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IT'S ALL ABOUT TIMING: WILL *KARNS* IMPACT THE IRS BATTLES OVER ADVANCE RECEIPTS?

Nicholas A. Mirkay*

I. INTRODUCTION

The accounting for advance receipts or payments continues to vex those who administer, and advise on, federal income tax law.¹ An “advance receipt” can be defined expansively to comprise any payment received in exchange for providing future services or product, or for the promise to repay the amount transferred.² Thus, an advance receipt can encompass loans and deposits as well as prepayments for services or product to be delivered in the following year.³ Under current income tax law, a taxpayer or tax advisor must generally make an initial threshold determination when addressing the tax treatment of an advance receipt: (i) is the amount received a loan or deposit, neither of which is generally required to be included in income; or (ii) is the receipt not a loan or deposit and, thus, includable in income as an “accession to wealth,” such as salary or wage income.⁴ If the latter is determined, the next step is to determine the proper year in which it should be recognized or reported as income.⁵

At the core of this next step is an issue with which the Internal Revenue Service (“IRS”) consistently deals — timing. The term “timing” is basically self-defined: in what taxable year should a receipt be reported as income or an expenditure reported as a deduction for federal income tax purposes. Determining the proper taxable year for the inclusion of income or the deduction of an expense can definitively impact a taxpayer’s ultimate tax liability.⁶ The timing issue is not just about determining whether inclusion or deduction occurs in year one or year two. Rather, it reflects (i) the substantive changes in the tax law, tax rates, and status of the taxpayer; (ii) the applicability of statutes of limitation; and (iii) the time value of money principles.⁷

The U.S. Supreme Court has addressed the proper federal income tax treatment of various forms of advance receipts in numerous decisions over the last four decades, the most recent of which occurred in its 1990 decision in *Com-*

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1. David Hasen, *The Tax Treatment of Advance Receipts*, 61 TAX L. REV. 395, 396 (2008).
2. *Id.* at 399.
3. *Id.* at 399-400.
4. *See infra* notes 16-17 and accompanying text.
5. *See, e.g.*, I.R.S. Tech. Adv. Mem. 200849015 (Dec. 5, 2008).
6. JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 588 (15th ed. 2009).
7. *Id.*

*missioner v. Indianapolis Power & Light Co.*⁸ In *Indianapolis Power*, the Court held that a public utility's receipt of a deposit was not includable in income at the time of receipt, finding there was a significant difference between a deposit and an otherwise "advance payment" for federal income tax purposes.⁹ Although practitioners and legal scholars hoped *Indianapolis Power* would provide some final clarity, it has nevertheless been criticized as lacking the necessary economic foundation and analysis on which income taxation should rely.¹⁰

Several federal circuit courts of appeal have applied *Indianapolis Power* subsequently with varying degrees of consistency. In *Johnson v. Commissioner*,¹¹ the Eighth Circuit ruled that amounts received by car dealerships for vehicle service contracts were properly includable in gross income in the year of the car sale. In *Westpac Pacific Food v. Commissioner*,¹² the Ninth Circuit determined that advance trade discounts received by the taxpayer in consideration for committing to future volume purchases were akin to security deposits or loans and, thus, not includable in gross income in the year of receipt. Finally, on virtually identical facts to those in *Westpac*, the Third Circuit, in *Karns Prime & Fancy Food, Ltd. v. Commissioner*,¹³ openly disagreed with *Westpac* and the Ninth Circuit's application of *Indianapolis Power*, concluding that funds provided to the taxpayer by its food supplier in exchange for a promissory note and a supply agreement constituted taxable income to the taxpayer in the year of receipt.

This article analyzes the most recent decision in this continually vexing area, *Karns*, and its impact on future applications of law in this area. Part II of this article discusses the evolution of federal income tax law governing advance receipts, highlighting the distinction and corresponding disparate tax treatment of loans and deposits versus "advance payments." Part III focuses on the federal circuit courts' conflicting application of *Indianapolis Power* in *Westpac* and *Karns*. In conclusion, Part IV of this article analyzes the propriety of the above-referenced distinction and disparate tax treatment of various advance receipts, emphasizing how the *Karns* decision impacts, if at all, this complex area of income tax law.

II. THE EVOLUTION OF FEDERAL INCOME TAX LAW WITH RESPECT TO ADVANCE RECEIPTS

A. Contrasting Tax Treatment Of Deposits With Other Forms Of Advance Receipts

1. Basic Income Principles Under Current Tax Law

Section 61 of the Internal Revenue Code¹⁴ broadly defines gross income as "all income from whatever source derived."¹⁵ In the seminal case of *Commissioner v. Glenshaw Glass Company*,¹⁶ the Supreme Court defined gross income as

8. 493 U.S. 203 (1990).

9. Unless otherwise indicated or defined herein, such as in the context of particular Treasury regulations or revenue procedures discussed in the text accompanying *infra* notes 91 and 97, the term "advance payment" typically denotes an "advance receipt" other than a loan or deposit.

10. Hasen, *supra* note 1, at 402 (citing William A. Klein, *Tailor to the Emperor With No Clothes: The Supreme Court's Tax Rules for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1718-23 (1994), and Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17, 20 (1998)).

11. 184 F.3d 786 (8th Cir. 1999).

12. 451 F.3d 970 (9th Cir. 2006), *rev'g* 82 T.C.M. (CCH) 175 (2001).

13. 494 F.3d 404 (3rd Cir. 2007).

14. Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended.

15. I.R.C. § 61(a) (2010).

16. 348 U.S. 426 (1955).

“undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”¹⁷ As to determining “complete dominion,” the Supreme Court explained in *Indianapolis Power* that “[t]he key is whether the taxpayer has some guarantee that he will be allowed to keep the money.”¹⁸ The Supreme Court has further described income as “[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition.”¹⁹

Section 446 requires taxpayers to compute their taxable income for a taxable year under any reasonable method of accounting, provided the method “clearly reflects” their income.²⁰ A taxable year is defined as a twelve-month period ending on the last day of a month;²¹ typically ending on December 31, unless the taxpayer elects a fiscal taxable year that ends on the last day of another month.²² The most common permissible methods of accounting are the cash receipts and disbursements method, and the accrual method.²³ Individual taxpayers most often use the cash receipts and disbursements method of accounting, which includes an item in income or permits a deduction of an expense on the receipt or payment of cash or an equivalent (e.g., property or services).²⁴ The accrual method, typically used (or required to be used) by business entities, employs an “all events” test with respect to income and deductions. Under the accrual method, an item is included in income when all events have occurred that fix the right to receive the income, and the amount of the income can be determined with reasonable accuracy.²⁵ A deduction for expenses is generally taken in the taxable year in which all the events have occurred that establish: (i) the fact of the liability; (ii) the amount, determined with reasonable accuracy; and (iii) economic performance has occurred with respect to the liability.²⁶

2. Tax Treatment Of Loans And Deposits

It is well established that a debtor does not include loan proceeds in his income because he has an obligation to repay the amount loaned at some designated point in the future.²⁷ In essence, the existence of the repayment obligation

17. *Id.* at 431.

18. *Indianapolis Power*, 493 U.S. at 310.

19. *James v. U.S.*, 366 U.S. 213, 219 (1961) (quoting *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932)).

20. I.R.C. § 446(a)-(b) (2010).

21. I.R.C. § 441 (2010).

22. I.R.C. § 441(a), (g) (2010); FREELAND, *supra* note 6, at 588.

23. *See generally*, I.R.C. § 446(c) (2010). The cash receipts and disbursements and accrual methods are the most common, but not the exclusive, methods of accounting. The Internal Revenue Code permits other methods, such as the installment sales method under section 453, the long-term contract method under section 460, and the special treatment of certain types of income and expense. Treas. Reg. § 1.446-1(c)(1)(iii) (amended 2006).

24. FREELAND, *supra* note 6, at 589; Treas. Reg. § 1.446-1(c)(1)(i) (amended 2006).

25. *Id.*; Treas. Reg. § 1.446-1(c)(1)(ii) (amended 2006).

26. Treas. Reg. § 1.446-1(c)(1)(ii) (amended 2006).

27. *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983).

disqualifies the loan proceeds from constituting an “accession to wealth” and, accordingly, income.²⁸ As a result, a fundamental question arises at the time a taxpayer receives any advance receipt — is the taxpayer unconditionally obligated to repay the advance?²⁹ In discerning whether a given transaction constitutes a loan, the substance, as opposed to the form, of the transaction controls.³⁰

Overall, the rules applicable to various forms of advance receipts are simultaneously settled and perplexing. As stated above, loan proceeds are not income due to the repayment obligation. Deposits, like loans, must be examined on a case-by-case basis to determine their federal income tax treatment. Depending on the terms of the deposit, the recipient may retain the money to be applied against future fixed or contingent liabilities, thus typically creating income, or may retain for potential refund to the deposit payor, thus garnering loan-like tax treatment, as in *Indianapolis Power*.³¹ In contrast to deposits and loans, other advance receipts are generally included in the recipient’s income upon receipt. For example, prepayments of rent are generally included in the landlord’s income in the year received.³² In addition, advance payments received by accrual method taxpayers (namely, business entities, as discussed above) in consideration for future services or product are generally includable in income upon receipt, with some narrow exceptions that permit deferral of recognition.³³

In slugging through this morass of complexity, this article first addresses the federal income tax treatment of deposits and the *Indianapolis Power* decision that ultimately led to the conflicting federal circuit decisions in *Westpac* and *Karns*. This article then compares and contrasts the usual exclusion of deposits from a recipient’s income to the income inclusion of other forms of advance receipts described above.

a. *Commissioner v. Indianapolis Power & Light Co.*

Indianapolis Power & Light Company (“IPL”) was a regulated utility in Indiana and an accrual method taxpayer. Like most utilities, it required certain of its customers with questionable credit (approximately five percent during the years of 1974 to 1977) to submit deposits to ensure payment of future utility bills.³⁴ The deposit typically amounted to twice the customer’s estimated monthly bill, and IPL paid 3 percent interest on deposits held for greater than six months.³⁵ After March 1976, IPL raised the interest rate to 6 percent payable on deposits held for greater than twelve months and instituted a more perfunctory rule for refunding the deposit. Prior to termination of utility service, IPL provided these

28. *Id.*; see also *James*, 366 U.S. at 219 (accepted definition of gross income “excludes loans”); *Comm’r v. Wilcox*, 327 U.S. 404, 408 (1946).

29. *Karns*, 494 F.3d at 408.

30. *Knetsch v. U.S.*, 364 U.S. 361, 365-66 (1960).

31. *Hasen*, *supra* note 1, at 400.

32. *Id.*; *Treas. Reg.* § 1.61-8(b) (amended 2004). The general income tax treatment of prepaid rent may be modified by section 467. *Hasen*, *supra* note 1, at 400 n.27.

33. *Hasen*, *supra* note 1, at 400-01. See also *Artnell Co. v. Comm’r*, 400 F.2d 981 (7th Cir. 1968); *Rev. Proc.* 2004-34, 2004-22 I.R.B. 991 (granting up to one year deferral for certain advance payments in certain instances).

34. *Indianapolis Power*, 493 U.S. at 203-04.

35. *Id.* at 204.

customers, upon satisfying a credit test, the option of either a refund of their deposits or application of the deposits against future utility bills. IPL did not recognize these deposits as income at the time of their receipt, but rather recorded them on its books as current liabilities in accordance with applicable state regulations. No dispute existed with respect to whether “IPL’s treatment of the deposits was consistent with accepted accounting practice and applicable state regulations.”³⁶ Upon audit, the IRS asserted that the deposits were advance payments for future utility services and, therefore, taxable to IPL in the year of receipt.³⁷

Upon appeal of the IRS’s deficiency notice, the United States Tax Court (“Tax Court”) in a full-court review (with one judge not participating) unanimously ruled in IPL’s favor following the “facts and circumstances” approach it adopted in *City Gas Co. of Florida v. Commissioner*.³⁸ Utilizing this approach, several factors persuaded the court that IPL’s exclusion of the deposits from its income was proper: (i) only five percent of its customers were required to submit a deposit; (ii) the customer rather than IPL possessed “the right to control the ultimate disposition of the deposit;” and (iii) IPL’s accounting for the deposits as current liabilities and payment of interest.³⁹ The Seventh Circuit affirmed on basically the same grounds, placing greater reliance on IPL’s payment of interest, which resulted in the deposit beginning “to serve purposes that comport more squarely with a security deposit.”⁴⁰

The Supreme Court unanimously upheld the lower courts’ rulings in favor of IPL. It began its opinion with the “common ground” that deposits are includable in income upon receipt if they constitute “*advance payments* for electricity to be supplied.”⁴¹ In a footnote, the Court cited to a string of prior cases in which it addressed advance payments and determined them to be “indisputably” income in the year of receipt because they represented payments for future services.⁴² In those cases, the Court explained, “the issue was *when* that income was taxable. Here, in contrast, the issue is whether these deposits, as such, are income at all.”⁴³ It further noted the IRS’s concession that customer deposits that secure the performance of non-income-producing covenants, such as the customer’s responsibility to ensure no damage to meters, are not taxable, comparing such deposits to the nontaxable receipt of loan proceeds.⁴⁴ The Court characterized the economic

36. *Id.* at 205.

37. *Id.* at 206.

38. 74 T.C. 386 (1980), rev’d, 689 F.2d 943 (11th Cir. 1982). In *City Gas*, similar to IPL’s facts, the Tax Court adopted a “facts and circumstances” test compiled from its prior decisions, ultimately determining that the amounts at issue were nontaxable security deposits. On appeal, the Seventh Circuit reversed the Tax Court, remanding for application of a “primary purpose test,” which looked to “whether the sums were intended to be applied to discharge payment for income items (*e.g.*, the final month’s bill for gas, or for turn-on and turn-off charges or other charges for services), or on the other hand were intended to secure performance of nonincome-producing covenants (*e.g.*, damage to meters).” *Id.* at 946. On remand, the Tax Court determined that the deposits were “better characterized as prepayments of income” than nontaxable security deposits. 47 T.C.M. (CCH) 971. The Supreme Court in *Indianapolis Power*, which addressed the then existing conflict between the Seventh Circuit’s decision in *Indianapolis Power* and the Eleventh Circuit’s decision in *City Gas*, effectively rejected the use of the Eleventh Circuit’s primary purpose test.

39. *Indianapolis Power*, 493 U.S. at 206.

40. *Id.* at 207 (quoting *Indianapolis Power & Light Co. v. Comm’r*, 857 F.2d 1162, 1169 (7th Cir. 1988)).

41. *Id.* at 207.

42. *Id.* at 207 (citing *Schlude v. Comm’r*, 372 U.S. 128 (1963)); *Am. Auto. Ass’n v. U.S.*, 367 U.S. 687 (1961); *Auto. Club of Mich. v. Comm’r*, 353 U.S. 180 (1957).

43. *Indianapolis Power*, 493 U.S. at 207. *See infra* notes 71-81 and accompanying text for a discussion of the cited cases.

44. *Indianapolis Power*, 493 U.S. at 207-08.

distinction between a loan and an advance payment as “one of degree rather than of kind.”⁴⁵ With a loan, the borrower can earn income on the use of the money prior to the time for repayment, but with an advance payment, the recipient achieves both “immediate use of the money ... *and* the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.”⁴⁶ Accordingly, although the Court agreed with the IRS’s assertion that IPL derived some economic benefit from the receipt of the deposits, it nevertheless decided, based on the above distinction, that the taxability turns more on the “nature of the rights and obligations” of both parties.⁴⁷

In the end, the Court turned to a less economic-based and a more “earmarks” approach; namely, whether the depositor is entitled in the future to demand repayment of the deposit.⁴⁸ In essence, for the Court, the depositor’s ultimate control over the deposit and its repayment is dispositive and distinguishes it from the income treatment accorded to other forms of advance payments. The IRS has subsequently adopted the *Indianapolis Power* distinction between deposits and advance payments as “one of degree rather than kind.” It recently explained that “[w]hile both bestow economic benefits to the recipient, economic benefits qualify as income only if the taxpayer [recipient] has complete dominion,” which is governed by whether the recipient has some guarantee that it will be allowed to retain the money.⁴⁹ As will be discussed in Part IV of this article, some legal scholars have dismissed the Supreme Court’s distinction between a deposit and other advance payments as illogical based on economics and tax theory.⁵⁰

b. *Indianapolis Power* Progeny

Not surprisingly, *Indianapolis Power* sparked a number of cases that adopted its “complete dominion” test as a basis for excluding deposits from recipients’ income, with varying outcomes. In *Oak Industries, Inc. v. Commissioner*,⁵¹ the issue concerned the tax treatment of deposits paid by subscribers to a subscription television operator. The television company was obligated to refund the entire deposit if no amounts were due from the subscriber upon termination of service by either party. A majority of subscribers chose to apply at least a portion of the deposit to pay monthly service charges on their final bill. In holding that the deposits were not taxable income to the television company at the time of the receipt, the Tax Court reasoned that the subscribers *controlled* whether the deposit would be refunded or applied against amounts due for services.⁵² Because the subscriber made no commitment to purchase a specified amount of services, if any, from the television company, no guarantee existed that the television company would be able to keep any portion of the deposit.⁵³

45. *Id.* at 208.

46. *Id.*

47. *Id.* at 208-09.

48. Klein, *supra* note 10, at 1718.

49. I.R.S. Tech. Adv. Mem. 200849015 (Dec. 5, 2008) (Payments received by accrual-basis taxpayer for sale of gift cards were includable in income upon receipt and not eligible for deferral as “advance payments” under Treas. Reg. § 1.451-5 (amended 2001) or Rev. Proc. 2004-34, 2004-22 I.R.B. 991).

50. *See infra* notes 162-166 and accompanying text.

51. 96 T.C. 559 (1991).

52. *Id.* at 571.

53. *Id.* at 572.

In *Buchner v. Commissioner*,⁵⁴ a direct mail advertising agency required its clients to make deposits into “postage impound accounts” to cover estimated postage expenses. In the event that a client failed to reimburse the agency for postage, money would be withdrawn from the client’s account. When a client terminated its relationship, any account balance was refunded. The Tax Court held that the deposits were not income to the agency under the *Indianapolis Power* “complete dominion” test because, provided clients paid their monthly bills, no portion of the deposits would be retained by the agency and applied to payments for services.⁵⁵

In *Johnson v. Commissioner*,⁵⁶ the Tax Court and, on appeal, the Eighth Circuit addressed the appropriate accounting method with respect to income received on sales of vehicle service contracts (“VSCs”) by related automobile dealerships. Upon sale of a car, a VSC, which is akin to a warranty agreement, is also offered for sale. Under the VSC, the dealership grants the VSC buyer (the “holder”) the right to have parts or components covered by the VSC repaired or replaced upon the occurrence of a mechanical breakdown.⁵⁷ Pursuant to the VSC’s terms, the dealership agreed either to repair or replace covered parts itself or to reimburse the holder for repairs done by other qualified facilities. In either event, the repair had to be preapproved by a VSC administrator either employed by, or contracted with, the dealership. The holder could cancel the VSC at any time and thereby receive a refund of a portion of the VSC contract price based either on the amount of the time elapsed since the purchase of the VSC or the miles travelled. Upon receipt of the VSC contract price, the dealership would retain a portion and include that amount in income, placing the remaining portion in escrow or a reserve fund intended to secure the performance of the dealership’s obligations under the VSC. The reserve fund would either reimburse the dealership or another authorized facility for the work done under the VSC.⁵⁸ Any investment income accrued on the reserve fund would be deposited therein. Customarily, any amounts remaining in the reserve fund at the termination of the VSC reverted to the dealership. The dealerships also procured insurance policies to cover losses exceeding the aggregate amount of reserve funds on all VSCs.⁵⁹

The primary issue in *Johnson* involved whether the amounts the dealerships placed in the reserve fund upon the sale of a VSC was income in the year of the car sale or when services were performed (and amounts withdrawn from the reserve fund). The Eighth Circuit affirmed the Tax Court’s conclusion that the money received by the dealerships upon the sale of the VSCs and immediately paid into the reserve funds was includable in income in the year of receipt.⁶⁰ In reaching its decision, the Tax Court expressly rejected the dealerships’ contention the amounts placed in the reserve fund amounted to nontaxable deposits governed by *Indianapolis Power*.⁶¹ The dealerships argued that because they retained the amounts allocated to the reserve fund subject to an obligation to refund them at the VSC holder’s option, the dealerships did not have “some guarantee that ... [they would] be allowed to keep the money” as long as they complied with the

54. 60 T.C.M. (CCH) 429 (1990).

55. *Id.*

56. 108 T.C. 448 (1997), *aff’d & rev’d in part*, 184 F.3d 786 (8th Cir. 1999).

57. *Johnson*, 184 F.3d at 787.

58. *Id.*

59. *Id.* at 787-88.

60. *Id.* at 788.

61. *Johnson*, 108 T.C. at 467.

terms of the VSC. Therefore, the reserves, according to the dealerships, were not income to them until applied to future purchases of repairs or released to them without restriction upon expiration of the VSC.⁶² The Tax Court responded that the dealerships' reliance on *Indianapolis Power* was "misplaced" in that "[n]ot all refundable payments can be excluded from income," citing to an extensive amount of case law to the contrary.⁶³ In addition, the Tax Court made the following important observation:

Indianapolis Power & Light did not purport to overrule these authorities and establish refundability as the exclusive criterion for distinguishing taxable sales income from nontaxable deposits in all cases.... [citations omitted] What distinguished the nontaxable deposits in the *Indianapolis Power & Light* line of cases from taxable income was not their refundability *per se*; ultimately the classification of these amounts as nontaxable deposits turned on the fact that the taxpayer's right to retain them was contingent upon the customer's future decisions to purchase services and have the deposits applied to the bill.... [citations omitted] The payments at issue in the cases at hand do not share this characteristic.⁶⁴

Ultimately, the courts in *Johnson*, like the Supreme Court in *Indianapolis Power*, considered the customer's continued control over the deposit — either claiming a refund or applying it against future services — as the single most important factor in determining the exclusion of a deposit from income.

3. Tax Treatment Of Advance Receipts Other Than Deposits

a. Historical Overview — No Deferral Of Income

As previously discussed, a taxpayer adopting the accrual method of accounting, which typically comprises most businesses, includes a payment or receipt in income when all events have occurred that fix the right to receive the income and the amount is determinable with reasonable accuracy, with any adjustments to be made in the year of actual receipt.⁶⁵ Typically, the all events test is satisfied as to income inclusion upon the earliest of the following to occur: (i) obligatory performance, (ii) payment is due, or (iii) payment is made.⁶⁶ Accordingly, a taxpayer generally includes any payments received in income upon receipt even though goods or services are to be rendered in a future taxable year.⁶⁷ However, the application of the all events test has proven to be more challenging in the context of advance receipts such as prepayments for products or services where accrual method taxpayers have long argued that the immediate taxation of such payments violates the "matching principle" of generally accepted accounting principles ("GAAP"). The matching principle requires that income recognition be deferred for financial accounting purposes until the period in which associated goods or services are rendered.⁶⁸

62. *Id.*

63. *Id.* at 470 (citations omitted).

64. *Id.* at 471 (citing *Indianapolis Power*, 493 U.S. at 210-12; *Oak Industries*, 96 T.C. at 571-72, 574-75; *Buchner*, 60 T.C.M. (CCH) 429).

65. Treas. Reg. § 1.451-1(a) (amended 1999).

66. *Id.*; *Schlude v. Comm'r*, 372 U.S. 128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

67. Treas. Reg. § 1.451-1(a) (amended 1999).

68. Hasen, *supra* note 1, at 404 (citing Geier, *supra* note 10, at 128-29).

Beginning in the late 1950s, the Supreme Court decided a trifecta of cases addressing the proper tax treatment of prepayments for future services or goods. From the cases emerged a general rule — upon receipt, accrual-basis taxpayers must include in income prepayments for future services. In each case, the taxpayer received an amount in year one for which it was required to provide services in year two, with some ambiguity as to the amount of services the taxpayer would actually provide.⁶⁹ These cases appear to collectively reject the financial accounting matching principle as fundamental in the tax accounting sphere.⁷⁰

In *Automobile Club of Michigan v. Commissioner* (hereinafter *Auto Club*), the Court addressed the proper income tax treatment of prepaid membership dues.⁷¹ The club conceded that it collected dues in advance for one-year memberships under the “claim of right” doctrine (basically, the right to receive dues without restriction as to their disposition), but contended that the dues could be recognized ratably over the membership term under clear reflection of income principles.⁷² The Court disagreed, explaining that “[t]he pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner [the club] may in fact be called upon to render for the member.”⁷³

In *American Automobile Association v. United States* (hereinafter *AAA*), the taxpayer included in its income only the portion of the prepaid annual membership dues actually collected in a taxable year that “ratably corresponded with the number of membership months covered by those dues” and occurring within that taxable year.⁷⁴ Any amount of dues not ratably corresponding in that year was deferred for recognition in the following taxable year. Operating expenses with respect to such memberships were similarly deducted ratably over the identical periods of time as those over which the dues were recognized as income. This method of accounting for income and expenses was in accordance with GAAP and regularly employed in the association’s industry. Similar to *Auto Club*, the IRS labeled the association’s accounting method as “purely artificial,” contending that it should have included the entire amount of membership dues actually received in its taxable income without regard to any expected future services with respect to those memberships in the following year.⁷⁵ The Court ultimately rejected AAA’s assertion that its accounting method was reliable, in part because of the association’s inability to predict when services, if ever, would be required on a particular membership.⁷⁶ Accordingly, the ultimate issue emerged as one of timing — in what year should the prepaid membership dues be included in income? The

69. Hasen, *supra* note 1, at 404.

70. *Id.*

71. 353 U.S. 180 (1957).

72. With respect to the proper tax treatment of prepayments, some courts initially analyzed under the “claim of right” doctrine, but later court decisions dismissed the doctrine as dispositive. *See, e.g.,* *Moritz v. Comm’r*, 21 T.C. 622 (1954) (pursuant to claim of right analysis, photographer taxed on deposits despite policy of permitting full refund if customer not satisfied); *Bressner Radio v. Comm’r*, 267 F.2d 520, 525 (2d Cir. 1959) (differentiated claim of right cases as involving income that taxpayers conceded was “earned”); *Beacon Publ’g v. Comm’r*, 218 F.2d 697, 699-700 (10th Cir. 1955) (distinguished “receipt” issue from “accounting” issue of timing of income recognition).

73. *Auto Club*, 353 U.S. at 189.

74. 367 U.S. 687, 688 (1961).

75. *Id.* at 690-91.

76. *Id.* at 691-92.

Court answered: the calendar year in which the dues are actually received, explicitly rejecting any method that employs statistical computation or estimation of income.⁷⁷

The third case in the trifecta was *Schlude v. Commissioner*, which involved tax accounting for contracts of an Arthur Murray franchise dance studio.⁷⁸ Two basic contract types governed dance lessons. The cash plan required a cash down payment at contract execution with installment payments of the balance. The deferred payment contract required only a portion of the down payment be in cash, with the remainder paid in installments and a negotiable note signed at contract execution with respect to the balance of the contract price. Although the contracts provided a designated term during which the lessons had to be taken, no detailed schedule was specified. Under both plans, the contract was “noncancelable,” resulting in the forfeiture of any unused balance if the client failed to take all of the designated lessons within the contract term.⁷⁹ Under the studio’s accrual-based accounting, upon execution of a contract, a “deferred income account” was credited with the total contract price. At the end of each fiscal year, a client’s record was analyzed and the total number of instruction hours utilized was multiplied by a designated hourly rate, with the result being deducted from the deferred income account and recognized as income on the studio’s financial statements and income tax returns. If no activity as to a client contract occurred for over a year, the remaining balance of the contract was cancelled, removing the unused contract price from the deferred income account and including it in the studio’s income.⁸⁰

The Court concurred with the IRS’s rejection of the studio’s accounting method as lacking clear reflection of income, noting both (i) that the dance lessons were not to take place on specific dates, but rather were left to the discretion of the client and the instructor; and (ii) taking into consideration the contract forfeiture provision, no certainty existed that remaining lessons under the contract would ever be demanded. Stating that the issue was “squarely controlled” by *AAA*, the Court held that all prepayments in cash, negotiable notes, and contract installments due and owing under the contract were immediately includable in the studio’s income for tax purposes.⁸¹

As previously discussed, *Schlude*, like its predecessors, appears to dispel the financial accounting notion of matching recognition of income in the same period in which the associated expenses are incurred.⁸² As one legal commentator noted, the Supreme Court “acknowledged that the matching of income and expense is a tax value, but declined to permit deferral on that basis in the absence of a sufficiently determinate showing of the future expenses.”⁸³ Essentially, if the timing or amount of the associated expenses was unclear, the matching principle was trumped by the IRS’s determination that any deferral of income does not clearly reflect income under section 446.⁸⁴ As a result, the Tax Court, among other

77. *Id.* at 693.

78. *Schlude*, 378 U.S. at 130.

79. *Id.*

80. *Id.* at 131-32.

81. *Id.* at 134-36. Only those amounts “neither due as a matter of contract, nor matured by performance of the related services” could be deferred from income recognition. *Id.* at 133 n.6.

82. Hasen, *supra* note 1, at 404.

83. *Id.* at 405 (citing Geier, *supra* note 10, at 120).

84. *Id.* (citing Geier, *supra* note 10, at 118).

courts, subsequently interpreted and applied *Schlude* as espousing a per se rule prohibiting the deferral of any advance payment.⁸⁵

However, some courts, as in *Artnell v. Commissioner*, viewed the Supreme Court trifecta as leaving the door open for possible deferral “where the time and extent of performance of future services” related to the prepayment for services are sufficiently definite.⁸⁶ In *Artnell*, the main issue was whether prepayments for future services — advance ticket sales proceeds for future baseball games — should be immediately included in income by the petitioner, the owner of the Chicago White Sox, or deferred until the baseball games were played and other services provided. The petitioner, an accrual basis taxpayer, booked as “deferred unearned income” amounts it received for season tickets, advanced ticket sales and other revenues allocable to games to be played in the next season. As the games were played, the petitioner recognized the allocable amount of previously deferred income.⁸⁷ In response to the IRS’s application of its nondeferral rule to these advance payments, the petitioner argued that its deferral under the accrual method of accounting clearly reflected its income. The petitioner further argued that the Supreme Court trifecta of cases all involved facts where the “extent and performance of future services were uncertain,” which was not present in this case because the “deferred income was allocable to games played on a fixed schedule.”⁸⁸ The Seventh Circuit agreed, finding that the prepayments for future fixed baseball games “approaches much closer to certainty” than the facts present in the Supreme Court trifecta of cases. Accordingly, it determined that the petitioner’s deferral of the prepayments did clearly reflect income and the IRS abused its discretion under section 446 in requiring income inclusion upon receipt.⁸⁹

b. Deferral Of Income On Certain Advance Payments

Although *Artnell* represents a departure from the general rule of inclusion of advance payments upon receipt, the decision has been narrowly construed and applied.⁹⁰ However, subsequent to the *Artnell* decision, the particular problems faced by accrual method taxpayers with respect to advance payments began to be heard by the IRS, which crafted limited deferral rules.

The first deferral rule exists under the section 451 regulations, which defers recognition of income on certain “advance payments.” An advance payment is defined under the regulations as an amount received by an accrual method taxpayer,

pursuant to, and to be applied against, an agreement: (i) [f]or the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his

85. See, e.g., *Decision, Inc. v. Comm’r*, 47 T.C. 58, 62 (1966) (citing to the “no-deferral rule” of *Schlude*); *Bell Elec. Co. v. Comm’r*, 45 T.C. 158, 166 (1965) (without a specific statutory exclusion, deferral is not allowed); *Huebner v. Comm’r*, 25 T.C.M. 406, 409-410 (1966) (“the [*Schlude*] court adopted the position that any relief from the current taxation of prepaid income must be provided by Congress”).

86. Hasen, *supra* note 1, at 405 (quoting *Artnell Co. v. Comm’r*, 400 F.2d 981, 983-84 (7th Cir. 1968), *rev’g and remanding* 348 T.C. 411 (1967)).

87. *Artnell*, 400 F.2d at 982-83.

88. *Id.* at 983-84.

89. *Id.* at 985.

90. Hasen, *supra* note 1, at 405-06.

trade or business, or (ii) [f]or the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.⁹¹

Pursuant to the regulations, an accrual method taxpayer can defer the income recognition of advance payments for goods until the taxable year in which they are properly accrued under the taxpayer's accounting method. This deferral is permissible provided that the taxpayer's accounting method results in the advance payments being recognized as income no later than when they are recognized in revenues pursuant to the taxpayer's accounting method for financial reporting purposes.⁹² If that financial reporting method requires income recognition sooner than for tax purposes, the regulations require the taxpayer to include the advance payments in income in that earlier year.⁹³ Furthermore, if the taxpayer's obligation to provide goods under the sales agreement ends, or the taxpayer fails to survive (death, dissolution, or other reason), income inclusion of the deferred amount is immediately triggered.⁹⁴

Another possibility for deferral of advance payments is granted to accrual method taxpayers by Revenue Procedure 2004-34.⁹⁵ Deferral is granted if the taxpayer (i) employs, or is changing to, an accrual method of accounting; and (ii) receives an "advance payment."⁹⁶ The revenue procedure defines an advance payment as a payment that the taxpayer (a) includes in gross income in the taxable year of receipt pursuant to a permissible method of accounting; and (b) recognizes, in whole or in part, in its financial statements as revenue for a subsequent taxable year (or earned in a subsequent taxable year if taxpayer has no financial statements). In addition, the advance payment must be made for: (i) services; (ii) sale of goods (other than for a sale for which the taxpayer defers income pursuant to the section 451 regulations); (iii) use of intellectual property by license or lease; and (iv) other uses and sales of property.⁹⁷ Under the revenue procedure, an advance payment excludes, with some exceptions, rent, insurance premiums, payments with respect to financial instruments (including prepayment of interest), service warranty contract payments, and other specific prepayments.⁹⁸

Revenue Procedure 2004-34 provides two permissible methods of accounting for advance payments as defined above. Pursuant to the "full inclusion method," a taxpayer includes the entire amount of an advance payment in income in the taxable year of receipt, regardless of whether the full amount of an advance payment is recognized in revenues for financial reporting purposes or is earned by the taxpayer in that taxable year.⁹⁹ The second method, the "deferral method," postpones the inclusion of an advance payment, in whole or in part, in income to the extent that the taxpayer defers recognition of the payment, in whole or in part, in its revenues for financial reporting purposes. However, the taxpayer includes

91. Treas. Reg. § 1.451-5(a)(1) (amended 2001).

92. Treas. Reg. § 1.451-5(b)(1)(ii)(a) (amended 2001).

93. Treas. Reg. § 1.451-5(b)(1)(ii)(b) (amended 2001).

94. Treas. Reg. § 1.451-5(f) (amended 2001).

95. Rev. Proc. 2004-34, 2004-22 I.R.B. 991, *modifying and superseding* Rev. Proc. 71-21, 1971-2 C.B. 549.

96. George L. White, 570-2nd BNA T.M. *Accounting Methods – General Principles*, at A-107 (2008).

97. Rev. Proc. 2004-34, 2004-22 I.R.B. 991 § 4.01.

98. *Id.* § 4.02.

99. *Id.* § 5.01.

the deferred portion of the advance payment in income in the next succeeding taxable year.¹⁰⁰ Similar to the section 451 regulations, the inclusion of an advance payment in income may be accelerated due to the taxpayer's death or dissolution.¹⁰¹ In contrast to the deferral permitted under the section 451 regulations, which defers recognition of advance payment until it is included in the taxpayer's revenues for financing reporting purposes, the revenue procedure generally permits deferral only to the taxable year after the taxable year of receipt.¹⁰² Although the deferral method under the section 451 regulations may provide a longer deferral period, the regulations and the revenue procedure are not mutually exclusive, with an advance payment partially eligible for deferral under the regulation and partially under the revenue procedure.¹⁰³ The result is a complex interplay between financial accounting rules and the above described tax deferral rules.

The above overview of the complex deferral rules for certain advance payments illuminates presumably the reason that taxpayers may strenuously argue that prepayments for goods or services are similar to deposits deserving nonrecognition treatment. Accordingly, the following discussion of *Westpac* and *Karns* tests the veracity of that asserted deposit analogy. The two federal circuits deciding those cases reached diverging conclusions on the application of *Indianapolis Power* to a particular type of advance receipt — an advance trade discount.

III. CIRCUIT CONFLICT: *WESTPAC* AND *KARNS*

In the retail industry, it is common for suppliers to incentivize distributors and retailers to make future purchases by providing cash payments, also known as “advance trade discounts.”¹⁰⁴ As with any advance receipt, the threshold determination a recipient must make is whether the cash payment is income upon receipt or can be excluded from income as a deposit or loan, or a purchase price reduction.¹⁰⁵ The proper tax treatment of such supplier to retailer payments resurfaced in the Ninth Circuit's opinion in *Westpac* and the Third Circuit's opinion in *Karns*, each of which are discussed below. Although these cases can be distinguished on their facts, they nevertheless illustrate the complexity of income tax law that taxpayers face when addressing advance receipts.

A. The Ninth Circuit's Decision In *Westpac*

In *Westpac*, the court had to decide whether cash paid in advance by manufacturers of products to Westpac, a food wholesaler, in exchange for volume purchase commitments (also known as advance trade discounts) constituted gross income to the wholesaler.¹⁰⁶ Under each purchase agreement, the wholesaler agreed that the manufacturer would be the primary or exclusive supplier of the particular product and, in some of the agreements, agreed to maintain a specific

100. *Id.* § 5.02(1).

101. *Id.* § 5.02(5).

102. White, *supra* note 96, at A-107.

103. *Id.* at A-108.

104. W. Eugene Seago, *Do Advance Trade Discounts Represent a Liability or Income?* 105 J. TAX'N 144 (2006).

105. *Id.*

106. *Westpac*, 451 F.3d at 971-72.

amount of shelf space for the manufacturer's product.¹⁰⁷ Upon termination of these agreements, Westpac agreed to reimburse the manufacturers on a prorated basis for any portion of the cash advance not earned due to the wholesaler's failure to purchase the agreed upon amount of product. The accrual-basis wholesaler booked the cash advances or discounts as liabilities akin to loans in favor of the manufacturers.¹⁰⁸ As merchandise was purchased under the agreement, Westpac applied the discounts pro rata to the full purchase price under each agreement, the net effect of which decreased its cost of goods sold and increased its net profit and, therefore, its taxable income.¹⁰⁹ The IRS conceded, and the Tax Court concurred, that Westpac's method of accounting was consistent with GAAP. Notwithstanding, the Tax Court dismissed the wholesaler's argument that the cash advances were trade discounts that reduced the cost of the goods purchased under Treasury Regulation § 1.471-3(b), finding the discount referenced under that regulation requires that the discount arise "contemporaneously" with the purchase of the goods.¹¹⁰ Accordingly, the Tax Court determined that the cash advances were income at the time of receipt and not eligible for deferral.¹¹¹

On appeal, the Ninth Circuit addressed the issue as simply "whether advance trade discounts constitute gross income when received;" ultimately concluding they did not and reversing the Tax Court.¹¹² The Ninth Circuit found that prior Supreme Court decisions compelled its answer: "Cash advances in exchange for volume purchase commitments, subject to *pro rata* repayment if the volume commitments are not met, are not income when received."¹¹³ In citing the Supreme Court decisions in *Indianapolis Power, Auto Club*, and *Schlude*, the Ninth Circuit concluded that *Indianapolis Power* governed the facts before it, analogizing advance trade discounts to security deposits due to their repayment feature. Unlike the membership dues in *Auto Club*, Westpac could not keep the cash advance "regardless of what happens after the receipt."¹¹⁴ It could only retain the entire advance if it met the volume purchase requirements and, therefore, like the security deposit, the cash advance, in whole or in part, was subject to repayment. In fact, under one of the contracts, the volume requirement was not met ultimately and Westpac reimbursed the manufacturer a pro rata amount of the cash advance. In addition, because of the repayment possibility, the cash advance did not constitute an "accession to wealth," reasoned the court, but rather was more like a loan or liability than income upon receipt.¹¹⁵ Accordingly, Westpac's receipt of the cash advances

107. The Ninth Circuit, like the Tax Court, did not divide the cash advances into a portion attributable to the shelf space, product exclusivity, and advances against future purchases. The Ninth Circuit agreed with Westpac's argument that due to the fact that the obligation was to be satisfied primarily through future purchases, the entire amount constituted advance trade discounts. See *Westpac*, 82 T.C.M. (CCH) 175 (2001); Seago, *supra* note 104, at 149.

108. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

109. *Westpac*, 451 F.3d at 972. The wholesaler based its case on the trade discount provisions in Treas. Reg. § 1.471-3(b), which provides that trade discounts may be used to reduce the cost of goods purchased. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

110. Seago, *supra* note 104, at 147-48. Seago noted that the IRS's holding in I.R.S. Tech. Adv. Mem. 200605010 (Feb. 3, 2006) seems to contradict the Tax Court's conclusion. In that TAM, the IRS held that rebates received by the retailer after the purchase of the goods constituted trade discounts that should reduce the cost of the goods purchased.

111. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

112. *Westpac*, 451 F.3d at 974.

113. *Id.* at 975.

114. *Id.* at 976.

115. *Id.* at 974.

increased its cash assets, not its income, offset by a corresponding liability in the amount of the advance. When Westpac purchased product under the agreement at list price, not a discounted price, it realized income for tax purposes.¹¹⁶

B. The Third Circuit's Decision In *Karns*

Over four years after the Tax Court issued its decision in *Westpac*, it confronted virtually identical facts in *Karns Prime & Fancy Food, Ltd. v. Commissioner*.¹¹⁷ Whereas in *Westpac* the issue was expressed as whether an advance trade discount constitutes income, the Tax Court in *Karns* stated that the only issue was whether the cash advance received from *Karns*' principal supplier constituted a loan when received and, thus, not included in income.¹¹⁸ The Tax Court concluded that the supplier's payment could not be characterized as a loan, which the Third Circuit subsequently affirmed. As in *Westpac*, both courts adopted the analysis utilized in *Indianapolis Power*. Nevertheless, the courts reached a result contrary to that reached by the Ninth Circuit in *Westpac*.

Karns operated a grocery store chain in Harrisburg, Pennsylvania. In order to obtain additional funds for capital improvements in its stores, *Karns* entered into two agreements with its principal supplier, Super Rite Foods, Inc. Under a supply agreement, *Karns* agreed to purchase annually \$16 million worth of product from Super Rite, granting Super Rite a security interest in its assets.¹¹⁹ The supply agreement held *Karns* to specific product pricing or markups, with provisions regarding payment dates, and billing and payment terms. *Karns* also executed a promissory note payable to Super Rite in exchange for \$1.5 million in immediate funds from Super Rite. Commencing on April 16, 2000, the note obligated *Karns* to six annual repayments of \$250,000 with stated interest on the unpaid balance, unless *Karns* met the volume purchase requirements for the previous calendar year under the supply agreement. In that instance, Super Rite agreed to forgive the \$250,000 due and owing for that year. Upon receipt of the \$1.5 million on May 4, 1999, *Karns* booked the amount as a long-term note payable.¹²⁰

Karns satisfied the supply agreement for the periods ending April 16, 2000 and 2001, resulting in the forgiveness of the required annual payments due under the note. For the taxable years ending January 30, 2001 and 2002, *Karns* reported forgiveness of debt income (also known as cancellation of indebtedness or COI income) in the amount of \$250,000 on its income tax returns. On March 9, 2001, *Karns* executed a second promissory note to SuperValu, Inc. (the successor to Super Rite resulting from an August 1999 purchase of Super Rite's parent company) in the amount of \$300,000 with stated interest. In exchange for the funds, *Karns* also executed a second amendment to the supply agreement, increasing the annual product purchase requirement from \$16 to \$21 million. Pursuant to the second note, *Karns* agreed to annual repayments to be made on March 9 beginning in 2002 and ending in 2005.¹²¹ *Karns* fulfilled the product purchase requirement for the period ending March 9, 2002, resulting in that \$250,000 repayment being forgiven. However, *Karns*

116. *Id.* at 977.

117. 90 T.C.M. (CCH) 357 (2005).

118. *Westpac*, 82 T.C.M. (CCH) 175 (2001); *Karns*, 90 T.C.M. (CCH) 357 (2005); *see also* Seago, *supra* note 104, at 148.

119. *Karns*, 494 F.3d at 405-06.

120. *Id.* at 406.

121. *Id.* at 407.

failed to meet the \$21 million product purchase requirement for the following period by \$1.2 million, obligating it to pay a pro rata payment of \$4,929.19 to SuperValu.¹²²

Pursuant to a notice of deficiency, the IRS determined that Karns should have included the entire \$1.5 million payment from Super Rite in its income for tax year ending January 30, 2000 (the taxable year of receipt). On appeal, the Tax Court held that the payment did not constitute a loan and thus was includable in income upon receipt.¹²³ According to the Third Circuit, in addressing whether a transaction constitutes a loan, the essential element is the recipient's unconditional obligation to repay the amount advanced.¹²⁴ Citing *Indianapolis Power* as the "leading decision" on the proper tax treatment of advance payments, the Third Circuit acknowledged the difficulty in analogizing the facts therein with the facts present in *Karns* because of the differences between the transactions and the parties' relative positions.¹²⁵ Notwithstanding, the court stated that the "key element" with respect to any advance payment, as announced in *Indianapolis Power*, is whether the recipient is able to keep the money advanced.¹²⁶ The Third Circuit explicitly agreed with the Tax Court's differentiation that the customers in *Indianapolis Power*, rather than the utility company, controlled whether the utility would retain the deposits; whereas, in *Karns*, Karns controlled whether it would retain the annual payment due under the note.¹²⁷ Karns alone, according to the court, had "complete dominion" over the money advanced by meeting the volume purchase requirements under the supply agreement. Therefore, the court determined that the \$1.5 million in advanced funds were "in substance a projected rebate for products to be supplied, analogous to an advance payment, and as such were taxable income."¹²⁸

In addressing *Westpac*, the Third Circuit took issue with the Ninth Circuit's handling of Supreme Court precedents *Auto Club* and *Schlude*, both of which concluded that advance payment of membership dues and fees for dance lessons, respectively, were income when received.¹²⁹ "The *Westpac* court ignored the discussion in *Indianapolis Power*," explained the Third Circuit, "that 'so long as the recipient fulfills the terms of the bargain, the money is its to keep.'"¹³⁰ The majority opinion in *Karns* dismissed the dissent's arguments that the supply agreement and note payable were not "one unitary advance rebate," and that Super Rite had greater ability to cancel the supply agreement thereby dissipating *Karns*' control over the advanced funds. With respect to the dissent's latter argument, the majority opinion responded that Karns was still obligated to make a certain amount of purchases under the supply agreement, with Super Rite obligated to forgive the annual repayments of the advance if Karns did so. Again, "so long as [Karns] fulfilled the terms of the bargain, the money [was] its to keep."¹³¹

122. *Id.* at 407-08.

123. *Id.* at 408.

124. *Id.*

125. *Id.* at 409.

126. *Id.* at 410 (citing *Indianapolis Power*, 493 U.S. at 212).

127. *Id.* at 410.

128. *Id.*

129. See *supra* notes 73 and 81 and accompanying text.

130. *Karns*, 494 F.3d at 411 (citing *Indianapolis Power*, 493 U.S. at 212). The Ninth Circuit addressed *Auto Club* and *Schlude* in a statement that its case "is like *Indianapolis Power*, not *Automobile Club of Michigan* or *Schlude*." *Westpac*, 451 F.3d at 976.

131. *Karns*, 494 F.3d at 412 (quoting *Indianapolis Power*, 493 U.S. at 213).

1. Judge Ambro's Concurrence In *Karns*

Judge Ambro, who joined in the majority opinion, wrote a separate concurring opinion based on a tax accounting perspective to support the court's holding. He began his concurrence with the preliminary statement that the case was really about "timing." He explained that "[b]oth loans and advance payments confer an economic benefit on recipients because they allow the recipient 'both immediate use of the money (with the chance to realize earnings thereon) and the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.'"¹³² However, under current income tax law, these two transfers are treated differently — loans are not income upon receipt whereas advance payments generally are.

Judge Ambro then proceeded to dissect and refute the basis for the Ninth Circuit's *Westpac* decision. As he explained, the Ninth Circuit asserted that its decision was based on (1) the lack of an absolute repayment obligation by *Westpac*, and (2) the lack of accession to wealth upon *Westpac*'s receipt of the cash advance.¹³³ The majority opinion addressed the first basis in that *Karns*, not *Super Rite*, "controlled whether the obligation to repay would occur."¹³⁴ Employing four hypothetical scenarios, Judge Ambro illustrated how deferral of income recognition can lead to tax savings in the initial years, thereby refuting the second basis for the *Westpac* conclusion. In the scenarios, he employed a basic set of facts: Hal Homemaker opens a grocery distribution center out of his garage, purchasing food valued at \$2,000 and reselling it for \$4,000.¹³⁵

In the first three scenarios, Judge Ambro distinguished between (i) an upfront twenty percent reduction or discount in the purchase price of goods equal to \$400, which reduces Hal's business deductions and increases his net profit and taxable income; (ii) a \$400 cash advance with an unconditional repayment obligation (owed regardless of whether Hal met minimum purchase requirements), which Hal treats as a bona fide loan without income tax consequences; and (iii) a \$400 cash advance accompanied by a six-year minimum purchase requirement with the supplier forgiving the cash advance at the end of the six years if the purchase requirement is met (a conditional repayment obligation under Hal's control). In that third scenario, Hal treats the cash advance as a reduction in his cost of the goods purchased in the first year, thereby decreasing his business deductions and increasing both his net profit and taxable income. In each of these first three scenarios, Judge Ambro concludes that Hal has computed his tax liability without controversy.¹³⁶

But, in the fourth scenario, Judge Ambro changed Hal's income tax reporting in the third scenario fact pattern. Instead of Hal deducting \$1,600 in the first year as a business expense, reflecting the \$400 advance payment as a reduction in the cost of goods purchased, Hal instead deducts \$2,000 as his business expense to offset his \$4,000 income, leaving the \$400 cash advance to be claimed as income in the sixth year as COI income. By deducting \$2,000 rather than \$1,600 as the cost of the goods purchased, Hal is able to realize a \$136 tax savings (\$816 in taxes under the third scenario less \$680 in taxes under the fourth scenario), which is multiplied, under time value of money principles, for the six years in which those savings can be invested. Judge Ambro's conclusion is straightforward: when a taxpayer is able to defer taxes on cash advances received in the first year and goods purchased in the first year are resold for profit, the taxpayer can definitely

132. *Id.* at 413 (quoting *Indianapolis Power*, 493 U.S. at 207).

133. *Id.* at 413 (citing *Westpac*, 451 F.3d at 975, 977).

134. *Id.* at 413.

135. *Id.*

136. *Id.* at 414-15.

earn more money, illustrating the very essence of the timing effect in taxation. When applied to the facts in *Karns*, deferring the recognition of the cash advance received by Karns yielded an approximate tax savings of \$500,000 by the end of the note term, roughly equal to the amount of the tax deficiency asserted by the IRS.¹³⁷

Judge Ambro concluded his concurrence by reiterating the timing problem inherent in the *Westpac* decision — “[f]unds received with no unconditional repayment obligation result in one set of profit margins and tax liabilities, and deferred tax payment on those same funds results in another set.”¹³⁸ The current income tax laws do not permit deferral of income recognition and taxation when a conditional repayment obligation exists.

2. The Effect Of *Erickson Post* On *Karns*

In the Tax Court’s decision in *Karns*, it distinguished the facts before it from those in *Erickson Post Acquisition, Inc. v. Commissioner*, on which Karns attempted to rely.¹³⁹ Similarly, the Third Circuit’s majority opinion, in a footnote, dismissed the memorandum opinion as nonbinding precedent.¹⁴⁰ Because both courts rendering decisions in *Karns* mentioned this case, it is constructive for this article to discuss the *Erickson Post* facts and decision.

In *Erickson Post*, the petitioner corporation is the owner and operator of two gasoline stations containing convenience stores. All of the petitioner’s issued and outstanding common stock was owned in equal shares by Richard Zimmerman and his wife, who served as president and vice president, respectively. The petitioner entered into an exclusive dealer supply agreement with Amoco for a five-year period commencing on July 1, 1996. The supply agreement was accompanied by a number of other agreements, including Amoco’s agreement to provide the petitioner with certain equipment and improvements as well as a cash advance of \$175,000, which the parties characterized as a loan.¹⁴¹ In exchange for the cash advance, Mr. Zimmerman, on behalf of the petitioner, executed a promissory note obligating the petitioner to repay the \$175,000 over ten years in annual payments of \$17,500 plus a six percent annual rate of interest. Pursuant to the note’s terms, the annual payment was deemed paid or forgiven by Amoco provided the supply agreement remained in effect on the payment due date. In addition to the note, Mr. Zimmerman, on behalf of the petitioner, executed a mortgage security agreement and assignment of rents securing petitioner’s repayment obligation. Because the supply agreement remained in effect throughout the note’s term, Amoco forgave all ten annual repayments plus any interest due and owing.¹⁴²

The petitioner booked the Amoco cash advance as “Amoco/Deferred Income,” and not explicitly as a loan or note payable. The petitioner reduced the Amoco/Deferred Income account monthly by \$1,458.33, a pro rata reduction of the \$175,000 over 120 months, with a corresponding recognition of income in the same amount. The petitioner did not book nor deduct any annual interest expense on the cash advance. In a notice of deficiency, the IRS determined that the entire Amoco cash advance was income to the petitioner in 1996, the year of receipt, characterizing it as a nondeferrable advance payment. Contrary to the petitioner’s assertion that the advance constituted a nontaxable loan, the IRS

137. *Id.* at 415-416.

138. *Id.* at 416.

139. *Karns*, 90 T.C.M. (CCH) 357 (2005) (citing *Erickson Post Acq., Inc. v. Comm’r*, 86 T.C.M. (CCH) 111 (2003)).

140. *Karns*, 494 F.3d at 412 n.2.

141. *Erickson Post*, 86 T.C.M. (CCH) 111 (2003).

142. *Id.*

concluded that the money represented an inducement received in exchange for the petitioner's purchase and distribution of Amoco products.¹⁴³

The Tax Court stated that a receipt will be characterized as a loan for federal income tax purposes if there was "an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure the payment."¹⁴⁴ Furthermore, the parties' intent to treat the advance as a loan must exist at the time it is made — the recipient's intent to repay and the transferor's intent to demand repayment.¹⁴⁵ The existence of a debtor-creditor relationship is a factual question determined by all surrounding circumstances. Based on the factual record, the Tax Court found that the \$175,000 cash advance constituted a loan and, therefore, was not income to the petitioner upon receipt. The court cited as persuasive the annual payments of principal and interest required under the note's terms and the mortgage securing the debt.¹⁴⁶

The IRS argued that the petitioner's obligation to repay the advance was conditional, in that repayment was triggered only if the supply agreement failed to remain in effect, citing the Tax Court's decisions in *Westpac* and *Colombo v. Commissioner*.¹⁴⁷ The facts in *Colombo* are somewhat similar to those in *Erickson Post*, involving a service station owner's receipt of a \$50,000 payment from a major oil company. In exchange for the payment, the station owner agreed to maintain and sell the oil company's products for a ten-year period. The station owner's repayment obligation was triggered only upon a contract breach. The Tax Court dismissed the owner's argument that the payment constituted a loan, reasoning that the owner owed nothing if it fulfilled its purchase and other obligations under the contract.¹⁴⁸ In essence, the Tax Court concluded, as it subsequently did in *Karns*, that a contract breach was a condition precedent to a liability creation, as further explained below.¹⁴⁹

The Tax Court explained that the crucial issue is whether a liability was created at the transaction's inception. "If existence of a liability depends on satisfaction of a condition precedent, the liability is not unconditionally fixed.... A liability subject to a condition subsequent, however, is definitely fixed, subject only to a condition which may cut off liability in the future."¹⁵⁰ As a result, the Tax Court quickly dispensed with the IRS's argument, explaining that in *Westpac* and *Colombo*, the taxpayers' repayment obligations did not arise "unless and until" a contract breach occurred (failure to purchase an agreed amount of product) — a condition precedent — with the repayment in proportion to the amount of nonpurchased product. Accordingly, in both cases, the repayment obligations possessed no loan characteristics; rather, they bore a closer resemblance to "forfeiture penalties" for contract breach.¹⁵¹ By comparison, the petitioner in *Erickson Post* maintained an unconditional obligation to repay the cash advance from its inception, secured that obligation with a

143. *Id.*

144. *Id.* (quoting *Haag v. Comm'r*, 88 T.C. 604, 616 (1987), *aff'd without published opinion* 855 F.2d 855 (8th Cir. 1988)).

145. *Id.* (quoting *Haag*, 88 T.C. at 615).

146. *Id.*

147. *Id.* (citing *Westpac*, 82 T.C.M. (CCH) 175 (2001); and *Colombo v. Comm'r*, 34 T.C.M. (CCH) 733 (1975)).

148. *Id.*

149. *Seago*, *supra* note 104, at 145.

150. *Erickson Post*, 86 T.C.M. (CCH) 111 (2003).

151. *Id.*

mortgage on its property, and had a potential for debt forgiveness in the future, all of which resulted in a fixed liability subject to a condition subsequent.

Finally, the Tax Court dismissed the IRS's assertion that under an *Indianapolis Power* analysis, the petitioner possessed "completed dominion" over the cash advance and, therefore, had income upon receipt. Examining both parties' rights and obligations at the time of the cash payment, the Tax Court concluded that the petitioner's control over the Amoco cash advance was "far less complete than is ordinarily the case in an advance payment situation."¹⁵² Upon receipt of the advance, the petitioner lacked any assurance it would be permitted to keep any portion of the payment.¹⁵³

At least one tax scholar has commented that the Tax Court "indirectly achieved" the correct result in *Erickson Post* when it applied the tax accounting principles of conditions precedent and subsequent to conclude that an advance trade discount or payment constituted a liability, thereby precluding any "accession to wealth" necessary for income recognition.¹⁵⁴ The IRS subsequently issued an Action on Decision, nonacquiescing in the Tax Court decision and vowing to continue its litigation on the issue.¹⁵⁵ The IRS also stated that the Tax Court's decision in *Karns* represented the "better analysis" by focusing on the substance when addressing a loan versus advance payment issue.¹⁵⁶

The Tax Court in *Karns* distinguished *Erickson Post* on the substance of the transaction at issue, determining that *Erickson Post* was "materially distinguishable" from the facts before it.¹⁵⁷ Specifically, the court found that, unlike the petitioner's obligation in *Erickson Post*, Karns' repayment obligation under the note payable did not arise until it materially breached the supply agreement with Super Rite and its successor.¹⁵⁸ In other words, Karns' repayment obligation was not unconditional because it was subject to a condition precedent (breach of the supply agreement) and, therefore, no liability existed from inception.¹⁵⁹ Accordingly, the Tax Court in *Karns* essentially ruled in a manner similar to *Erickson Post*. It seems that the Third Circuit, instead of dismissing *Erickson Post* as nonprecedential, might have cited *Erickson Post* as persuasive support of both the Tax Court's and its ultimate conclusion that Karns' arrangement with Super Rite (and its successor) did not constitute a loan for federal income tax purposes and, therefore, was includable in income upon receipt.

152. *Id.*

153. *Id.* (citing *Indianapolis Power*, 493 U.S. at 210-11; and *Highland Farms, Inc. v. Comm'r*, 106 T.C. 237, 250-52 (1996)).

154. Seago, *supra* note 104, at 150.

155. I.R.S. Action on Dec. 2006-01 (Oct. 10, 2006).

156. *Id.*

157. *Karns*, 90 T.C.M. (CCH) 357 (2005).

158. *Id.*

159. The Tax Court in *Karns* did refer to a "condition precedent" early on in its legal analysis when defining a loan:

In order for a transfer of funds to constitute a loan, at the time the funds are transferred there must be an unconditional obligation (i.e., *an obligation that is not subject to a condition precedent*) on the part of the transferee to repay, and an unconditional intention on the part of the transferor to secure repayment of, such funds.

Id. (emphasis added).

IV. THE IMPACT OF *KARNS* ON THE LAW GOVERNING ADVANCE RECEIPTS

The clear import of *Karns*, by utilizing *Indianapolis Power* and distinguishing *Westpac*, is that the more two parties to a transaction treat an advance payment (or an advance trade discount) as a loan from its inception, the more likely the recipient will prevail against the IRS in excluding that advance from income upon receipt. From the cases discussed herein, that liability treatment should: (i) include loan documentation such as a note payable, (ii) avoid contractual language tying the receipt of the advance to any future services, and (iii) provide for forgiveness of the loan amount upon satisfaction of a condition subsequent (for example, achieving a fixed level of purchases or providing a fixed amount of services).¹⁶⁰ In applying this distinction between loan-like deposits and other advance payments as well as the complete dominion test of *Indianapolis Power*, the Third Circuit in *Karns* seems to have gotten it right. As discussed above, no facts were present in *Karns* that supported the existence of an unconditional repayment obligation akin to a loan, as established by *Indianapolis Power* and reasserted more recently in *Erickson Post*. Nevertheless, as discussed below, the *Indianapolis Power* decision is fraught with criticism over its lack of economic-based analysis as well as facts that seem to belie the Court's choice of analysis and, thus, its ultimate conclusion.

In contrast to *Karns*, the Ninth Circuit misapplied the *Indianapolis Power* "complete dominion" test in *Westpac*. Unlike IPL (the taxpayer in *Indianapolis Power*) whom the Supreme Court found lacked complete dominion over the utility deposits received from customers, *Westpac* appeared to control and have complete dominion over the cash advances received from product manufacturers. Specifically, *Westpac*, rather than those manufacturers, controlled whether it retained or repaid the cash advances, in whole or in part, by fulfilling fixed volume purchase requirements under its agreements with those manufacturers. The Ninth Circuit in *Westpac* completely failed to acknowledge and distinguish this disparate fact.¹⁶¹

Although *Karns* arguably prevails over *Westpac* in properly applying the loan versus other advance payment distinction, the more significant question involves the validity of the distinction in the first place. This question of validity has not escaped several legal commentators who have noted the "incoherence" of the distinction as a matter of economics or tax theory.¹⁶² The Supreme Court's asserted distinction between loans and, by extension, certain deposits and prepayments for services is nonexistent. In critiquing the Seventh Circuit's decision in *Indianapolis Power*, one commentator, William Klein, noted:

The court seems to suggest that the prospect of repayment of a loan somehow constrains the use of the loan funds while, in the case of an advance payment, the prospect of delivering some quid pro quo does not. Stated so baldly, this proposition makes no sense. Stated any less baldly, it has no apparent meaning.¹⁶³

Whether an advance receipt is characterized as a loan, deposit, or an advance payment under current income tax rules, in all cases, asserts Klein, the recipient receives the right to use the amount received for a period of time prior to any obligation to repay or provide services.¹⁶⁴ Essentially, Klein argues that all advance receipts should be given like treatment, postulating

160. Seago, *supra* note 104, at 150.

161. *Id.* at 148.

162. Hasen, *supra* note 1, at 403 (citing Klein, *supra* note 10, at 1713-23).

163. Klein, *supra* note 10, at 1716.

164. *Id.* at 1721.

three possible solutions: (i) all advance receipts should not be includable in income upon receipt; (ii) all deposits should be includable in income upon receipt, thereby eliminating the tax disparity between them and other advance payments; or (iii) continued inclusion of advance payments in income with accrual of the related expenses. Klein acknowledges that there are pros and cons to each of these approaches with an overshadowing reality that neither Congress nor the IRS will likely tackle a full-scale overhaul of this complex area.¹⁶⁵ Other legal commentators agree fundamentally with Klein's preliminary conclusion that there is no fundamental basis for treating various types of advance receipts differently, but propose alternative solutions, which are beyond the scope of this article.¹⁶⁶

In addition to perpetuating the loan versus other advance payment distinction, *Indianapolis Power* can also be criticized on the basis that the Supreme Court may have misapplied its own-stated distinction by inaccurately viewing the deposits received by IPL as loans rather than advance payments for future utility services. The Tax Court's record in *Indianapolis Power* reveals that over the four-year period at issue, approximately 62 percent of the time, on average, IPL's customers applied their deposits as credits against future utility bills.¹⁶⁷ This fact alone seems to belie IPL's assertion, and the Supreme Court's conclusion, that IPL lacked sufficient control over when, if ever, the deposit would be "its to keep."¹⁶⁸ If approximately 62 percent of the time customers applied their deposits as credits against their bill rather than requesting a refund, a good argument can be made that these deposits were not akin to loans, but rather constituted "advance payments for electricity to be supplied."¹⁶⁹ If that assertion is viable, the Supreme Court should have focused more of its determination on when the advance payments were income in accordance with its trifecta of decisions in *Auto Club*, *AAA*, and *Schlude*, rather than on whether IPL retained sufficient dominion or control over the deposits so as to treat them as nontaxable loans upon receipt. In that trifecta, the Court declined to permit deferral of the advance payments under the matching principle due to an indeterminate showing of future expenses.¹⁷⁰ However, based on the 62 percent average of crediting the deposits against future utility bills, IPL might have countervailed the trifecta by arguing that there was a sufficiently definite showing of associated future expenses that would permit it to defer recognition of such advance payments until the occurrence of a credit or refund, citing to *Artnell* as persuasive authority. Under either characterization (loan or advance payment), the result to IPL is virtually identical — no income recognition until a customer credit or refund — but the analysis in reaching that conclusion would have been entirely different. Once again, this illustrates that the legal distinction and corresponding tax treatment imposed on deposits versus other advance receipts, such as prepayments for services, is both confusing and overly fact sensitive likely resulting in disparate tax treatment to similarly situated taxpayers.

Because *Indianapolis Power* was decided on the deposit side of the distinction, the *Karns* court was clearly bound by its precedent. But, because the Third Circuit limited its decision and discussion as to whether the cash advance received by *Karns* constituted a loan, it missed an opportunity to further clarify the disparate tax treatment of other advance payments.

165. *Id.* at 1731-33.

166. See Hasen, *supra* note 1, at 403 (citing and discussing Geier, *supra* note 10, at 133; and Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245, 256-65 (2007)).

167. *Indianapolis Power & Light Co. v. Comm'r*, 88 T.C. 964, 970 (1987).

168. *Indianapolis Power*, 493 U.S. at 212.

169. See *supra* note 41 and accompanying text.

170. See *supra* note 83 and accompanying text.

In particular, it might have seized the opportunity to expand the deferral potential created by the Seventh Circuit in *Artnell*. Could the future purchases requirement under Karns' supply agreement constitute a sufficiently definite showing of associated future expenses so as to permit deferral in whole or in part under *Artnell*? In other words, could Karns have deferred recognition of a portion of the cash advance on a pro rata basis as future purchases were made under the supply agreement? As in *Artnell*, an argument could be made that such treatment clearly reflects income under the deferral and matching principles inherent in the accrual method.

In the end, *Karns*' legacy may be simple, yet pertinent — it ended a line of cases like *Westpac* and *Erickson Post* that successfully challenged the IRS's long-held position that advance payments and advance trade discounts are includable in income upon receipt.¹⁷¹ Even though it perpetuated the complex distinction between loan-like deposits and other advance payments, *Karns* nevertheless applied legal precedent appropriately and, through Judge Ambro's concurrence, reaffirmed the importance of timing considerations in income tax accounting. Although challenging the Supreme Court's trifecta on facts arguably similar to *Artnell* may constitute a viable academic exercise, the ultimate responsibility to clarify or reduce the complexity of the income tax treatment with respect to advance receipts lies practically with Congress and the IRS, not the judicial system.

171. Seago, *supra* note 104, at 144.