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Comments

The Taxation of Notional Principal Contracts After Notice 89-21: A Clear Reflection of Income or an Abuse of the Commissioner's Discretion?

I. Introduction

Suppose you are the sole shareholder of a corporation with a large net operating loss (NOL). You have entered into negotiations for the sale of your stock to another corporation. The buyer would like to utilize your corporation's net operating loss to offset its income, but is precluded from doing so by Section 382 of the Internal Revenue Code (I.R.C.).[1] In 1988, your tax advisor suggested that your corporation enter into something called a notional principal contract. The proposed transaction would be as follows: Your corporation and an unrelated third party would enter into a notional principal contract.[2] Pursuant to this notional principal contract, prior to the sale your corporation would receive a large upfront payment from the party with whom it entered the contract. In accordance with the Internal Revenue Service's (the "Service") long-standing position as to prepaid income,[3] this entire payment would be taxable in the year of receipt, thereby absorbing your corporation's entire NOL. This seems like the perfect solution - or is it? Until February of 1989, your tax advisor may have felt comfortable suggesting the use of one or more notional principal con-

1. All references are to the Internal Revenue Code of 1986, as amended. I.R.C. § 382 prevents or limits the use by acquiring corporation of target corporation's various tax attributes, including NOLs.

2. *See infra* notes 6 to 22 and the accompanying text for an explanation of what notional principal contracts are. A notional pricipal contract is usually entered into by contacting an investment banker who acts as an intermediary and finds a third party to the contract.

3. *See infra* notes 43 to 60 and the related text for a discussion of the Service's position with respect to prepaid income.

tracts. Today, however, he might feel a little uneasy making that suggestion. The reason for this uneasiness is that in February, 1989, the Service issued Notice 89-21 (the "Notice"),[4] which contained the Service's position as to the taxation of up-front lump sum payments received pursuant to notional principal contracts. In a nutshell, the Service's position is that Section 382 cannot be circumvented or manipulated by the use of notional principal contracts.[5] The controversial aspect of notional principal contracts, which is the focus of the Notice, is the timing of income. That is, in which year or years must the recipient of the payment include the up-front payment in income? The Notice requires the up-front payment to be included in income over the term of the contract. This article will first explain what notional principal contracts are and why they are used in today's commercial environment. The second part of this article discusses the tax treatment that similar lump sum payments have historically been accorded by the Service and the courts. The third part of this article explains the Service's proposed treatment of up-front lump sum payments received pursuant to notional principal contracts. Finally, the fourth part of this article critiques the Service's position and concludes that while the Service has statutory authority for its position, it must be careful that asserting its authority does not damage its long-standing victories in the prepayment area.

II. What is a Notional Principal Contract?

A notional principal contract is a term used by the Service to describe certain financial instruments such as interest rate swaps, currency swaps, interest rate caps and similar financial arrangements ("notional principal contracts").[6] It is appropriate to recognize at the outset that notional principal contracts are not new products developed by tax advisors. Rather, as explained below, they serve bona fide non-tax business needs of commercial enterprises around the world. In particular, the uses of notional principal contracts include reducing a company's borrowing costs,

4. I.R.S. Notice 89-21, 1989-8 I.R.B. 23.

5. The Notice also impacts the use of notional principal contracts to utilize expiring NOLs, as well as their use in characterizing income for purposes of Subpart F of the Code.

6. I.R.S. Notice 89-21, 1989-8 I.R.B. 24. The scope of the Notice is uncertain at this time. The use of the word "certain" appears to refer to financial instruments. It is possible, however, that the Service might attempt to apply Notice 89-21 to only certain notional principal contracts, thereby leaving unaffected any contracts entered into for bona fide non-tax reasons. *See*, however *infra*, note 84.

matching fixed and variable rate assets and liabilities (referred to as "asset and liability management"), and providing an alternative investment for investors.[7] The present abuse involving these contracts is that they are being entered into solely for tax reasons, and they are being structured to include large up-front payments which generate income to offset expiring NOLs or to circumvent the application of Section 382. Before one can understand the taxation of notional principal contracts, the mechanics and purpose of each instrument must be understood.

A. *Interest Rate Swaps*

There are many types of interest rate swaps. The simplest type of swap, which has become known as the "plain vanilla" swap, is the type that will be used in this article to illustrate the tax issues involved. The issues discussed herein are, however, applicable to all of the various types of swaps.[8] A plain vanilla swap involves only one currency (as contrasted with swaps involving several different currencies). One party exchanges its fixed-rate interest obligation for the variable-rate interest obligation of the second party. In return, the second party assumes the fixed-rate interest obligation of the first party.[9] The parties exchange only their interest obligations, not the underlying obligations to repay the debts. The underlying principal obligation is called the notional principal amount.

The swap results in one party converting its fixed-rate obligation into a variable-rate obligation, while the second party converts its variable-rate obligation into a fixed-rate obligation.[10] This concept

7. *See* Henderson, *Swap Credit Risk: A Multi-Perspective Analysis*, 44 BUS. LAW. Feb. 1989; Olander and Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 MD. L. REV. 21 (1986).

8. Although this article will utilize the plain vanilla swap to illustrate the concepts involved, swaps can be very complex and the variation among the different swaps is dramatic. *See*, for example, Wishon and Chevalier, *Interest Rate Swaps--Your Rate or Mine*, 160 J. OF ACCT. Sept. 1985 at 68, for an explanation of a "CIRCUS" (a Combined Interest Rate and Currency Swap).

9. *Id.* at 64.

10. In addition to converting assets from variable rate to fixed rate or visa versa (referred to as "asset and liability management"), swaps can be used for other purposes including, *inter alia*, capping the cost of variable rate debt, and obtaining cheaper debt. *See* Arnold, *How To Do Interest Rate Swaps*, 62 HARV. BUS. REV., Sept. - Oct. 1984, at 96. A party may desire that its debt be tied to a different index. Thus, an interest rate swap in this situation would involve two parties each of whom have a variable rate obligation tied to a different index. The purpose of this type of swap would be to tie your debt to a particular index.

is best illustrated by an example. Assume that Company X has a $1-million variable-rate liability at the prime rate, and Company Y has a $1-million liability on which it pays a fixed rate of 10 percent. A plain vanilla swap agreement would provide that Company X will pay Company Y $100,000 per year (10 percent of the $1-million notional principal amount) and Company Y will pay Company X an amount computed on the prime rate. If the prime rate for year 1 is 11 percent, Company Y will owe Company X $110,000. Rather than each party writing a check, swap agreements usually provide for a net payment from the party whose obligation under the swap is greater.[11]

B. *Interest Rate Caps, Floors and Collars*

A "cap" is a vehicle that a party can use to limit its exposure from an increase in interest rates. A cap is an agreement under which one party (the "seller") agrees that with respect to an agreed upon notional amount, it will make payments to another party (the "purchaser") if the interest rate goes above an agreed upon rate.[12] The parties agree that the interest rate will be determined by reference to a specified index. If during the term of the agreement the interest rate rises above the agreed upon rate, the seller of the cap pays the purchaser an amount equal to the amount of interest that is attributable to the interest rate exceeding the agreed upon

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11. A. KRAMER, TAXATION OF SECURITIES, COMMODITIES, AND OPTIONS,§ 5A.2 at 15 (1989 Supp.). There are two ways in which payments could be made. First, the parties could exchange checks. In our example, Company X would give Company Y a check for $100,000 and Company Y would give Company X a check for $110,000. The second alternative is for the parties to agree to "net payments." Under the second alternative, Company Y would give Company X a check for $10,000, and receive nothing from Company X. If the prime rate drops to 9% in year 2, Company X would give Company Y a check for $10,000, and receive nothing from Company Y. It is noteworthy that a party does not have to remain in a swap until its maturity. A swap can be terminated in one of several different ways (referred to as "unwinding the swap"). *See* Grant, *Why Treasurers are Swapping Swaps*, EUROMONEY April 1985 at 19. One way to terminate a swap is with the consent of the other party. Naturally, this manner of unwinding a swap is possible only if both parties want out of the swap. If so, the value of the swap agreement is usually paid to the other party. *See* Grant, *Why Treasurers are Swapping Swaps*, EUROMONEY April 1985 at 19. A secondary market has developed for swaps. Thus, another way to unwind a swap is through the use of a mirror swap. A mirror swap is one which is effected by entering into another swap with a different party on terms that effectively cancel the first swap. The first swap remains valid, but it is negated by the second swap. *Id.* A mirror swap can be entered into without informing the counter-party to the first swap.

12. Interest Rate and Currency Swaps 1989 (Practising Law Institute) at 47. The sellers of caps are usually investment houses.

rate.[13] The purchaser pays the seller a fee under the agreement.[14] The fee is usually paid when the agreement is entered into or at the beginning of the term of the cap.[15]

For example, assume Company X is contemplating obtaining a $1-million variable-rate liability at the prime rate. The company, however, is concerned about the possibility of interest rates increasing, and has determined that it would be financially impracticable for it to pay the interest if rates climbed above 15 percent. Accordingly, Company X (the purchaser) enters into an agreement with Company Y (the seller) whereby Y agrees if the interest rate on X's loan go above 15 percent, Y will pay X the amount of interest in excess of 15 percent. Thus, 15 percent is the "interest rate cap." In exchange for this promise, Company Y will receive a fee at the beginning of the term of the cap from Company X.

A "floor" is the flip side of a cap. As the name implies, a floor is an agreement under which the seller agrees to pay the purchaser if the interest rate (determined by reference to a specified index) falls below an agreed upon rate.[16] As with the cap, the purchaser pays the seller a fee at the beginning of the term of the floor. For example, assume that in the above example Company X owns an asset which generates income based on London interbank offered rate (LIBOR). Company X desires some assurance that this asset will continue to generate at least a 10 percent rate of return. To achieve this result, Company X purchases a floor from Company Y. Under this floor arrangement, if LIBOR drops below 10 percent, Company Y agrees to pay Company X an amount equal to the income lost as a result of LIBOR dropping below 10 percent.[17]

A "collar" is a combination of a cap and a floor.[18] It is an arrangement whereby the seller agrees to pay the purchaser if the

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13. Henderson, *Swap Credit Risk: A Multi-Perspective Analysis*, 44 BUS. LAW. Feb. 1989 at 365, n. 2.(hereinafter cited as *Henderson*). The seller can then limit its exposure on the cap by specifying an upper limit on the interest rate for which it will pay the purchaser. This device is called a vertical cap. A vertical cap may be desired not only by the seller to reduce his risk on the cap, but also by the purchaser to reduce his cost of the cap. *Id.*

14. *Id.* A cap is very similar to an insurance policy in that the purchaser pays a fee (a premium) to the seller for the purpose of reducing the purchaser's risk with respect to the interest costs of certain debt. Thus, the purchaser has in effect purchased an insurance policy against the increase in interest rates.

15. *Id.*

16. *Id.* A floor is useful when a person is holding an asset that produces income based on a variable or floating rate. *Id.* In such a situation, the purchaser is in effect purchasing a guaranteed minimum rate of return on the asset.

17. *See infra*, note 19.

18. *Henderson, supra* note 13 at 365, n.2.

interest rate falls below a certain rate (the floor) and the purchaser agrees to pay the seller if the interest rate goes above a certain rate (the cap).[19] For example, assume the facts of the example above. In addition, Company Y is willing to sell a cap to Company X at an up front price of $50,000. However, this might be more than Company X is willing to pay. Alternatively, Company Y might be willing to sell this cap to Company X for $40,000 if Company X agrees to pay Company Y if the interest rate drops below 10 percent. Thus, Company X has protected itself against an increase in interest rates at a lower initial out of pocket cost by giving up some of the benefits (in the form of lower interest costs) of a drop in interest rates. Company X has "collared" its interest costs: it will pay a minimum of 10 percent, but no more than 15 percent. From Company Y's perspective, it has sold the cap for lower price, but it has the potential to generate additional profits if interest rates decline.[20]

C. *Currency Swaps*

A currency swap is similar to an interest rate swap except that debts denominated in different currencies (*i.e.*, U.S. dollar and British pound) are swapped.[21] In a currency swap, one party agrees to pay fixed periodic amounts in one currency and the other party agrees to pay fixed periodic amounts in another currency.[22] Al-

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19. *Id.* A collar can also apply to a situation where the purchaser agrees to pay the seller if the interest rate falls below an agreed upon rate and the seller agrees to pay the purchaser if the rate exceeds an agreed upon rate. The interest rate that serves as a basis for a swap, cap, floor or collar is usually based on an independent index. The most common indices are: U.S. dollar fixed, prime, London interbank offered rate ("LIBOR"), bankers acceptance, treasury bill, certificate of deposit, commercial paper, and zero coupon rates. *Id.* at 366.

20. This example is based on Company X wanting to limit its risk of exposure on a liability. An example of an asset driven collar would be one where Company X owned an asset that generated income on LIBOR basis. If Company X wanted to guarantee a 10% rate of return on this asset, it could purchase a floor from Company Y whereby Company Y would agree to pay Company X if LIBOR fell below 10%. Alternatively, Company Y would probably be willing to sell Company X the floor at a lower price if there was a possibility that it could share in some of the future income generated by the asset. Thus, rather than just purchasing a floor from Company Y, an agreement could be entered into whereby Company Y would sell the floor to Company X in exchange for a lower fee and if LIBOR rises above 14%, Company X will pay Company Y the amount of income generated by this asset in excess of 14%. The effect of this transaction is that Company X has guaranteed itself a minimum rate of return of 10% and a maximum rate of return of 14%. Company Y, on the other hand, has sold a floor for a lower up front fee than it normally would, but has secured the potential for a substantially higher fee over the term of the agreement.

21. Interest Rate and Currency Swaps 1989 (Practising Law Institute) at 11.

22. *Id.*

though currency swaps are within the scope of Notice 89-21, this article discusses Notice 89-21 only as it applies to other notional principal contracts.

III. The Historical Treatment of Lump Sum Payments For Future Services

As indicated above, a notional principal contract can provide for payments to be made periodically over the term of the agreement. If the contract is structured in this manner, the payments will be included in the recipient's income when they are received or receivable, depending on the recipient's method of accounting.[23] Alternatively, an agreement pursuant to any of the above notional principal contracts can provide that one party will make an up-front payment to the other party.[24] It is the latter situation to which Notice 89-21 is addressed. The year in which the party receiving the up-front payment must report the income for tax purposes is the subject of this article.

For example, assume that Loss Corporation has a $200,000 NOL that expires at the end of 1990.[25] Loss has determined that it will not be able to generate any income in 1990 to absorb the NOL. Loss decides to enter into a notional principal contract in July, 1990. The term of the contract is five years. Assume that the total amount to be received by Loss over the term of the contract is $200,000. Consider the tax consequences of the two alternative ways of structuring the payments. If payments are to be received over the term of the contract, Loss will receive only $20,000 in

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23. Under either the cash method or the accrual method of accounting, this would probably clearly reflect the taxpayer's income. *See infra*, notes 29-39 and the accompanying text. Under the cash method of accounting, the taxpayer would include each payment in income in the year that it is actually or constructively received. Under the accrual method of accoutning, the taxpayer would include each payment in income in the year in which the "all events" test is met.

24. For example, in an interest rate cap contract, the purchaser (i.e., the company which desires protection from rising interest rates) will usually pay the seller a fee up-front, even though the cap has a term of several years. In an interest rate swap, rather than agreeing to net payments, the parties can agree that the party who is to make the fixed rate payments under the terms of the swap agreement will pay the other party an up-front lump sum payment equal to the present value of that party's obligation to make future payments under the swap agreement. *See* Cantrell, Hanna, and Kurtz, *Notice 89-12 Crashes the Interest Swap Party* Tax Notes 338 (October 16, 1989). (hereinafter cited as "Cantrell").

25. Under Section 172, a corporation that incurs a NOL may carry that NOL forward to offset its income in the next fifteen tax years. If the NOL is not used by the end of the fifteenth taxable year, it expires and is lost forever.

1990.[26] Under this alternative, if Loss' operations break even, $20,000 of the NOL will be used in 1990, and the remaining $180,000 will expire.[27] If, however, the transaction is structured so that loss receives the entire $200,000 in 1990, the historical position taken by the Service would require the entire $200,000 to be included in Loss' income in 1990, thereby utilizing its entire NOL.[28]

A. *Basic Statutory Rules*

The basic statutory rules regarding reporting income are contained in Sections 446[29] and 451.[30] Section 446(a) contains the general rule that the taxable income of a taxpayer shall be computed using the same method of accounting as the taxpayer uses in keeping its books.[31] Section 446(b) contains an exception to the general rule of Section 446(a) by providing that if the method of accounting used by the taxpayer does not clearly reflect income, then the taxpayer's taxable income shall be computed using the method which, in the Secretary of the Treasury's opinion, does clearly reflect income.[32] The regulations under Section 446 provide that a

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26. This assumes that the same amount of money will be received each year. Thus, $40,000 is attributable to each year of the contract. Since there are only six months remaining in 1990, Loss would receive only $20,000 in 1990.

27. In addition, over the remaining years of the contract, Loss would include the remaining $180,000 in its income. If Loss does not generate any new losses to offset this income, it will pay tax on the entire $180,000.

28. For illustration purposes, this assumes that Loss would receive the entire $200,000. However, the amount Loss would actually receive would be the present value of $200,000.

29. 26 U.S.C. 446 (1986).

30. 26 U.S.C. 451 (1986).

31. 26 U.S.C. Section 446(a) (1986) states, "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The regulations under Section 446 define the term "method of accounting" to include "not only the over-all method of accounting but also the accounting treatment of any item." Treas. Reg. Section 1.446-1(a)(1). *See also* Chesapeake Financial Corp. v. Comm'r, 78 T.C. 869, 878 (1982)(*citing* Sandor v. Comm'r, 62 T.C. 469 (1974), *aff'd,* 536 F.2d 874 (9th Cir. 1976)). Thus, the accounting treatment on a taxpayer's books of lump sum payments received pursuant to notional principal contracts constitutes a method of accounting. Accordingly, under the general rule of Section 446, the taxpayer must compute his taxable income from these payments in the same manner as such income is reported on his books.

32. 26 U.S.C. Section 446(b) states:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The regulations seem to go a little further by stating, "However, no method of accounting is acceptable unless, in the opinion of the commissioner, it clearly reflects income." Treas. Reg. Section 1.446-1(a)(2).

method of accounting which clearly reflects the consistent application of generally accepted accounting principles in a particular trade or business will ordinarily be considered to clearly reflect income.[33] Thus, from these rules one can glean the general rule that if a taxpayer computes its taxable income using the same method of accounting as it keeps its books, and its books are kept in conformity with generally accepted accounting principles, then it will ordinarily be considered to be using a method of accounting that clearly reflects income.

As to the year in which an item of income is to be reported, the first part of Section 451(a) sets forth the general rule that a taxpayer shall include any amount received in income in the year it is received by the taxpayer.[34] The second part of Section 451(a) contains an exception to this general rule by providing that if under the taxpayer's method of accounting an amount properly belongs to a period other than the one in which it is received, then it is included in the taxpayer's income in such other period.[35]

The regulations under Section 446 specifically address two permissible methods of accounting: the cash receipts and disbursements method and the accrual method.[36] Under the cash method of accounting, an item is includible in income in the year that it is actually or constructively received.[37] Thus, if a taxpayer using the cash method of accounting receives a lump-sum payment that is attributable to services to be performed in future years, based on this regulation, the payment would ordinarily be included in the taxpayer's income in the year in which it is received by the taxpayer.

Under the accrual method of accounting, an item is includible in

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33. *See* Treas. Reg. Section 1.446-1(a)(2), which states (in part):

A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

34. Section 451(a) states:

The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as a different period.

35. *Id.*

36. *See* Treas. Reg. Section 1.446-1(c). The use of the cash method is permitted (subject to several exceptions) even though it is not ordinarily permitted under generally accepted accounting principles.

37. Treas. Reg. Sections 1.451-1(a) and 1.446-1(c)(i).

income in the tax year "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[38] Thus, in a situation where the taxpayer receives a payment for future services and he will not be required to return the payment, the entire payment is taxable in the year of receipt.[39]

It is noteworthy that reporting the entire payment as income in the year of receipt is contrary to generally accepted accounting principles. Under generally accepted accounting principles, the payment would be taken into income over the term of the agreement for which the payment was received. This disparity between tax accounting and financial accounting is a product of the different objective that each of these methods attempts to achieve.[40] Financial accounting attempts to match income and expenses by recognizing income in the same period in which the expenses which produced that income occurred, thereby providing users with information for management or investment decisions.[41] This is consistent with the general accounting principle of conservatism.

The primary objective of tax accounting, on the other hand, is not with conservatism or matching income and expenses. Rather, its purpose is to raise revenue, and accordingly is based on the taxpayer's ability to pay the tax on the item received.[42] This basis is reflected not only in permitting the cash method of accounting, but also in the all events test for accrual method of accounting under the regulations. Thus, for tax accounting purposes, a prepayment for services will generally be entirely taxable in the year of receipt, whereas, for financial accounting purposes, it will be included in income over the period when the services are performed.

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38. Treas. Reg. Sections 1.446-1(c)(ii) and 1.451-1(a).

39. *See* Automobile Club of Mich. v. Comm'r, 353 U.S. 180 (1957); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Comm'r, 372 U.S. 128 (1963); RCA Corp. v. United States, 664 F.2d 881 (2nd Cir. 1981); T.F H. Publications, Inc. v. Comm'r, 72 T.C. 623 (1979) and the cases cited therein. *Cf.* Artnell Co. v. Comm'r, 400 F.2d 981 (7th Cir. 1968).

40. *See* Silk, *Advance Payments — Prepaid Income: Recent Developments; An Old Problem Put to Rest*, 30 N.Y.U.INST. FED. TAX'N. 1651, 1652 (1972).

41. As the Supreme Court stated in Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc.

42. *See Silk, supra* note 40 at 1653. *See also*, RCA Corp. v. United States, 664 F.2d 881, 887 (2nd Cir. 1981).

B. *The Courts' Treatment of Prepaid Income*

Beginning in 1957, the Supreme Court settled the issue of the Commissioner's discretion as to the taxation of prepayments for services when it decided the famous trilogy of *Automobile Club of Mich. v. Comm'r*,[43] *American Auto. Ass'n. v. United States*,[44] and *Schlude v. Comm'r*.[45] In each of these cases the Supreme Court agreed with the Commissioner's determination that the taxpayer's method of reporting the prepaid fees over the term of the agreement did not clearly reflect income. The taxpayers used the accrual method of accounting, under which they recognized the income from the prepayments over the terms of their agreements.

In *Michigan, supra*, the Supreme Court addressed the issue of whether membership dues received by an automobile club were income when they were received or when they are earned. The taxpayer received dues in advance for services to be performed during the next year.[46] The taxpayer took one-twelfth of the dues into income each month of the year for which the dues were paid. The taxpayer consistently used this method of accounting.

The Commissioner determined that the taxpayer had received these prepaid dues under a claim of right and without restriction as to their use. As such, under the holding of *North American Oil Consolidated v. Burnet*,[47] the entire amount of dues received should be reported by the taxpayer in income in the year in which they are received. The Court noted that the pro-rata allocation of the prepaid dues was artificial and it bore no relation to the services to be rendered by the taxpayer.[48] Accordingly, the Court held that the Commissioner did not abuse his discretion in taxing the prepayments in the year they were received.[49]

In 1961, the Supreme Court decided *AAA, supra*. The factual situation in *AAA* was identical to *Michigan*. The taxpayer in *AAA* argued that *Michigan* was distinguishable because AAA's method

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43. 353 U.S. 180 (1957).

44. 367 U.S. 687 (1961).

45. 372 U.S. 128 (1963).

46. *Michigan*, 353 U.S. at 188. The dues were deposited in the taxpayer's general banking account and were available, and were actually used, for general corporate purposes. *Id.* When the dues were received, the taxpayer recorded them on its books as a liability (unearned dues). As each month passed, a ratable portion of these dues were recorded as income, with a corresponding reduction in the taxpayer's liability. *Id.*

47. 286 U.S. 417 (1932).

48. *Michigan*, 353 U.S. at 189.

49. *Id.* at 189-90.

of accounting was based on and supported by past experience.[50] Nonetheless, the Court held that the Commissioner had not abused his discretion in requiring taxation in the year of receipt.[51]

The Court, in *AAA*, based its holding on Congressional action, rather than on its decision in *Michigan.*[52] The Court reasoned that when Congress retroactively repealed Sections 452 and 462, which would have permitted the taxpayer's method of accounting, it effectively forbid the taxpayer's method of accounting for tax purposes.[53] In addition, Section 455, which permits the deferral of income in certain industries, was added to the Code after the Court's decision in *Michigan.*[54]

The last of the trilogy was *Schlude*, which involved a taxpayer who received advance payments for dancing lessons to be given at future unspecified times. Like *Michigan* and *AAA*, the prepayments were non-refundable and the dance lessons were not to be rendered on definite dates. Rather, the times of the lessons were determined by the student and the instructor. The Court stated that the case was controlled by *AAA.*[55] The Court in *Schlude* held that the taxpayer's method of accounting had the same defect as the method used by the taxpayers in *Michigan* and *AAA*; the payments were received for services which were to be performed essentially upon the "customers' demands without relation to fixed dates in the future."[56] Accordingly, the Commissioner did not abuse his discretion in requiring the prepayments to be recognized

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50. *AAA*, 367 U.S. at 691.

51. *Id.* The Court addressed the relevance of generally accepted accounting principles by stating that although the taxpayer's method of accounting was in accord with generally accepted accounting principles, "It is not to hold that for income tax purposes it [the use of generally accepted accounting principles] so clearly reflects income as to be binding on the Treasury." *Id.* at 693 (footnote omitted).

52. In both *Michigan* and *AAA*, the Court distinguished Beacon Publishing Co. v. Comm'r, 218 F.2d 697 (10th Cir. 1955) and Schuessler v. Comm'r, 230 F.2d 722 (5th Cir. 1956), both of which permitted deferral of prepaid income.

53. 367 U.S. at 694-95.

54. *Id.* at 696. Section 455 permits the deferral of income from prepaid subscriptions of newspapers, magazines and periodicals. The Court in *AAA* noted that "An effort was made in the Senate to add a provision in Section 455 which would extend its coverage to prepaid automobile club membership dues. However, in conference the House Conferees refused to accept this amendment." *Id.*

55. *Schlude*, 372 U.S. at 134.

56. *Id.* at 135. The Court stated:

> Relying upon Automobile Club of Michigan v. Commissioner, . . . the Court [in *AAA*] rejected the taxpayer's system as artificial since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from the very same vice, for the studio sought to defer its cash receipts on the basis of contracts

in the year of receipt.

The cases decided subsequent to *Schlude* have generally required immediate taxation of prepayments for services based on the Commissioner's discretion under Section 446(b). The focus of these cases has been on whether the dates of future services were fixed. For example, in *RCA Corp. v. United States*[57], the Second Circuit held that the Commissioner did not abuse his discretion in requiring the payments received for service contracts to be included in the taxpayer's income in the year of receipt, rather than over the terms of the contracts, which ranged from three to twenty-four months. The Court held that these service contracts, like the contracts in *Michigan*, *AAA* and *Schlude*, obligated the taxpayer to perform upon the customers' demands, rather than at fixed times in the future.[58] At the inception of the contract, the taxpayer could not be certain as to the time and number of performances required, and accordingly could not be certain of the income it would earn and when it would be earned.[59] Thus, the Commissioner did not abuse his discretion.[60]

The Service has not been successful in all its attempts to tax prepayments in the year of receipt. In *Artnell Co. v. Comm'r*[61], the Seventh Circuit permitted the taxpayer to defer the recognition of prepayments for services. The taxpayer purchased all the stock of the Chicago White Sox, Inc., which operated the Chicago White Sox baseball team. Shortly thereafter the taxpayer liquidated White Sox, Inc. and continued to operate the team. At the time of the liquidation, the White Sox had received prepayments as a result of advance sales of tickets.[62] Under the taxpayer's method of

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which did not provide for lessons on fixed dates after the taxable year. . . .
Id.

57. 664 F.2d 881 (2nd Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982), *See also*, Standard Television Tube Corp. v. Comm'r, 64 T.C. 238 (1975).

58. 664 F.2d at 888.

59. *Id.* The Court further stated that "The Commissioner was not required to subject the federal revenues to the vicissitudes of RCA customers' future demands for services." *Id.*

60. *Id.* at 889. The District Court found that the taxpayer's method of accounting clearly reflected income. However, the Court of Appeals stated that the issue was not whether the taxpayer's method of accounting "adequately reflected income." Rather, the issue is whether the Commissioner abused his discretion. *Id.* at 889. The standard used by the Court to determine whether the Commissioner abused his discretion was that "[it] must be upheld unless it is clearly unlawful." *Id.* at 886.

61. 400 F.2d 981 (7th Cir. 1968).

62. *Id.* The prepayments included the proceeds of advance sales of season tickets, single admissions to games, revenues for broadcasting and televising games, and season parking books. *Id.* at 982. The liquidation of White Sox, Inc. resulted in a short tax year that ended on May 31, 1962. The Commissioner argued that the money received from advance sales as

accounting, the amount of income allocable to each game would be taken into income at the time the game was played. The Commissioner argued that the proceeds from advance sales were taxable when received.

The Tax Court held that the proceeds were taxable in the year of receipt, regardless of the taxpayer's method of accounting.[63] The Court of Appeals for the Seventh Circuit remanded the case back to the Tax Court to determine whether the taxpayer's method of accounting clearly reflected income. The Seventh Circuit stated that there are some deferral techniques that so clearly reflect income that the Commissioner would abuse his discretion if he disallowed it.[64] The Court distinguished *Michigan*, *AAA* and *Schlude* based on the uncertainty of the timing of the future events in those cases, which was not present in *Artnell*.[65]

The Tax Court has since stated that it will not follow *Artnell* unless, "the facts present a certainty, of performance or fixed dates, such as was presented in *Artnell Co.*"[66] However, on at least one occasion the Tax Court has followed *Artnell*.[67] But in this case, *Artnell* was followed because of the *Golsen* rule.[68]

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of May 31 was taxable to White Sox, Inc. in the short tax year ended May 31. *Id.*

63. Artnell Co. v. Comm'r, 48 T.C. 411 (1967), *rev'd* 400 F.2d 981 (7th Cir. 1968).

64. 400 F.2d at 985. The Court of Appeals perceived the Tax Court's position to be that the Commissioner has "complete and unreviewable discretion to reject deferral of prepaid income where Congress has made no provision." *Id.* at 984. The Seventh Circuit's response to the Tax Court's position was:

> It is our best judgment that, although the policy of deferring, where possible, to congressional procedures in the tax field will cause the Supreme Court to accord the widest possible latitude to the commissioner's discretion, there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the commissioner rejects it.

Id. at 984-85. On remand, the Tax Court held that the taxpayer's method ofaccounting was more supportable than the method asserted by the Commissioner. Thus, the taxpayer's method of accounting for advance sales was sustained. *See* Artnell v. Comm'r, 29 T.C.M. 403 (1970).

65. 400 F.2d at 983-85. The Court stated: "The uncertainty stressed in those decisions is not present here. The deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. We would have no difficulty distinguishing the instant case in this respect." *Id.* at 984.

66. T.F.H. Publications, Inc. v. Comm'r, 72 T.C. 623, 644 (1979) (*citing* Standard Television Tube Corp v. Comm'r, 64 T.C. 238, 242 (1975) *aff'd*, 622 F.2d 579 (3d Cir. 1980)). *See also*, Allied Fidelity Corp. v. Comm'r, 66 T.C. 1068, 1077 (1976), *aff'd*, 572 F.2d 1190 (7th Cir. 1978).

67. *See*, Collegiate Cap & Gown Co. v. Comm'r, T.C. Memo 1978-226.

68. Golsen v. Comm'r, 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971), *cert. denied* 404 U.S. 940 (1971).

IV. NOTICE 89-21

In Notice 89-21, the Service took a surprising and, in light of the above discussion, a seemingly contradictory position. The Service took the position that up-front lump sum payments, received pursuant to notional principal contracts, are not taxable in the year of receipt. Rather, they are to be taken into income over the term of the agreement.[69] The Service asserts that including the entire payment in income in the year of receipt does not clearly reflect the taxpayer's income. In order to clearly reflect income, the Commissioner, pursuant to I.R.C. Section 446(b), will require the payment to be taken into income over the term of the contract.

Although this appears to be a pro-taxpayer position, the purpose of Notice 89-21 is to prevent certain perceived abuses that can occur when the normal rules for the taxation of prepayments (*i.e.*: *Michigan, AAA* and *Schlude*) are used. The abuse occurs principally in three situations. First, Notice 89-21 is intended to prevent corporations from offsetting NOLs shortly before the corporation is about to be acquired. The second perceived abuse occurs when a corporation enters into a notional principal contract to utilize expiring NOLs.[70] The third scenario pertains to the characterization and timing of income for purposes of Subpart F of the Code.[71]

The first situation occurs when a corporation (the "acquiring corporation") wishes to purchase another corporation (the "target corporation"). When the target corporation has a very large net operating loss carryover from prior years. I.R.C. Section 382 severely limits the amount of the target corporation's NOL that the acquiring corporation can use to offset its income in future years.[72] To circumvent the limitations imposed by Section 382, the target corporation would enter into an interest rate swap contract with an investment banker.[73] The terms of the swap would include an up-front lump sum payment to the target corporation, rather than netting payments over the term of the contract.[74]

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69. I.R.S. Notice 89-21, 1989-8 I.R.B. 24.

70. For an example, *see supra*, notes 25 to 28 and the accompanying text.

71. Subpart F of the Internal Revenue Code contains the rules dealing with income earned from sources outside the United States. Although Notice 89-21 impacts these rules, they are beyond the scope of this article.

72. 26 U.S.C. Section 382 (1986) limits the use of target corporation's NOL when there has been a change in ownership of target. For an explanation of Section 382, *see* Barr, *Net Operating Losses—Sections 381, 382 & 269*, 27-5th TAX MGMT. (BNA).

73. Alternatively, target could enter into an interest rate cap contract or one of the other types of notional principal contracts. *See supra*, notes 12 to 22.

74. *See supra*, note 11 for a discussion of the netting process. The amount of the up-

Under *Michigan*, *AAA* and *Schlude*, which also represented the Service's position until Notice 89-21 was issued, the target corporation would include the entire up-front payments in income in the year of receipt, thereby using its entire NOL. Some time after the interest rate swap, acquiring corporation will purchase the target corporation. Under the terms on the swap contract, the target corporation will make periodic payments to the bank over the term of the contract. Thus, acquiring corporation will indirectly receive the benefit of the target corporation's NOL because the acquiring corporation will receive the benefit of the target's deductions for interest payments made after the target is purchased.

Although this article discusses only the clear reflection of income aspect of Notice 89-21, it is important to keep in mind that the Notice expressly limits its scope by excluding from its application any transactions that are "not properly characterized as notional principal contracts."[75] Thus, if the up-front payment is characterized as a loan or an insurance premium, Notice 89-21 will not apply. Rather, the payment will be treated as any other item properly characterized as a loan or insurance premium.[76]

V. The Service's Tightrope

No doubt, the Service will attempt to distinguish *Michigan*, *AAA* and *Schlude* on the same basis that *Artnell* distinguished these cases: the timing of performance in the *Michigan* trilogy was not fixed whereas under the swap contract, the dates for payment are fixed.[77] Thus, the Service will argue that *Artnell* should be followed in notional principal contract cases, thereby attempting to turn its defeat in *Artnell* to its advantage.

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front payment to the target corporation will be the present value of the investment bank's obligation to make future payments under the swap contract. The terms of the swap will be that the target corporation is swapping its fixed debt for the investment bank's variable debt. Thus, the amount and timing of the bank's future payments are known and their present value can be calculated. *See* Cantrell, *supra* note 24 at 338 (*citing* F. Martin Belmore, *Interest Rates & Currency Swaps 1988*, (Practising Law Institute) at 135 and 151.

75. I.R.S. Notice 89-21. More specifically, the Notice states:

> No inference should be drawn from this notice as to the proper treatment of transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans. In addition, no inference should be drawn from this notice as to the characterization of a contract as an insurance contract or annuity contract or the proper treatment of payments made under insurance or annuity contracts.

76. For an analysis of the loan or insurance premium characterization, *see* Cantrell *supra*.

77. *See*, *Artnell*, *supra* notes 61 to 65 and the accompanying text.

The Service must be careful, however, as to how strenuously it attempts to distinguish the trilogy and follow *Artnell.* The Service is walking a tightrope. It wishes to defer the taxation of up-front payments when notional principal contracts are involved. But when any other type of prepayment is involved, the Service wants the taxpayer to recognize income immediately.[78] If the Service does not aggressively distinguish the trilogy, it will not overcome the precedent which almost seems to be cast in stone. But, if the Service successfully distinguishes the trilogy, and the Supreme Court agrees, this could breathe new life into *Artnell.* Certainly it would be a new basis upon which taxpayers could attempt to assail the *Michigan* trilogy, thereby deferring income and tax revenues. Thus, the Service could win the battle over notional principal contracts, but blow a "gaping hole" in its defense against the war on prepayments, which until Notice 89-21, it seemed to have won.

In Notice 89-21, the Service expressly relies on Section 446(b) of the I.R.C. as its authority for its position. Although the cases repeatedly refer to the Commissioner's broad discretion under Section 446(b),[79] it must be kept in mind that the Service relied on Section 446(b) in *Michigan, AAA* and *Schlude* to reach a contrary result in very similar situations.

Taxpayers will argue that the cases in the *Michigan* trilogy are controlling. In this regard, the Service's position may be difficult to sustain, at least outside the Seventh Circuit and the Claims Court. It is relevant to keep in mind that the Tax Court has expressly stated that it will not follow the reasoning in *Artnell.*[80] Thus, the taxpayer will opt to resolve any notional principal contract disputed in Tax Court where at least the Court has indicated its disagreement with *Artnell.*

Despite the Tax Court's disapproval of *Artnell,* taxpayers should not feel too comfortable in Tax Court. After all, the Tax Court has repeatedly upheld the Commissioner's broad discretion.[81] In addi-

78. As indicated in Note 6, *supra,* the scope of Notice 89-21 is uncertain at this time. It is possible that the Service could take the very aggressive position that the Notice applies only to notional principal contracts that are tax-motivated. Under this approach, the Service would attempt to defer recognition of income on "abusive notional principal contracts", but retain the general rule of *Schlude* when taxing notional principal contracts entered into for bona fide non-tax business reasons.

79. *See* Continental Illinois Corp. v. Comm'r, ___ T.C.M. (CCH) 790 (1989); Molsen v. Comm'r, 85 T.C. 485, 498 (1985); Applied Communications, Inc. v. Comm'r, ___ T.C.M. (CCH) ___ (1989). *See also infra* note 82.

80. *See supra,* note 66 and accompanying text.

81. *See supra* note 79.

tion, the Supreme Court on several occasions has recognized the Commissioner's broad discretion under Section 446(b).[82]

VI. Conclusion

The Service's controversial position in Notice 89-21 would clearly be within its discretion under Section 446(b) if *Michigan*, *AAA* and *Schlude* were not on the books. These cases cast some uncertainty on the Service's position because it is a complete reversal of its long-standing position on prepayments. As indicated above,[83] the Service could apply Notice 89-21 to all notional principal contracts or only to certain "abusive" notional principal contracts (i.e: ones which were entered into solely for tax reasons).[84] Under either approach, the Service's authority under Section 446(b) will be tested. Certainly, the final determination of Notice 89-21 in the courts will indicate whether the Service has, as has been suggested, "complete and unreviewable discretion"[85] or whether *Artnell* is the anomaly it appears to be.

Albert J. Vernacchio

82. In addition to upholding the Commissioner's determinations in the trilogy, the Supreme Court has expressly recognized the broad discretion granted to the Commissioner under Sectionn 446(b). *See Thor Power Tool*, *supra* note 41; United States v. Catto, 384 U.S. 102 (1966) ("Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers." *Id.* at 114). *See also* Comm'r v. Hansen, 360 U.S. 446 (1959).

83. *See supra* note 6.

84. The Service has implicitly indicated that it will apply Notice 89-21 to all notional principal contracts. *See* P.L.R. 8938068, 1989 P.L.R. LEXIS 2029 (June 29, 1989) (Service applied Notice 89-21 and held that a bank must take income from the up-front lump-sum payment into income over the term of the contract).

85. *Artnell*, 400 F.2d at 984. *See supra*, note 64.