would not have been required if the payments had been made as the discounts were earned. In the latter case, the IRS agrees that the payment could be attached to inventory.

In fact, even the examining agents involved in this TAM were not asserting that was not the case—rather, the key question in the TAM was whether the payments were for services rendered to the vendor outside the purchasing of goods, something that the National Office ruled was not what was happening regardless of some unfortunate language in the agreements.

## Conclusions

Where do we stand? Well, probably more confused than we were after *Karns*—and we weren't terribly clear on this point then. However, both the IRS and the Ninth Circuit appear to have relatively clear interpretations of the law—they are just in total conflict with each other. The Tax Court's position is a bit more subtle than either the IRS or the Ninth Circuit's view.

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What this means is that in advising clients, we will need to be sure to pay attention both to the structure of their arrangement and what venue would be used to litigate the matter if it comes to that. If you are involved before the deal is signed, you may find that some minor changes could be made to the agreement to come to a similar result, but without triggering the tax uncertainty.

That said, if the client is looking primarily to get an advance for cash flow purposes (including needing that advance to expand or just to get started), your options may be more limited and you will need to advise your client of the possible reporting positions, remembering that the final choice of the position is the client's after they have been properly informed of the risks and benefits.