Tax Accounting

By John B. Palmer III

When Can A Payment Subject To An Offsetting Obligation Be Excluded From Income?

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It is not uncommon for a taxpayer to receive a payment subject to an offsetting legal obligation, either to repay the funds under specified circumstances or to expend the funds in a manner directed by the payor. If the transaction is not clearly documented as a loan, the taxpayer faces the question whether the payment must be included in income.

Although this issue can arise in an almost infinite variety of factual contexts, in most situations the case law resolves the tax treatment of the payment under (1) the "claim of right" doctrine, (2) the developing body of case law relating to "deposits," or (3) "agency," "conduit," or "trust fund" theories. A common thread in all these lines of authority is that the treatment of the payment depends almost entirely on the nature of the obligation to return or expend the funds. Surprisingly, whether the taxpayer segregates or earns a return on the received funds does not appear to be of much significance in resolving the income recognition issue.

Most practitioners are generally familiar with the law that governs these situations, but, in the author's experience, many are not aware of all the circumstances under which a payment received under an offsetting obligation may be excluded from income. This column will examine the tax treatment of such payments, focusing specifically on the factors that bear on whether the taxpayer can avoid including the payment in income.

The Claim of Right Doctrine

A good starting point for the analysis is the "claim of right" doctrine. In the typical "claim of right" case, the taxpayer receives a payment subject to a potential repayment obligation.[1] This obligation may be contingent as of the end of the year in which the payment is received (*e.g.*, where the repayment is required only upon the occurrence of an event in a future year); or, it may be fixed at that time, but the taxpayer may not believe that the obligation exists or does not intend to honor the obligation.

The classic formulation of the "claim of right" doctrine holds that when a taxpayer receives a payment under a "claim of right and without restriction as to its disposition," it is required to include the payment in income in the year received, "even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."[2] If the taxpayer returns the payment in a later tax year, it cannot amend the tax return for the earlier tax year for the purpose of changing the treatment of the item previously reported,[3] for that would violate the annual accounting period doctrine.[4] Instead, the taxpayer may be allowed to claim a deduction for the repayment in the later tax year.[5]

This formulation of the "claim of right" doctrine suggests that whether a taxpayer is required to report a payment has two components: whether the taxpayer has received the payment under a "claim of right," and whether there are "restrictions as to the disposition" of the received funds. In practice, however, the courts have focused primarily on one factor, namely, whether a fixed obligation to repay the funds exists and is acknowledged by the taxpayer as of the end of the tax year in which the funds are received. If the legal obligation to repay the funds is contingent on events occurring in a later tax year (*e.g.*, the obligation to repay insurance commissions if a policy is not renewed), the taxpayer must include the payment in income in the year of receipt.[6] Even if a fixed and legally binding obligation to return the payment technically exists at the end of the year in which the payment is received, the courts will ordinarily require the taxpayer to include the payment in income if he or she *acts* as the owner of the income (*e.g.*, where at year-end the taxpayer believes that he or she is entitled to keep the payment[7] or is aware of the obligation to return the payment but intends to ignore it[8]). To paraphrase the classic *Glenshaw* definition of income,[9] acting as if one is entitled to retain a payment is sufficient "dominion" over the payment to regard it as an "accession to wealth" that is includible in income.

By contrast, if the taxpayer expressly acknowledges an existing and fixed obligation to repay an amount erroneously received and makes provisions for repayment prior to the end of the tax year in which the payment is received, the courts will usually allow the taxpayer to exclude the payment from income.[10] In this situation, it does not appear to matter whether the taxpayer commingles the funds or is legally restricted in its use of the funds during the period between the date of receipt and the date of repayment. Effectively, a sufficient acknowledgment of the legal obligation to return the funds converts what would otherwise be income into a loan.

In summary, the "claim of right" cases establish that if a payment is received under an obligation to return the funds, the mere existence of that obligation is not sufficient to prevent the inclusion of a payment in income. Rather, unless the obligation is unconditional and the taxpayer affirmatively acknowledges the obligation and makes provision for its repayment before the end of the tax year in which the payment is received, the taxpayer will ordinarily be deemed to have received the payment under a "claim of right" and must include it in income. If the taxpayer does acknowledge the obligation and makes provision for payment in a timely manner, the fact that the taxpayer commingles and uses the received funds during the interval between receipt and repayment of the funds appears to be of no great importance.

Income v. Deposits

Recent years have witnessed considerable litigation over the question whether a payment is a nontaxable "deposit" or an advance payment that is includible in income. Conceptually, the "deposit" cases are a subset of the "claim of right" cases, in that they involve the receipt of a payment subject to the potential obligation to return the payment to the customer at a later date. What sets these cases apart from the typical "claim of right" case is that the taxpayer usually receives the payment from a customer under an agreement that allows any unrefunded portion of the payment to be applied to income earned by the taxpayer under certain circumstances. This factor causes the payment to resemble taxable prepaid income and, not surprisingly, that is the view often taken by the IRS.

As most practitioners are aware, the tax treatment of this kind of deposit[11] was settled in *Indianapolis Power and Light Co.*[12] In that case, an electric utility

(IPL) required certain customers to make deposits "to insure prompt payment" of future utility bills. IPL commingled these payments with its other funds, but agreed to refund a customer's payment prior to the termination of service if the customer demonstrated acceptable credit. The refund was usually paid in cash or by check, but the customer could choose to have the deposit applied to future utility bills.

The Court ruled that in determining whether the deposits were includible in income, the critical factor is "whether the taxpayer has some guarantee that he will be allowed to keep the money."[13] If the taxpayer can assure itself of the right to retain the payment, then, according to the Court, the payment is income; but, if control over the return of the funds resides in the customer, the deposit is more like a loan than an advance payment and will be treated as such.

The Court went on to say that if a deposit meets the *Indianapolis Power* test for exclusion from income, the fact that the taxpayer commingles the funds with other assets, or earns a return on those deposits, is irrelevant to the income tax treatment of the deposit.[14] That stands to reason, for if the taxpayer is under an obligation to refund the payment, then the taxpayer's interim ability to use and invest the proceeds should be vested with no greater significance than a borrower's use or investment of loan proceeds prior to repayment.[15]

The Court also indicated that the customer's right to apply the payment to future utility bills, by itself, had no bearing on the treatment of the deposit in the year of receipt, because the customer was under no compulsion to do so. It is, according to the Court, "that element of choice that distinguishes an advance payment from a loan."[16] The Court elaborated:

> The individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep. The customer who submits a deposit to the utility . . . retains the right to insist upon repayment in cash; he may choose to apply the money to the purchase of electricity, but he assumes no obligation to do so, and the utility therefore acquires no unfettered 'dominion' over the money at the time of receipt.[17]

In other words, the customer's right to apply the deposit to the payment of future utility bills was not materially different than his or her right to demand the refund in cash and use the proceeds to pay such utility bills.

Indianapolis Power thus established that whether a payment received by a taxpayer is a nontaxable deposit or prepaid income turns on whether the taxpayer has control over the right to retain the funds.[18] The deposits at issue in the case met the Court's test for excluding a payment from income, because the customer, rather than the taxpayer, controlled whether the deposit was refunded or applied to the payment of utility bills. In the Court's words, "[s]o long as the customer fulfills his legal obligation to make timely payments, his deposit ultimately is to be refunded, and both the timing and method of that refund are largely within the control of the customer."[19]

Indianapolis Power was a watershed, not just because it established that customer deposits may be excluded from income, but also because it opened the door for the exclusion of other kinds of payments as well. Cases decided after *Indianapolis Power*[20] suggest that *any* payment will be excludible from income, regardless of what it is called, if the taxpayer has an obligation to return the payment that satisfies the *Indianapolis Power* standard.[21]

An example of the reach of *Indianapolis Power* is *Houston Industries Inc.*[22] There, a public utility charged its customers for fuel costs based on a fixed charge per kilowatt hour, subject to an obligation (imposed by a regulatory authority) to compensate its customers, with interest, to the extent the charges exceeded actual fuel costs. The taxpayer recorded overrecoveries of fuel costs, as well as underrecoveries and interest, in a deferred credit book account and ultimately refunded the balance in that account through credits to the bills of its customers in 1984 and by check in 1985. The Government argued that the overrecoveries were contingent upon the existence of sufficient underrecoveries to absorb them, but the court, relying on *Indianapolis Power*, ruled that the overrecoveries were not income, because the taxpayer had a statutory obligation to offset these amounts against later underrecoveries or to refund the balance to its customers.[23] The fact that the amounts at issue were billed to the taxpayer's customers in the same manner as other utility charges and were not called "deposits" had no bearing on the decision.

One of the critical issues emerging from *Indianapolis Power* is the nature of the taxpayer's obligation that is required to avoid inclusion of a payment in income. The first and somewhat obvious point to note here is that the taxpayer's obligation to refund a payment must not be contingent if the taxpayer is to avoid taxation on receipt of the payment. If there is a set of circumstances under which the taxpayer can retain the funds (other than the customer's independent decision to apply the funds to the payment of income), *Indianapolis Power* cannot shield the taxpayer from the claim of right doctrine. For example, in *Continental Illinois Corporation*,[24] the taxpayer received interest payments under a floating rate loan, but agreed that at maturity it would refund any interest received in excess of a stated cap. The Seventh Circuit refused to apply *Indianapolis Power* to any interest in excess of the cap that the taxpayer collected prior to maturity, because the taxpayer's obligation to refund that interest was contingent.

A second point to make about *Indianapolis Power* is that it makes the exclusion of a payment from income depend on whether the customer is granted a right to receive a refund "in cash." The obligation to refund the upfront payment in cash was, in the Court's view, the thing that distinguishes an advance payment of income from a nontaxable deposit.[25] It follows from *Indianapolis Power* that a payment that is refundable solely by credits against payments required to be made under a contract cannot escape current taxation.[26]

In *Kansas City Southern Industries,*[27] however, the taxpayer escaped taxation on upfront payments that were effectively used to offset contract payments. In that case, the taxpayer, a railroad, agreed with various shippers to construct "sidetracks" to the shippers' industrial facilities under agreements that required the shipper to deposit the construction costs with the taxpayer. The agreements required the taxpayer to refund the construction costs to the shippers over a period of time in installments, with each payment calculated on the basis of the number of railcars originating on or destined to the sidetrack, multiplied by a fixed dollar amount. While the opinion is not entirely clear, it appears that the taxpayer made these refunds in cash; however, their effect was to provide a discount on shipping services purchased from the taxpayer. To underscore the connection between the refunds and the purchase of services from the taxpayer, the agreement provided that if the shipper failed to carry on business at the plant for three consecutive months in any 12-month period, or if it sold its business, then the taxpayer had the right to terminate its obligation to refund construction costs.

On these facts, the Tax Court held that the upfront payments received by the taxpayer from the shippers were nontaxable deposits. Relying on *Indianapolis Power,* the court rejected the IRS's argument that the taxpayer's right to retain the payment upon the shipper's discontinuation or sale of its business at the location amounted to "some guarantee" that it could keep the money. In the court's view, whether the taxpayer could retain the upfront payment depended entirely on whether the shipper continued to use the taxpayer's services, which was, in the court's view, entirely in the shipper's control.[28]

Kansas City Southern suggests that if a taxpayer has a properly documented contractual right to "earn" a deposit (*e.g.,* through the performance of services), it can avoid triggering the inclusion of the deposit in income in the year of receipt. Suppose, for example, that a customer makes an upfront payment to the taxpayer under a long-term agreement for services that is terminable at any time by the customer but requires the taxpayer to refund only a proportionate part of the upfront payment upon termination. Does taxpayer's right to earn the payment over time undermine its argument that the upfront payment is a mere deposit, rather than an advance payment of income? Or, does the customer's right to terminate the contract unilaterally at any time satisfy the *Indianapolis Power* test as to the portion of the deposit that would be refunded upon such termination?

Although the Court in *Indianapolis Power* made a point of emphasizing that customers who established good credit with the taxpayer had the right to receive full refunds of their deposits without regard to whether they continued to purchase utility services from the taxpayer,[29] the opinion seems to imply that other arrangements could pass muster under the *Indianapolis Power* test. If the customer has the right to receive a cash refund upon the termination of the contract, then the customer's unilateral right to terminate the contract should be sufficient to cause the portion of the upfront payment that is refundable upon termination to be excludible from income.

At least one court has addressed this issue and agrees with this conclusion. In *Highland Farms, Inc.,*[30] an accrual method operator of a continuing care residential retirement community charged new residents "entry fees." Each new resident was granted the unilateral right to terminate his or her rental contract, and if the contract were terminated (or the resident died) within five years, the taxpayer was required to refund a portion of the entry fee. The IRS argued that the entry fees were prepaid rent and required the taxpayer to include them in income in the year of receipt. The court saw it differently, however. Relying on *Indianapolis Power*, the court held that the entry fees were mere deposits, not includible in income in the year received, and that only the nonrefundable or nonforfeitable amount was includible in income each year. It also ruled that the IRS's attempt to invoke Code Sec. 446(b)[31] was an abuse of discretion.[32]

Highland Farms and *Kansas City Southern* suggest that *Indianapolis Power* may provide a reliable basis for circumventing authorities requiring accrual method taxpayers to include advance payments for services, *etc.,* in income in the year received.[33] That is, if a contract provides for a prepayment but permits the customer to terminate the contract at will during its term with proportionate refunding of the prepayment, the taxpayer's lack of control of the refund supports the conclusion that the upfront payment is not income until the year it becomes nonforfeitable.

In summary, the *Indianapolis Power* line of cases permits a taxpayer to exclude a payment received from a customer from income if the taxpayer has an unconditional contractual, statutory or regulatory obligation to refund the payment in cash and lacks the power to defeat the obligation. Whether the taxpayer segregates the funds or earns a return from the investment of such funds is not significant.

Agency, Conduit and Trust Fund Theories

What if a taxpayer receives a payment under an obligation not to return the payment to the payor, but rather, to expend the funds for the benefit of the payor? Suppose, for example, that the seller of a building induces the taxpayer to enter into a long-term lease of a building from the prospective purchaser for above market rentals by paying the taxpayer a lump sum amount having a present value equal to the above market rentals. Does the taxpayer's obligation to make above market rental payments provide a basis for excluding the up front payment from income?

Taxpayers have employed "agency" and "conduit" theories to address similar questions, with some degree of success. Under these theories, a taxpayer can make a case for excluding a payment from income by showing either that it received the payment as agent for a third party and under an obligation to forward the payment to such third party,[34] or that it was a mere intermediary to facilitate a payment by the payor to the third party.[35] For example, the IRS has ruled that a university faculty member who receives fees (*e.g.*, from a court) for services provided to indigent clients under a university sponsored program and is obligated to turn such fees over to the university can exclude the payments from income.[36]

Similarly, taxpayers have successfully avoided income recognition from payments that are intended to reimburse them for expenses incurred in an activity conducted on behalf of the payor, even in situations where the taxpayer was not employed by the payor.[37] For example, in Rev. Rul. 77-279[38] and Rev. Rul. 77-280,[39] the IRS ruled that expense reimbursement payments received by foster care and day care providers from program sponsors were excludible from income to the extent the payments did not exceed the expenses incurred by the provider.[40]

The agency and conduit theories, however, have an important limitation, namely, that neither appears to accommodate the situation where the taxpayer is permitted to use and even invest the received payment pending the expenditure of the funds. Consequently, the above authorities are unlikely to be helpful in a wide variety of situations (including the one described above).

For this situation, however, there is yet another line of helpful authorities, the so-called "trust fund" cases. Borrowing from the well-established rule that payments received by a trustee solely and expressly for the benefit of another are not income to the trustee in his individual capacity,[41] the "trust fund" doctrine allows a taxpayer to exclude a payment received from another party from income provided the arrangements satisfy conditions that, it turns out, are remarkably similar to those prescribed by *Indianapolis Power*.

The leading case is *Seven-Up Co.*,[42] which was decided well before *Indianapolis Power*. In that case, participating bottlers of 7-Up paid money to the taxpayer, the manufacturer of 7-Up extract, "for purposes of advertising" the 7-Up beverage. The taxpayer placed the advertising funds received from the bottlers in one or more regular operating accounts, thereby commingling the advertising funds with its own operating funds, but it accounted for the advertising funds separately on its books in a special liability account. No individual bottler retained any right to the funds it contributed, so that when a bottler's franchise was sold or canceled, all amounts previously contributed to the advertising fund by the bottler were retained by the taxpayer for advertising. However, the taxpayer did, in fact, honor its obligation to spend all the received funds for advertising. Although the advertising benefited the taxpayer by improving its sales of extract, the court found that the all parties understood that the advertising was conducted for the benefit of the bottlers.

On these facts, the Tax Court held that the funds received by the taxpayer "constituted a trust fund" for "advertising purposes" and were not includible in Seven-Up's gross income. The taxpayer's unconditional written obligation to use all of the received funds for advertising, its accounting for the advertising funds as a liability on its books and the fact that the taxpayer honored its obligation to spend all the received funds for advertising for the benefit of the bottlers were critical to the court's determination.

Significantly, the court rejected the Government's contention that the commingling of funds destroyed the identity of the trust, based on the fact that the taxpayer had sufficient cash and securities on hand to satisfy its obligations to purchase advertising and that "its books showed precisely the amounts contributed and unexpended."[43] It noted that:

> As custodian of the funds and agent for the bottlers, petitioner was obligated to expend them for national advertising and any diversion for corporate or other purposes might be enjoined by the bottlers by a suit in equity. [44]

Seven-Up thus established that if a taxpayer receives a payment under a binding legal obligation to expend the amount received for the benefit of the payor, the taxpayer is deemed to hold the payment "in trust" and is not required to include the payment in income.[45] Significantly, the "trust fund" doctrine can apply even if the arrangement does not constitute a trust under state law.[46]

In order to avail itself of the "trust fund" doctrine, it appears that a taxpayer must satisfy only two requirements. First, the taxpayer must show that it has a legally enforceable obligation to pay the amount received for a specified purpose.[47] In a number of cases, taxpayers have proven the enforceability of their promises to spend the money received for the specified purposes by presenting evidence of a binding written contract.[48] However, a case can be made that even a written contract is not required, if the taxpayer can otherwise demonstrate the existence of a binding obligation. For example, in *Ford Dealers Advertising Fund, Inc.*,[49] the taxpayer, a special purpose corporation formed for the purpose of facilitating advertising for Ford dealers, was permitted to exclude from income recognition payments received from Ford Motor Co. in the absence of a written agreement with Ford as to the disposition of the funds received, where there was testimony at trial that amounts paid by Ford were supposed to be spent on advertising for the benefit of the dealers.[50]

Although in many of the trust fund cases, the payor was the person who possessed the right to enforce the taxpayer's promise, the "trust fund" doctrine can apply where another person has that right. In *Illinois Power Co.*,[51] the Illinois Commerce Commission (ICC) ordered the taxpayer to increase its electricity rates for certain commercial customers to encourage conservation. From the time the order was issued, the ICC made clear that the taxpayer would not be allowed to keep the additional money it collected from its customers under this directive, but the ICC failed to specify the precise manner in which Illinois Power would be required to disgorge the money, or when, to whom or with what interest. In 1979, the Commission decided that the money would be disbursed in the form of a credit on the utility bills of all of the taxpayer's customers (*i.e.*, not just the commercial customers from which the payments were originally collected). The Seventh Circuit held that under these facts, the increased charges were not includible in the taxpayer's gross income, because the taxpayer was only a "custodian" of the funds with no beneficial interest therein.[52]

The second requirement of the "trust fund" doctrine is that the taxpayer must be obligated to spend the received funds for the benefit of someone other than the taxpayer. In most of the "trust fund" cases, the intended beneficiary was the payor or group of payors. For example, in many of the cases, the taxpayers were required to spend the received funds for the advertising and promotion of products sold by the payors.[53] Similarly, in *Broadcast Measurement Bureau, Inc.*,[54] the court held that fees received from subscribers for the purpose of funding the cost of compiling and distributing nationwide surveys measuring radio station and network audiences for the benefit of subscribers were excludible from income.

However, just as a settlor of a trust is not required to name himself as beneficiary, the "trust fund" cases do not appear to be limited to situations where the taxpayer is required to spend the received payment for the benefit of the payor. For example, in the *Ford Dealers Advertising Fund* case mentioned earlier,[55] the taxpayer was allowed to exclude from income funds received from Ford Motor Co. (in addition to the funds received from its dealers) to provide for advertising that, according to the court, was intended to benefit the dealers, not Ford itself.

Another example of this is *Illinois Power Co.*[56] As noted earlier, in that case, the ICC ordered the taxpayer to increase its electricity rates for certain commercial customers to encourage conservation.

At the time the additional revenues were collected, neither the ICC, the taxpayer, nor the payors knew to whom (or for what) the additional collected amounts would be paid and ultimately the collected funds were paid to all Illinois customers (not just the commercial customers from whom the funds were collected). The court allowed the taxpayer to exclude the additional revenues from income, stating:

> When a company collects sales tax as the government's agent, the money does not go to the customers who made the purchases on which the tax was levied. And the settlor and the trustee of a trust are not the same persons as the beneficiaries. . . .
>
> And we cannot see what difference it makes that the refunds here were to a class of customers some or many members of which may have been different individuals from those who paid the higher rates ordered by the Commission.[57]

Consistent with *Indianapolis Power*, the "trust fund" doctrine does not apply if the terms on which the taxpayer receives the funds permit the taxpayer to retain all or a portion of the payment.[58] This means that the agreement under which the funds are received must require the taxpayer to spend all of the received funds for the specified purposes or obligate the taxpayer to return any unexpended funds to the payor.

For example, in *Broadcast Measurement Bureau,*[59] the taxpayer collected subscription fees for the purpose of compiling and distributing a nationwide survey measuring radio station and network audiences according to a uniform standard. The court analyzed the subscription contracts and the taxpayer's performance under the contracts, finding that (1) the contracts called for a single study, (2) use of the fees other than for a corporate purpose would be a violation of the contracts, and (3) the taxpayer was required to return any excess fees to its members, either by refund or by a credit against the cost of future studies. Based on these findings, the court concluded that "it was settled from the outset that [the taxpayer] would receive no gain" and held that the taxpayer was allowed to exclude the subscription fees from income.[60]

Similar to *Broadcast Measurement* are the advertising fund cases. In each of these cases, the court's determination that payments received were excludable from income was based on the court's finding that (1) the use of the funds was restricted by contract to advertising and promoting products "and necessary corporate expenses incident thereto," (2) any funds left upon the dissolution of the taxpayer were required to be utilized for the same purpose, and (3) the taxpayer was not permitted to receive any "compensation for handling the funds."[61]

These cases stand in contrast to *Krim-Ko Corp.*[62] There, a manufacturer of chocolate syrup and its distributors engaged in an advertising program pursuant to which the distributors paid the taxpayer a certain amount per gallon of syrup, and, in return, the taxpayer furnished "advertising features and sales promotion services." Although the taxpayer maintained separate records for each customer's contribution to the advertising pool, the agreements did not expressly require the taxpayer to expend all the funds on advertising or to return any unexpended funds to the distributors. Not surprisingly, the Tax Court refused to characterize the arrangement as a "trust," finding instead that "Krim-Ko, as an adjunct to its principal business, had undertaken to sell special advertising material and services to its customers."[63] Based on this determination, the court required the taxpayer to include the payments made to the advertising fund in income.[64]

The restriction on the taxpayer's right to benefit from the "trust fund" does not preclude the taxpayer from receiving incidental financial benefits from the payment. On the contrary, the cases allowing taxpayers to exclude payments received from income under the "trust fund" doctrine have explicitly or implicitly permitted the recipient of a payment to benefit incidentally in three ways.

First, the case law makes clear that the taxpayer may commingle the funds received with other funds belonging to the taxpayer. Consequently, prior to spending the funds for the prescribed purpose, it appears that the taxpayer is allowed to use the funds (and even retain the earnings from the temporary investment of the funds) without forfeiting the right to exclude the payment from income, as long as the taxpayer spends an amount equal to the total amount received for the specified purpose.[65]

Second, in at least one instance, a court allowed the taxpayer to avoid taxation on funds used to cover overhead expenses.[66]

Third, the case law implicitly permits the taxpayer's business to benefit indirectly from the specified expenditures, as long as that benefit is incidental to the purpose of the expenditure. In *Seven-Up*, for example, the taxpayer was permitted to avoid taxation of payments devoted to advertising, even though the taxpayer indirectly benefited from the advertising (in the form of an increase in the volume of extract sold).[67]

Conclusion

While the "claim of right" doctrine, the deposit cases, and the agency, conduit and trust fund authorities all deal with different situations, they have as a common premise the notion that a payment cannot be income if the taxpayer does not have the power to control whether it will retain the payment. Where the taxpayer lacks such power, its ability to invest or use the proceeds in the period between the receipt and refund (or expenditure) of the funds has very little bearing on the tax treatment of the payment.

ENDNOTES

1 The "claim of right" doctrine has also been invoked where an accrual method taxpayer properly accrues an item of unpaid income that may be forfeited in a later year. *See, e.g., Brown v. Helvering*, SCt, 291 US 192 (1934) (insurance commissions returnable upon the cancellation of the insurance policies); and *Barker v. McGruder*, CA-DC, 38-1 USTC ¶9052 , 95 F2d 122 (usurious interest).

2 *See North American Oil Consolidated v. Burnet*, SCt, 3 USTC ¶943, 286 US 417, 424, 53 SCt 613 (1932).

3 *See E.R. Lewis,* SCt, 51-1 USTC ¶9211, 340 US 590, 71 SCt 522 (reversing a lower court that permitted the taxpayer to amend his tax return for a prior year in order to exclude from income an erroneously paid, but previously reported, bonus that was received under a "mistake of fact."

4 One of the cornerstones of federal income tax law, the annual accounting period doctrine holds that a tax return for a tax year cannot be amended to change the treatment of an item based on an event occurring in a later year. *See Burnet v. Sanford & Brooks Co.,* SCt, 2 USTC ¶636, 282 US 359, 365, 51 SCt 150 (1931) (annual accounting period is a practical necessity stemming from the need of the Government to collect taxes at regular intervals based on events occurring within each interval).

5 *See, e.g., North American Oil Consolidated v. Burnet, supra*, at 424 ("If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year"); and *Nordberg v. Commissioner,* 79 T.C. 655, 665 (1982), *aff'd in unpublished opinion*, 720 F.2d 658 (1st Cir. 1983) ("where the taxpayer is required to repay some or all of the money in a later year, a deduction may then be available to him in the later year to the extent permitted by law").

6 *See, e.g., Brown v. Helvering, supra* note 1; *Barker v. McGruder, supra* note 1.

7 An example of this is *E.R. Lewis, supra* note 3, where the taxpayer received an erroneously calculated bonus. Even though Lewis never possessed the legal right to retain the bonus (and was ultimately forced to return it), he was required to include the bonus in income in the year of receipt.

8 The claim of right doctrine requires a taxpayer to include embezzled funds in income despite the known existence of an absolute obligation to repay the funds. *See E.C. James,* SCt, 61-1 USTC ¶9449, 366 US 213, 219, 81 SCt 1052 (claim of right doctrine applies when "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").

9 *See Glenshaw Glass Co.,* SCt, 55-1 USTC ¶9308, 348 US 426, 431, 75 SCt 473 (taxpayers are required to include in income "all accessions to wealth clearly realized, and over which the taxpayers have complete dominion").

10 *See, e.g., R.D. Merrill,* CA-9, 54-1 USTC ¶9275, 211 F2d 297, *Bates Motor Transport Lines, Inc.,* CA-7, 52-2 USTC ¶9564, 200 F2d 20; and *Smarthealth, Inc.,* 81 TCM 1777, Dec. 54,374(M), TC Memo. 2001-145. The cases vary on the nature of the acknowledgment that is required. For example, cases involving embezzlement seem to require a stronger acknowledgment of liability than other cases. *Compare W. Buff,* CA-2, 74-1 USTC ¶9353, 496 F2d 847 (affidavit of confession of judgment and agreement to repay out of wages not enough), with *J.W. Gaddy,* 38 TC 943, Dec. 25,673 (1962) *aff'd in part, rem'd in part,* CA-5, 65-1 USTC ¶9342, 344 F2d 460 (evidence that both parties recognized obligation to repay was good enough); and *Smarthealth, Inc.* (no income recognized where taxpayer adjusted customer account balances prior to year end without informing customers).

11 It has been long-settled that deposits to secure the performance of non-income producing covenants (e.g., a security deposit in a lease) are excludible from income. *See e.g., Warren Service Corp.,* CA-2, 40-1 USTC ¶9333, 110 F2d 723.

12 *Indianapolis Power and Light Co.,* SCt, 90-1 USTC ¶50,007, 493 US 203, 110 SCt 589.

13 *Id.* at 210.

14 *Id.* at 209-210.

15 See also *Oak Industries, Inc.,* 96 TC 559, 577, Dec. 47,262 (1991); *Kansas City Southern Industries, Inc.,* 98 TC 242, Dec. 48,051 (1992), *nonacq.* 1994-2 CB 1.

16 *Indianapolis Power and Light Co., supra* note 12, 493 US at 212.

17 *Id.*

18 *See also Oak Industries, Inc., supra* note 15, at 571-577 (payments to secure future payment of subscription fees to over-the-air subscription television operator were deposits; right to apply payments against unpaid subscription fees at disconnect did not give taxpayer "complete dominion" over the funds).

19 *Indianapolis Power and Light Co., supra* note 12, 493 US at 209.

20 *See, e.g., Houston Industries Inc.*, CA-FC, 97-2 USTC ¶50,651, 125 F3d 1442; *Cinergy Corp.*, FedCl, 2003-1 USTC ¶50,302, 55 FedCl 489; *Florida Progress Corp.,* 114 TC 587, Dec. 53,937 (2000), *aff'd per curiam*, CA-11, 2003-2 USTC ¶50,694, 348 F3d 954; *Highland Farms, Inc.*, 106 TC 237, Dec. 51,296 (1996); *Kansas City Southern Industries, Inc.,* 98 TC 242, Dec. 48,051 (1992), *nonacq.* 1994-2 CB 1; *Oak Industries, Inc., supra* note 15; *Perry Funeral Home, Inc.,* 86 TCM 713, Dec. 55,376(M), TC Memo. 2003-340.

21 *See, e.g., Westpac Pacific Foods,* CA-9, 2006-2 USTC ¶50,369, 451 F3d 970, *rev'g*, 82 TCM 175, Dec. 54,407(M) , TC Memo. 2001-175 (cash advances received from *suppliers* in consideration for volume purchase commitments were excludible from income under *Indianapolis Power*).

22 *Houston Industries Inc.*, CA-FC, 97-2 USTC ¶50,651, 125 F3d 1442.

23 *See also Cinergy Corp.*, FedCl, 2003-1 USTC ¶50,302, 55 FedCl 489 (following *Houston Industries*); and *Florida Progress Corp.,* 114 TC 587, Dec. 53,937 (2000), *aff'd per curiam*, CA-11, 2003-2 USTC ¶50,694, 348 F3d 954. In Rev. Rul. 2003-39, IRB 2003-17, 811; 2003-1 CB 811, the IRS stated that it will follow *Houston Industries, Cinergy, and Florida Progress.*

24 *Continental Illinois Corporation*, CA-7, 93-2 ¶50,400, 998 F2d 513.

25 *See* language quoted at note 17.

26 *See, e.g., Michaelis Nursery, Inc.,* 69 TCM 2300, Dec. 50,562(M), TC Memo. 1995-143 ("deposits" received for sale of trees were advance payments of income, where customer had no right to cancel contract

Endnotes

and receive refund in cash).

27 *Kansas City Southern Industries, Inc.,* 98 TC 242, Dec. 48,051 (1992), *nonacq.* 1994-2 CB 1.

28 *Id.,* at 262. *See also, Erickson Post Acquisition, Inc., 86 TCM 111, Dec. 55,238(M), TC Memo. 2003-218* (loan from major oil company to a retail gasoline dealer, evidenced by a promissory note secured by a mortgage, was a true loan, even though the note provided that each installment due would be forgiven if the borrower remained a dealer of the lender's products on the maturity date of the loan). In *Westpac Pacific Foods, supra* note 21, the taxpayer avoided taxation on an advance trade discount that it was entitled to retain only if it honored its volume purchase commitment. Despite the fact that the taxpayer's obligation to repay the advance trade discount depended entirely on its own performance, the court held that the payment was not income. Although a contrary result was reached in *Karns Prime & Fancy Food, Ltd.,* CA-3, 2007-2 USTC ¶50,570, 494 F3d 404, the IRS has since indicated that it will follow *Westpac* with respect to taxpayers that adopt the "Advance Trade Discount Method" of accounting in accordance with Rev. Proc. 2007-53, 2007-30 I.R.B. 233.

29 *Indianapolis Power and Light Co., supra* note 12, 493 US at 209, 213-14.

30 *Highland Farms, Inc.*, 106 TC 237, Dec. 51,296 (1996).

31 Code Sec. 446(b) gives the IRS the discretion to disallow accounting methods that do not "clearly reflect income."

32 *R.A. Johnson,* 108 TC 448, Dec. 52,090, *aff'd in part, rev'd in part,* CA-8, 99-2 USTC ¶50,699, 184 F3d 786, appears to be to the contrary. There, amounts received by an automobile dealer from customers pursuant to vehicle service contracts were placed in escrow and made available to pay the taxpayer for repair services. Despite the fact that the contracts were terminable by the customers, the court required the taxpayer to include the payments in income in the year received.

33 *See, e.g., Automobile Club of Michigan,* SCt, 57-1 USTC ¶9593, 353 US 180, 77 SCt 707; *American Automobile Association,* SCt, 61-2 USTC ¶9517, 367 US 687, 81 SCt 1727; *M.E. Schlude,* SCt, 63-1 USTC ¶9284, 372 US 128, 83 SCt 601; Rev. Rul. 2007-32, IRB 2007-21, 1278 ("Under the 'all events' test, a taxpayer's right to receive income becomes fixed on the earlier of the date that: (1) payment is earned through performance; (2) payment is due; or (3) payment is actually received"); Rev. Rul. 2003-10, IRB 2003-3, 288; 2003-1 CB 288; Rev. Rul. 84-31, 1984-1 CB 127.

34 *See, e.g.,* Rev. Rul. 76-479, 1976-2 CB 20 ("[A]mounts received by an agent on behalf of a principal, and turned over to the principal, are not taxable to the agent under section 61(a) of the Code"); Rev. Rul. 74-581, 1974-2 CB 25 (fees received by law school faculty and students for representation of indigent defendants and turned over to university were not includible in income, where taxpayers were working "solely as agents of the law school"); Rev. Rul. 69-274, 1969-1 CB 36; Rev. Rul. 68-123, 1968-1 CB 35; Rev. Rul. 65-282, 1965-2 CB 21; Rev. Rul. 58-220, 1958-1 CB 26; and Rev. Rul. 58-515, 1958-2 CB 28.

35 *See, e.g., R. Martinez,* 90 TCM 272, Dec. 56,137(M), TC Memo. 2005-213 ("a taxpayer need not treat as income payments that it did not receive under a claim of right, that were not his to keep, and that he was required to transmit to someone else as a mere conduit"); *Aiken Industries, Inc.,* 56 T.C. 25 (1971), *acq. on another ground*, 1972-1 CB 1. *Cf. Stevens Brothers,* 24 TC 953, Dec. 21,205 (1955) (taxpayer not taxable on payment representing another party's share of profits; *H. Mill,* 5 TC 691, Dec. 14,733; *J.A. Nunez,* 28 TCM 1150, Dec. 29,786(M), TC Memo. 1969-216 (funds received by law firm as mere conduit in conspiracy to pay kick backs for the awarding of a contract were not taxable).

36 *See, e.g.*, Rev. Rul. 74-581, *supra*; Rev. Rul. 69-274, *supra*. Note, however, that if the taxpayer receives compensation from employment not associated with the university (or other institution) but turns the income over pursuant to institutional policy or agreement (or because the taxpayer is under a vow of poverty), assignment of income principles may require the taxpayer to report the compensation. *See* Reg. §1.61-2(c); *F. Schuster,* CA-7, 86-2 USTC ¶9664, 800 F2d 672; *G.P. Fogarty,* CA-FC, 86-1 USTC ¶9139, 780 F2d 1005 (Jesuit priest); *E.J. Hogan,* DC Me., 85-2 USTC ¶9846 (Catholic chaplain); *M.K. Samson,* CA-FC, 84-2 USTC ¶9784, 743 F2d 884; Rev. Rul. 84-13, 1984-1 CB 21; Rev. Rul. 83-27, 1983-2 CB 25; Rev. Rul. 81-267, 1981-2 CB 196; Rev. Rul. 79-132, 1979-1 CB 62; Rev. Rul. 78-229, 1978-1 CB 305; Rev. Rul. 77-290, 1977-2 CB 26; and Rev. Rul. 76-323, 1976-2 CB 18.

37 *See* Rev. Rul. 59-92, 1959-1 CB 11 (researcher and administrator of a research program not taxable on grant to cover costs associated with a research program).

38 Rev. Rul. 77-279, 1977-2 CB 12.

39 Rev. Rul. 77-280, 1977-2 CB 14.

40 While the rationale for these rulings is not explicitly stated, it appears clear that the IRS viewed the taxpayers as agents for the sponsoring institutions or as incurring the expenditures on their behalf. *See* Rev. Rul. 77-280, *supra* Situations 1 and 2 (taxpayers deemed to be working for child-placing agencies) and Situations 3 and 4 (reimbursements paid to taxpayers engaged in profit-making venture not taxable because they were for expenses of the child-placing agencies); Rev. Rul. 77-279, *supra*, Situation 1 (taxpayer not taxable because it is deemed to be working for (and incurring expenses on behalf of) charitable organization and Situation 2 (taxpayer working for parent in profit-making venture taxable on reimbursements); GCM 36349 (Jul. 29, 1975) (conclusions in Situations 3 and 4 of Rev. Rul. 77-280 are based on rule that where a taxpayer makes expenditures under an agreement that he will be reimbursed therefor, such expenditures are not includible in gross income, citing *Henry F. Cochrane*, 23 B.T.A. 202, 208 (1931)); GCM 35958 (Aug. 21, 1974).

41 *See Healy*, SCt, 245 US 278, 282 (1953).

42 *Seven-Up Co.,* 14 TC 965, Dec. 17,656, *acq. in result only,* 1974-2 CB 4.

43 *Seven-Up Co.,* 14 TC 965 at 978.

44 *Id.* In support of this conclusion, the court cited *Charlton v. Chevrolet Motor Co.*, 115 W.Va. 25, 174 S.E. 570 (1934), which held that dealers have a right in a court of equity to enforce a promise to spend an advertising fund for its intended purposes.

45 *See Affiliated Foods, Inc.,* CA-5, 98-2 USTC ¶50,750, 154 F3d 527; *Illinois Power Co.,* CA-7, 86-1 USTC ¶9460, 792 F2d 683; *Ford Dealers Advertising Fund, Inc.*, 55 TC 761, Dec. 30,654, *aff'd*, CA-5, 72-1 USTC ¶9228, 456 F2d 255, *nonacq.*, 1974-2 CB 5, and 1974-2 CB 64; *Angelus Funeral Home*, 47 TC 391, Dec. 28,310, *acq.* 1969-2 CB 20, *aff'd*, 69-1 USTC ¶9216, 407 F2d 210; *Michigan Retailers Assoc.,* DC Mich.. 88-1 USTC ¶9157, 676 FSupp 151; *Greater Pittsburgh Chrysler Dealers Association of Western Pennsylvania*, 39 A.F.T.R.2d 77-1088 (W.D. Pa. 1977); *Florists' Transworld Delivery Ass'n*, 67 TC 333, Dec. 34,124 (1976), *acq.* 1978-2 CB 2; *nonacq.* 1978-2 CB 3; *Park Place, Inc.,* 57 TC 767, Dec. 31,298 (1972); *New York State Ass'n of Real Estate Boards Group Ins. Fund*, 54 TC 1325, Dec. 30,186 (1970); *Dri-Powr Distributors Ass'n Trust*, 54 TC 460, Dec. 30,001 (1970); *Broadcast Measurement Bureau, Inc.*, 16 TC 988, Dec. 18,264, *nonacq*, 1974-2 CB 4, and 1974-2 CB 14; *F. Schochet*, TC Memo. 1982-416, Dec. 39,208(M), 44 TCM 556; Rev. Rul. 56-152, 1956-1 CB 56 (brokerage commissions that brokers were obligated to deposit in a special fund to be administered for public purposes were not taxable).

46 *See, e.g., Ford Dealers Advertising Fund, Inc.*, 55 TC 761, Dec. 30,654, *aff'd*, CA-5, 72-1 USTC ¶9228, 456 F2d 255, *nonacq.*, 1974-2 CB 5, and 1974-2 CB 64 ("there are no specific words of trust in the present case but we conclude . . . that as to all funds received a trust was created by virtue of the contractual agreements, the bylaws and charter, the operations of Advertising itself and the intentions of all parties concerned"); *Broadcast Measurement Bureau, Inc.*, 16 TC 988, at 997, Dec. 18,264, *nonacq*, 1974-2

ENDNOTES

CB 4, and 1974-2 CB 14 ("No express words of trust were used, but none are required"); *Affiliated Foods Inc.*, *supra* note 45; *Illinois Power Co.,* CA-7, 86-1 USTC ¶9460, 792 F2d 683; *Schochet, supra* note 45, at 82-1841 ("we have found no authority in our prior decisions that accords significance to the form of the organization receiving the restricted payments"); and *Michigan Retailers Assn., supra* note 45.

47 *See, e.g., Ford Dealers Advertising Fund, Inc.*, 55 TC 761, Dec. 30,654, *aff'd*, CA-5, 72-1 USTC ¶9228, 456 F2d 255, *nonacq.*, 1974-2 CB 5, and 1974-2 CB 64 (payments received from dealers under agreement to spend the funds on advertising); *Dri-Power Distributors Assn., supra* note 45; *Greater Pittsburgh Chrysler Dealers Association of Western Pennsylvania, supra* note 45; *Affiliated Foods Inc., supra* note 45 (payments received from vendors under agreement to spend the funds on advertising and promotion); *Florists' Transworld Delivery Ass'n, supra* note 45; (payments received to cover advertising costs and clearinghouse operations); *Illinois Power Co.,* CA-7, 86-1 USTC ¶9460, 792 F2d 683 (payments received from customers and required to be applied as directed by regulatory body).

48 *E.g., Seven-Up Co., supra* note 42; *Ford Dealers Advertising Fund, Inc.*, 55 TC 761, Dec. 30,654, *aff'd*, CA-5, 72-1 USTC ¶9228, 456 F2d 255, *nonacq.*, 1974-2 CB 5, and 1974-2 CB 64 (written agreement with dealers); *Greater Pittsburgh Chrysler Dealers Association of Western Pennsylvania, supra* note 45.

49 *Ford Dealers Advertising Fund, Inc.*, 55 TC 761, Dec. 30,654, *aff'd*, CA-5, 72-1 USTC ¶9228, 456 F2d 255, *nonacq.*, 1974-2 CB 5; Rev. Rul. 74-528, 1974-2 CB 64.

50 *See also Michigan Retailers Association, supra* note 45; (taxpayer was "constrained under the attending circumstances and equities" to use payments received for the benefit of its members); *Illinois Power Co.,* CA-7, 86-1 USTC ¶9460, 792 F2d 683 (source of the obligation was a directive of the state regulatory body with jurisdiction over the taxpayer; payors not aware of obligation).

51 *Illinois Power Co.*, CA-7, 86-1 USTC ¶9460, 792 F2d 683.

52 Under similar facts, the Tax Court reached a contrary result in *Lykes Energy, Inc.,* 77 TCM 1535, Dec. 53,286(M), TC Memo. 1999-77 There, the taxpayer was required to include in income amounts received from customers that were required to be spent on programs under the Florida Energy Efficiency and Conservation Act ("FEECA"). Without citation or discussion of *Illinois Power*, the court concluded that no trust existed, because the purported settlors (the taxpayer's customers) did not know they were funding the FEECA program and assumed that the payments were for natural gas. The court was also influenced by the fact that the FEECA programs benefited the taxpayer by encouraging customers to purchase appliances from the taxpayers.

53 See *Seven-Up Co., supra* note 42; *Ford Dealers Advertising Fund, Inc., supra* note 49; *Affiliated Foods, Inc.,* supra note 45; *Florists' Transworld Delivery Ass'n*, supra note 45; and *Dri-Power Distributors Association*, supra note 45.

54 *Broadcast Measurement Bureau, Inc.*, 16 TC 988, Dec. 18,264, *nonacq*, 1974-2 CB 4, and 1974-2 CB 14.

55 *Ford Dealers Advertising Fund, Inc., supra* note 49.

56 *Illinois Power Co.,* supra note 51.

57 *Illinois Power Co.,* CA-7, 86-1 USTC ¶9460, 792 F2d 683, at 689.

58 *See Ford Dealers Advertising Fund, Inc,, supra* note 49 at 773 ("The benefit, profit, or gain is not to accrue to the intermediary but rather to some other entity"); *Angelus Funeral Home, supra* note 45 (taxpayer's right to withdraw funds for capital expenditures beneficial to its business caused amounts received to be includible in income). *Compare Houston Industries Inc., supra* note 20, where the court held that fuel cost overrecoveries received by a utility were excludible from income as a "deposit" under *Indianapolis Power* because the taxpayer was required to apply them to offset future fuel cost underrecoveries. The Court distinguished an earlier decision from the same Circuit, *Iowa Southern Utilities Co., and Subsidiary Cos.,* CA-FC, 88-1 USTC ¶9228, 841 F2d 1108, on the ground that the construction surcharge collected by the taxpayer in that case was to finance construction and therefore "was for the benefit of the utility."

59 *Broadcast Measurement Bureau, Inc., supra* note 54.

60 *Broadcast Measurement Bureau, Inc., supra* note 54, at 999-1000.

61 *See Seven-Up Co., supra* note 42; *Ford Dealers Advertising Fund, Inc., supra* note 49; *Affiliated Foods, Inc., supra* note 45; *Florists Transworld Delivery Ass'n, supra* note 45; *Greater Pittsburgh Chrysler Dealers Association of Western Pennsylvania, supra* note 45; and *Dri-Power Distributors Ass'n, supra* note 45.

62 *Krim-Ko Corp.,* 16 TC 31, Dec. 18,023 (1951).

63 *Id.,* at 39.

64 *See also* Rev. Rul. 76-276, 1976-2 CB 14 (Congressman required to include in gross income funds contributed to a trust to defray travel expenses incurred by him and his staff in the performance of their official duties). Rev. Rul. 76-276 should be contrasted with Rev. Rul. 59-92, 1959-1 CB 11, in which the IRS ruled that a scientist is not required to report funds received under a grant to pay research expenses if he cannot receive any part for himself and any unexpended balance must be returned to the grantor. The ruling states: "In the instant case, the taxpayer clearly did not receive the funds granted as his own property. He was burdened with the obligation to use them for the purposes and in the manner set forth in the terms of the grant." *Cf. Texas & Pacific Railway Co.,* SCt, 286 US 285 (1932) (payment for the purpose of supporting taxpayer's operations is taxable subsidy); *Coastal Utilities, Inc.,* 99 A.F.T.R.2d 2007-2014 (S.D. Ga. 2007), *aff'd,* 101 A.F.T.R.2d 2008-836 (11th Cir. 2008); *D.H. Deason,* CA-5, 79-1 USTC ¶9269, 590 F2d 1377; and Rev. Rul. 2007-31, IRB 2007-21, 1275.

65 *E.g., Seven-Up Co., supra* note 42; and *Illinois Power Co., supra* note 51.

66 *Florist's Transworld Delivery Ass'n, supra* note 45, at 346 ("Whatever 'benefit' petitioner may have obtained in virtue of the allocation of a portion of general administrative and overhead expenses to the Clearing House and Marketing Divisions . . . was incidental and secondary").

67 *Cf. Kansas City Southern Industries, Inc., supra* note 27 (payments received from customers to build sidetracks were nontaxable deposits despite obvious benefit brought to the taxpayer's business from greater access to the customer's facility, because taxpayer was obligated to return amounts received to customers over time.)