

# TAX UPDATE

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## A Matter of Timing-When Income and Deductions are Reported

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## Offsets and Recognizing Income or Deduction

The Tax Court this week, in the case of *Trinity Industries v. Commissioner*, 132 TC No. 2, took a look at an issue regarding the amount and timing of the recognition of income and expense items. The case serves as a review of the principles involved in strange world where accounting theory meets tax law, with the result being a rather unique set of timing rules for the recognition of economic events. The bad news for the taxpayer in this case is that they had to recognize all income immediately, but were not able to currently claim a deduction for the cash that they were not being paid (and in their customers views, would not be paid).

### I. Accrual Method and Recognition of Income

Before we get into the background of the case in question, it's useful to review the basic rules for the timing of recognition of income and expense. Under generally accepted accounting principles, we most often look to wishing to recognize income and expense in a form to provide proper matching with related expenses and when the earnings process is complete. As well, contingent liabilities are generally recognized at the point they can be reliably estimated and it is likely they will be paid.

However tax law requirements are not quite the same, and we can end up with different dates of recognition for tax and accounting purposes, even though both claim to measure income and expense on the accrual basis.

**A. Recognition of Income**

Accounting methods are covered in the Internal Revenue Code by §446. However, the Code provision itself is rather short on details—it merely tells us that acceptable methods include the following [§446(c)]:

(c) Permissible methods

Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting--

- (1) the cash receipts and disbursements method;
- (2) an accrual method;
- (3) any other method permitted by this chapter; or
- (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Reg. §1.446-1 begins to flesh this out a bit more for us, telling us that [Reg. §1.446-1(c)(ii)(A)]:

(A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.

The key test for income is twofold in the above—all events have taken place to give us the right to receive the income and we can determine the amount of income.

**B. Recognition of Expenses**

For expenses we keep reading the regulation, which provides [Reg. §1.446-1(c)(ii)(A)]:

Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Now we have a general three part test to claim an expense based on a liability—again, all events have to have occurred to establish the fact that there is a liability, we can determine what that liability is with reasonable accuracy and economic performance must have occurred. Economic performance is defined generally at IRC §461(h)(2) based on a test of timing:

(2) Time when economic performance occurs

Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

(A) Services and property provided to the taxpayer

If the liability of the taxpayer arises out of--

(i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,

(ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or

(iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

(B) Services and property provided by the taxpayer

If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

(C) Workers compensation and tort liabilities of the taxpayer

If the liability of the taxpayer requires a payment to another person and--

(i) arises under any workers compensation act, or

(ii) arises out of any tort,

economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

(D) Other items

In the case of any other liability of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

While we won't consider economic performance in detail today, it is important to note that there are various exceptions and special cases—but they aren't what we are dealing with today.

What if we have a liability that we are disputing? For accounting purposes, we look at the likelihood of our prevailing under SFAS No. 5, and based on our evaluation of our chances we may have to accrue and recognize the most likely cost, even if we continue to dispute that any amount is due.

However, for tax purposes our dispute over whether any amount is actually due poses a problem, since we do not yet meet the first prong of our test. That would generally be true even if we had already transferred some funds to the other party to potentially deal with this liability (perhaps to reduce any interest charges that might be imposed down the line should we be found liable). However, there is a limited exception at §461(f) which provides:

(f) Contested liabilities

If--

- (1) the taxpayer contests an asserted liability,
- (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,
- (3) the contest with respect to the asserted liability exists after the time of the transfer, and
- (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of subsection (h),

then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

We have four hurdles to clear in the above section. The first and third really aren't much of a hurdle—if we aren't disputing the fact that we owe the liability, then all elements necessary to allow the deduction under the normal rule would generally have occurred if we meet the other tests.

The second test is more substantial—we have to transfer money or property to the other party. Quite often that is going to be done when we may still believe we shouldn't owe the amount, we also recognize that our view has a very good possibility of not prevailing.

The final test applies all of the other rules, but ignores for the moment the fact we are disputing the reality of the liability. So long as we otherwise would have been able to claim the deduction in the current year or in a prior year, we get the deduction in the year we transfer the money or other property in satisfaction of the liability.

## II. The Case of Offsets

We now turn to today's case where we look at the problem when a customer claims the right to offset against amounts they owe for current work the amount of liabilities they believe exist from the vendor to the customer for prior work. That is the fact pattern we are looking at in the case of *Trinity Industries v. Commissioner*, 132 TC No. 2.

### A. Facts of the Case

In the case in question, there are two sets of contracts we have to deal with. The Tax Court outlined the facts of each:

#### **The First Contracts With Flowers and Florida Marine**

In the late 1990s Trinity entered into a series of contracts to build barges for J. Russell Flowers, Inc. (Flowers), and, separately, for Florida Marine Transporters, Inc. (Florida Marine) (hereinafter we sometimes refer to these contracts collectively as the first contracts). Payment under these contracts was generally due upon delivery of each barge. Trinity delivered the barges to Flowers and Florida Marine on various dates between September 1997 and March 2000. Petitioner accrued and reported the sales income in the taxable year in which Trinity delivered the barges.

#### **The Second Contract With Flowers and Florida Marine**

On May 22, 2000, after the delivery and acceptance of the barges that were the subject of the first contracts, Trinity entered into another contract (the second contract) with Flowers and Florida Marine. Under the second contract, Trinity, as builder, agreed to deliver certain barges to Flowers, as purchaser;

Flowers had the right to assign its contractual rights to Florida Marine (which was also a signatory to the contract) with respect to a specified number of the barges.

The contract price was generally \$1,290,000 for each barge, with \$1 million to be paid upon completion and acceptance of each barge. The contract provided for "interim financing" of the \$290,000 balance, which the purchaser was to pay to Trinity, with interest, within 18 months of delivery of each barge. Pursuant to the second contract, Trinity built numerous barges and delivered them to either Flowers or Florida Marine at various times between April 2001 and September 2002.

Disputes arose about the work done on the first barges after the second contract was signed, and litigation began between the parties. This contest continued through the years involved in this case, and the Tax Court notes:

#### **Withholding of Deferred Payments**

During 2002, 2003, and 2004 deferred payments fell due from Flowers and Florida Marine with respect to barges that Trinity had delivered to them under the second contract in 2001 and 2002. Because the deferred payments were due 18 months after delivery, however, deferred payments for barges delivered in 2002 fell due only during 2003 and 2004. The parties have stipulated that Flowers withheld total payments of \$8,020,000, of which \$2,320,000 was attributable to barges delivered in 2002. The parties have also stipulated that Florida Marine withheld additional total payments of \$2,836,060, of which \$2,200,000 was attributable to barges delivered in 2002.

#### **Settlement Agreement With Florida Marine**

On March 12, 2004, Trinity and Florida Marine entered into a settlement agreement. In compromise of the disputed claims, Trinity agreed to credit Florida Marine with the \$2,200,000 of unpaid deferred obligations as to which Florida Marine had asserted a right of offset. Florida Marine agreed to pay Trinity the remaining \$617,400 balance over 12 months. Trinity further agreed to repair specified barges sold to Florida Marine under the first contracts.

#### **Settlement Agreement With Flowers**

On April 28, 2005, Trinity and Flowers entered into a settlement agreement. Trinity agreed to repurchase certain barges sold to Flowers under the first contracts and to pay Flowers \$5,764,000 in damages. Flowers agreed to pay Trinity the \$8,020,000 it withheld under the second contract. The settlement agreement specified that this amount was to be offset by the agreed-upon damages, resulting in a payment from Flowers to Trinity of \$2,256,000.

While this was going on, the taxpayer had to file tax returns, and the taxpayer's reporting was as follows:

### **Income Tax Reporting**

Petitioner used the accrual method of accounting for all relevant periods. With respect to barges delivered under the second contract in 2001, petitioner accrued the full amount of the sales, including deferred payments, and reported these amounts as income in 2001. With respect to barges delivered under the second contract in 2002, however, petitioner reported as income only the amounts received during 2002; it excluded the \$4,520,000 of deferred payments as to which Florida Marine and Flowers asserted rights of offset.

The IRS disputed the taxpayer's contention that they had the right to take into account the disputed claims to reduce income recognized under the second contract, and assessed the taxpayer had to report that \$4,520,000.

### **B. Income Recognition**

The Tax Court initially notes that, normally, there would be no question that the entire amount earned on the second contract would have to be recognized as income when the contract was completed:

Trinity's delivery of each barge to Flowers or Florida Marine unconditionally fixed its right to receive the full contract price under the second contract. Absent the offset claims by Flowers and Florida Marine, there would appear to be no dispute that petitioner was required to accrue the full contract price of each barge, including deferred payments, in the year of delivery. Indeed, that is the way petitioner reported its consolidated income with respect to barges delivered under the second contract in 2001, before Flowers and Florida Marine asserted their offset claims.

On the accrual basis of accounting, we don't wait until we are paid—rather, as noted above, once we have done all work necessary and have earned the income, we pick it up on the return.

But the taxpayer was noting there are some exceptions to the general rule.

Petitioner contends that it was not required to accrue these deferred payments in 2002 because of Florida Marine's and Flowers' claims of rights to offset the deferred payments under the second contract against damages allegedly arising under the first contracts. Petitioner relies upon a line of cases which stands generally for the proposition that in certain circumstances an accrual basis taxpayer need not accrue unpaid income if the obligor disputes the

validity of the claim. See, e.g., *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932); *Gar Wood Indus., Inc. v. United States*, 437 F.2d 558 (6th Cir. 1971); *Cold Metal Process Co. v. Commissioner*, 17 T.C. 916 (1951), *affd.* per order 53-1 USTC par. 9135 (6th Cir. 1952); *Jamaica Water Supply Co. v. Commissioner*, 42 B.T.A. 359 (1940), *affd.* 125 F.2d 512 (2d Cir. 1942); *Ryan v. Commissioner*, T.C. Memo. 1988-12, *affd. sub nom. Lamm v. Commissioner*, 873 F.2d 194 (8th Cir. 1989); *Breeze Corps. v. United States*, 127 Ct. Cl. 261, 117 F. Supp. 404 (1954).

The Tax Court looked specifically at the *Gar Woods Indus.* case, noting the taxpayer had placed great reliance on that case. It summarized that case as follows:

...in *Gar Wood Indus., Inc. v. United States*, supra, upon which petitioner places particular reliance, the taxpayer manufactured equipment for the U.S. Army Corps of Engineers (Corps). The contracts contained "price redetermination" clauses, which authorized renegotiation of the contracts after partial performance. *Id.* at 559. When certain of the contracts were nearing completion, the Corps, anticipating a price redetermination, unilaterally began withholding amounts otherwise due to the taxpayer under the contracts. The pricing dispute was resolved 2 years later. The court held that the taxpayer was not required to accrue the withheld amounts in the year the withholding occurred because the taxpayer "never had a fixed right to the full contract price" and the Corps' refusal to honor the contract price negated whatever right the taxpayer otherwise had to receive the withheld amounts. *Id.* at 561. Similarly, all the other cases upon which petitioner relies involve situations in which obligors disputed the fact or amount of their liability with respect to the item to be accrued.

The last sentence in the above summary makes clear the point on which the Tax Court was going to distinguish this case from those the taxpayer saw as supporting its position—that the customers were withholding payments on a contract wholly separate from the one that gave rise to the dispute. The Court notes:

By contrast, insofar as the record shows, neither Flowers nor Florida Marine ever disputed the fact or amount of its obligation to Trinity under the second contract. To the contrary, their filings in the commercial litigation expressly acknowledged their obligations to Trinity under the second contract and indicated that they were setting the withheld amounts aside in "escrow" or as "collateral security" to offset whatever damages Trinity might ultimately be determined to owe them with respect to their claims under the first contracts.

The Tax Court then goes on to describe a case they believe is more on point to the matter at hand:

In *Commissioner v. Hansen*, 360 U.S. 446 (1959), the Supreme Court considered a somewhat analogous situation in which buyers withheld a portion of the sales price to satisfy potential claims against the taxpayer seller. More particularly, in *Hansen* auto dealers entered into a financing arrangement whereby they sold customers' installment notes to finance companies, which withheld a portion of the purchase price as security to cover possible losses on the notes. The Supreme Court held that the auto dealers were required to accrue the withheld amounts as income when the notes were sold. The Court rejected the dealers' argument that accrual was excused by their present inability to compel the finance companies to pay them the reserved amounts. "[T]he question is not whether the taxpayers can presently recover their reserves, for \* \* \* it is the time of acquisition of the fixed right to receive the reserves and not the time of their actual receipt that determines whether or not the reserves have accrued and are taxable." *Id.* at 464.

The Court noted that although the reserves were subject to being offset by the dealers' contingent liabilities to the finance company, "only the obligations \* \* \* arising from those liabilities may be offset against a like amount in the dealer's reserve account." *Id.* at 465. Consequently, the Court reasoned, any use of the reserves in paying those obligations would amount to the dealers' receiving something of value. The Court stated: "In any realistic view we think that the dealer has 'received' his reserve account whether it is applied, as he authorized, to the payment of his obligations to the finance company, or is paid to him in cash." *Id.* at 466. The Court concluded that the dealers must contemporaneously accrue the withheld amounts, even if those funds were not available for paying the resulting tax liability, stating: "it is a normal result of the accrual basis of accounting and reporting that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them". *Id.* at 466-467; see also *Stendig v. United States*, 843 F.2d 163 (4th Cir. 1988) (requiring the taxpayer to accrue rents received from its apartment complex, including a portion that was deposited into reserve accounts to secure the maintenance and operation of the complex); *Clark v. Woodward Constr. Co.*, 179 F.2d 176 (10th Cir. 1950) (requiring the taxpayer to accrue income from highway construction contracts when the State accepted the work, notwithstanding a contractual provision which permitted the State, after accepting the work, to withhold 15 percent of the contract price pending publication of statutory notice to any claimants against the taxpayer).

The Court then concludes there is even less justification, in its view, for reducing the income recognize in this case than there was in *Hansen*, noting:

The instant case presents a stronger argument, we believe, for requiring accrual of income than *Commissioner v. Hansen*, supra, or the other cases just cited. Unlike these other cases, the instant case does not involve any question as to whether the right to receive income was vitiated by a contractual provision for withholding a portion of the sales price. Rather, as previously discussed, under the second contract petitioner had a fixed and absolute right to the deferred payments as soon as each barge was delivered. Pursuant to the claims of offset asserted by Flowers and Florida Marine, the withheld payments were to be applied only in satisfaction of Trinity's or petitioner's alleged obligations to them arising under the first contracts. Petitioner effectively received the withheld amounts when, pursuant to the settlement agreement, they were applied in compromise of Flowers' and Florida Marine's claims. In the final analysis, then, the offset claims affected only the timing of petitioner's receipt of income under the second contract and not its right to receive the income.

The Court finally rejects any claim that due to doubt as to ultimate collection would allow the offset in this case, quoting the Supreme Court from the *Spring City Foundry Co.* case from the 1930's that "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." Only later when the debt becomes uncollectible will the taxpayer be able to take a deduction for income that will not be received.

### C. Maybe a Deduction Then?

Well, if the taxpayer can't get a benefit from reducing income, perhaps they can take a current deduction for the amounts involved. After all, we have a disputed liability and the customers are now holding onto funds that, under the second contract, they are required to pay to us—so they are holding, at least in our view, our property. Doesn't this get us a deduction under §461(f) noted above?

The IRS says no, but the taxpayer disagrees. The key issue is whether the taxpayer satisfied the second prong of the §461(f) test. As was noted:

The parties disagree primarily as to whether petitioner meets the second requirement listed above that there be a transfer of money or other property in satisfaction of the asserted liability. Petitioner contends that it transferred property to Flowers and Florida Marine "when Flowers and Florida Marine withheld payment under the Second Contract as an offset against their alleged damages".

The Court first deals with a timing problem that arises under Trinity's theory:

The record shows, however, that the \$4,520,000 of deferred payments as to which petitioner claims a deduction came due under the second contract in 2003 and 2004. Flowers and Florida Marine cannot meaningfully be said to have withheld the deferred payments before they came due. At most, Flowers and Florida Marine threatened in 2002 to withhold the deferred payments, although as previously discussed the record does not establish that Florida Marine even asserted its offset claim before 2003.

Section 461(f) allows a deduction only for "the taxable year of the transfer." Consequently, even if we were to agree with petitioner that the withheld payments represented transfers of funds to Flowers or Florida Marine, we would conclude that the transfers occurred in 2003 and 2004, so that petitioner would not be entitled to the claimed deduction under section 461(f).

However, the Court's real objection is that, regardless of when this event happened, there still is not a transfer of property.

More fundamentally, we disagree with petitioner's contention that the withholding of the deferred payments by Flowers and Florida Marine represented a transfer by petitioner within the meaning of section 461(f). The regulations require that the taxpayer transfer "money or other property beyond his control \* \* \*. \* \* \* In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property." Sec. 1.461-2(c)(1), Income Tax Regs. As a necessary corollary, and as common sense dictates, before a taxpayer may transfer money or other property beyond its control or authority, it first must have the money or other property within its control or authority.

Obviously, the deferred payments were not in petitioner's control or authority, at least not so long as Flowers and Florida Marine withheld them. By withholding the deferred payments, Flowers and Florida Marine merely perpetuated their own control over these funds. Although, as previously discussed, Trinity possessed contractual rights to the withheld payments sufficient to require accrual of the income, neither Trinity nor petitioner relinquished those rights, at least not in 2002, but instead vigorously disputed the claimed rights of offset.

In contending that the withheld payments constituted a transfer within the meaning of section 461(f), petitioner relies upon *Chernin v. United States*, 149 F.3d 805 (8th Cir. 1998). Petitioner's reliance is misplaced. In *Chernin*, the court held that a transfer was accomplished within the meaning of section 461(f) by a court-issued writ of garnishment that forced the taxpayer to transfer funds owed to him as compensation. The court reasoned that the writ of garnishment "shifted actual control over the funds from the taxpayer to the garnishees". Id. at 810. By contrast, in 2002 there was no court-issued writ or

other order of any competent legal authority to force Trinity to transfer funds owed to it.

In sum, we conclude and hold that in 2002 petitioner did not transfer money or other property in satisfaction of Flowers' and Florida Marine's asserted liabilities and consequently is entitled to no deduction pursuant to section 461(f).

Due to lack of a transfer, the deduction cannot be claimed at this time.

### **III. Conclusions**

The taxpayers will eventually get a deduction—but when is important, and in this case the benefits are delayed.

As tax practitioners we must be aware of the timing rules—and those of us that are CPAs need to be very aware that the GAAP rules are very different, and that we need to be sure to comply with both sets of rules.