SHELF PROJECT

tax notes

Closing Deferred Revenue

By Calvin H. Johnson

Calvin H. Johnson is professor of law at the University of Texas. He wishes to thank Eric Chason, Charles Davenport, Elliot Manning, and Larry Zelenak for very helpful comments, without binding anyone to conclusions with which they disagree.

The closing deferred revenue proposal would require a taxpayer to close "deferred revenue" as if the taxpayer received cash equal to the amount of the deferred revenue account when it is closed. Deferred revenue accounts arise because the taxpayer receives cash (or "debit-side" benefits) but does not then pay tax because the cash or other benefit is not yet earned or because of offsetting obligations. The accounting will not reflect the cash and the books will not balance unless the deferred revenue is closed into revenue or reduced cost. Current law has to be confirmed, however, because KPMG LLP sold billions of dollars of son-of-BOSS shelters that rested on the assumption that deferred revenue accounts could disappear without tax consequences.

The proposal is made as a part of the Shelf Project, a collaboration of tax professionals to develop and perfect proposals to strengthen the tax base. Shelf Project proposals are intended to raise revenue without raising rates — the best systems have the lowest feasible tax rates because the taxes are unavoidable. Shelf projects defend the tax base and improve the rationality and efficiency of the tax system. Given the current calls for tax stimulus, some shelf projects may stay on the shelf for awhile. A longer description of the Shelf Project can be found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," Tax Notes, Dec. 10, 2007, p. 1077, Doc 2007-22632, 2007 TNT 238-37. Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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Under current law, taxpayers can receive cash but not pay tax on it because the cash is considered deferred revenue. When a taxpayer writes an option or sells stock short, for example, the taxpayer receives cash, but the cash is not considered gain or loss until the option is exercised or until the short sale stock is replaced. In accounting, the cash received is not income, but deferred income. Under limited circumstances, the taxpayer may also defer prepayments received for future goods or services.

The proposal here would uniformly treat the deferred income account as if it were cash received when the offsetting obligation terminates, is assumed, or is satisfied or when it is no longer appropriate for the revenue to be deferred. At very latest, the deferred revenue would be closed into a revenue account at death or liquidation of the taxpayer. The cash would sometimes be income, sometimes a reduction of basis or cost, and sometimes a part of amount realized. The proposal creates a framework that does not propose substantive law on how the cash would be treated, but only insists that the closing of the deferred revenue account be treated as cash received.

The proposal confirms current law as best understood. KPMG LLP and other syndicators, however, have marketed billions of dollars of fictive losses that arose from failure to close the deferred revenue accounts into revenue. The extraordinary scale of the KPMG shelters, and the unsatisfactory nature of the legal remedies directed against the abuse by both courts and Congress indicates that current law has to be restated and codified, at least to accomplish clarity.

An appendix proposes statutory language, a new section 108A of the code.

A. Current Law

1. Deferred revenue accounts. Under current law, tax-payers can receive cash that is not taxed immediately but is considered "deferred revenue." A taxpayer who writes a call option receiving an "option premium" of \$100 million in cash, for instance, is not taxed on the \$100 million cash when received because of the offsetting obligation to satisfy the option. Instead the cash is accounted for when the obligation lapses or is assumed or satisfied.²

Before Rev. Rul. 58-234 conceded the issue, the IRS had previously ruled that the cash received for issuing an option

(Footnote continued on next page.)

¹The \$100 million example is not hyperbole. The deferred revenue cash in *Stobie Creek Investments v. United States*, 2008-2 USTC para. 50,471 (Cl. Ct. 2008), *Doc 2008-5274*, 2008 TNT 49-13, was \$202 million.

²Kitchen v. Commissioner, 353 F.2d 13, 15 (4th Cir. 1965); Virginia Iron Coal & Coke Co., 37 B.T.A. 195, 198 (1938), aff'd, 99 F.2d 919, 921 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939); Rev. Rul. 78-182, 1978-1 C.B. 265, 267 (ruling B1) modifying Rev. Rul. 58-234, 1958-1 C.B. 279, 283. See generally Bruce Kayle, "Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property," 48 Tax L. Rev. 233 (1993).

COMMENTARY / SHELF PROJECT

In accounting terms, the cash is deferred revenue rather than immediate income. The deferred revenue is a credit-side (right) entry, reported on the credit (right) side of the balance sheet, below liabilities of the taxpayer, but above equity accounts considered to improve net worth.

In economic terms, the taxpayer has no expected gain from the \$100 million cash for writing the option because of the offsetting obligation to satisfy the option. If the option is exercised, the taxpayer must sell the underlying property at the exercise price and the holder will exercise the option only when the exercise price under the option gives the holder a bargain. Indeed, the holder was willing to give the writer the \$100 million cash at the outset only because the holder thought the future bargain would be large enough to be worth at least the \$100 million the holder gave up at the start. Because the holder and writer negotiate adversely regarding the \$100 million, it is reasonable to presume there is obligation on the writer to give a bargain that has a \$100 million burden offsetting the writer's \$100 million cash.

The \$100 million cash is eventually accounted for, however, when the offsetting obligation disappears. If the option lapses without exercise, the \$100 million cash received earlier is income. Under current law, the income has the character of short-term capital gain, which bears tax at ordinary rates.³ If the option is exercised, the \$100 million cash is part of the price the option writer receives for the sale of the underlying property.

In accounting terms, when the option term ends, there is a journal entry that "debits" \$100 million to zero out the deferred revenue account and there is, therefore, also a corresponding \$100 million "credit" to some revenue account. The taxpayer is treated as if the \$100 million cash were received for the first time, not on the writing of the option, but at the end of its term. The character of the credit depends on the circumstances at the end of the option term. The credit will have a character of shortterm capital gain, under section 1234(b), if the option lapses. The credit will be included in the amount realized from the sale of the underlying property if the option is exercised; the character of the amount realized will depend on whether the underlying property is capital asset held for more than a year. The exercise will be a gain or loss depending on whether the taxpayer's costs to buy the underlying property to satisfy the option are higher or lower than the exercise price. Whatever the character and whether there is a final gain or loss, once it is time to zero out (debit) the deferred revenue account, the books will not balance unless there is a corresponding credit to some account that produces recognized income, gain or a reduction of loss.

Deferred revenue accounts arise not just in writing an option, but also in short sales. A short seller receives, for example, \$100x by selling borrowed shares, but the \$100x is not taxed income but deferred revenue when received. As with cash from writing options, the cash from short selling is offset by an obligation, for short sales, to replace

was ordinary income to the issuer immediately. O.D. 1028, 5 C.B. 83 (1921); I.T. 3681, 1944 C.B. 64 (both revoked).

the borrowed shares, quite possibly at a considerably appreciated price. If the underlying property appreciates substantially, a short sale can prove to be an expensive way to borrow \$100x cash. As for writing options, the \$100x is given in an arm's length transactions with an adverse party betting on the other side, so it is fair to presume that the \$100x is not economic gain when received. Under the deferred revenue system for short sales, the \$100x cash received initially in the short sale is taxed as amount realized with respect to the sold shares when the borrowed shares are finally replaced.⁴ Since 1997, cash from short sales are eligible for deferral treatment only if the sale will be closed at least within the tax year following the receipt of cash.⁵

Another Shelf Project proposal would treat cash received for writing options or short selling stock to be the realization on gain built into stock that the taxpayer (or an affiliate) already holds.⁶ If cash is taxable when received, the deferred revenue account would not include that cash, and when the deferred revenue account is closed to revenue, it would still not include the cash that has been previously taxed. Even under that Shelf Project proposal, however, cash received would be deferred revenue if the taxpayer and affiliates do not own stock with built-in gain, and then the deferred revenue would arise and be treated as if it were cash received only when the deferred revenue is closed.

Current law also allows deferred revenue when the cash received is not earned. Rev. Proc. 2004-347 allows an accrual method taxpayer to defer prepayments received for services, hotel rooms, copyrights, patents, and membership subscriptions for up to a year if the prepayment is deferred on financial statements. Reg. section 1.451-5 allows deferral for prepayments for sale of inventory built by the taxpayer if the taxpayer defers the gain on financial statements. Deferral is more problematic in those cases than for writing options and short sales because the deferral violates time value of money principles. When \$100x is prepaid for profit or services, for example, the best measure of the net present value of the income is in fact the \$100x cash received.8 Deferral understates the time value of the cash received. Obligations to deliver services or profit do not ordinarily prevent cash from being taxed. Nonetheless, the deferred revenue account created as a credit when the cash is received is closed into income when the payment ceases to be a prepayment because of performance of the

³Section 1234(b).

⁴Reg. section 1.1233-1(a)(1) (1971) (a short sale is not deemed to be consummated until delivery of property to close the short sale).

⁵Section 1259(c)(3) (exempting from constructive sale rules short sales closed within the year following the year cash is received).

⁶Calvin H. Johnson, "End Tax-Free Monetization of Wealth," *Tax Notes*, June 30, 2008, p. 1361, *Doc 2008-13933*, 2008 *TNT 127-41*.

⁷2004-1 C.B. 991, Doc 2004-9841, 2004 TNT 89-19.

⁸Johnson, "The Illegitimate 'Earned' Requirement in Tax and Nontax Accounting," 50 *Tax L. Rev.* 373 (1995). Costs associated with prepaid goods, however, need to be taken out of closing inventory to identify the profit on the prepayments.

service, or delivery of the good or passing of the time of rental, with a character determined as if the cash were received not as a prepayment.

Professor Wayne Barnett has called the credit balance of a liability or deferred revenue account "antibasis."9 Basis is the tax analog of the accounting term "asset," or "deferred expense." Basis arises because, for example, the taxpayer has paid for an investment but the cost is not taken into account in computing income until a future year when the investment is sold or depreciates. Basis is a kind of IOU from government to taxpayer measuring cost invested but not yet recognized for tax purposes. So similarly, antibasis, in Barnett's terminology, is the liability or deferred revenue account that arises, as a creditside entry, when a taxpayer has cash or an asset that is not taxed. Antibasis represents the mirror image of basis in that it is an IOU from taxpayer to government measuring cash or asset received that has not been recognized for tax purposes. For basis, the taxpayer has to have a loss or reduced gain, at latest when the asset is sold or otherwise disposed of. For antibasis the taxpayer has to have a gain or reduced loss, at latest when the transaction is completed.

The statute of limitations has no effect on costs put into basis in years long since barred by the statute of limitations. Similarly, in a comprehensive tax, the deferred revenue has to become taxable revenue eventually, without regard to the statute of limitations on the year the deferred revenue arose.

2. Son-of-BOSS shelters. Notwithstanding the settled principles on recognition of deferred revenue, billions of dollars of son-of-BOSS shelters were created and sold in the late 1990s and early 2000s, primarily by the accounting firm KPMG, that purported to generate large artificial tax losses because they never recognized the deferred revenue when the deferred revenue account disappeared. KPMG marketed son-of-BOSS shelters they called bond linked issue premium structure (BLIPS) or short option strategy to hundreds of high-income taxpayers between 1999 and 2002 that claimed at least \$7 billion of artificial losses. The legal opinions accompa-

 9 Much of the logic of antibasis is described in Prof. Barnett's amicus brief on behalf of himself in *Tufts v. Commissioner*, 461 U.S. 300 (1983), but he did not use the term "antibasis" there. He did use the term "antibasis" to a generation of his students at Stanford Law School.

¹⁰Son-of-BOSS draws its nickname from an earlier, abusive shelter called BOSS, an acronym for Bond and Option Sales Strategy. Lee A. Sheppard, "Treasury Shuts Down Baby BOSS Deals," *Tax Notes*, Aug. 14, 2000, p. 850, *Doc 2000-21199*, 2000 *TNT 156-1*. All son-of-BOSS shelters share the characteristic that some obligation is assumed by a taxpayer's partnership or corporation. The obligation reduces the value of the partnership interest or shares, but is claimed not to reduce basis. The high basis and low value means there is fake loss built into the shares or partnership interest, which is realized by sale or liquidation. In the original BOSS shelters, the fake loss was created at the entity level, whereas in son-of-BOSS shelters, the fake loss is created at the owner level.

¹¹KPMG Deferred Prosecution Agreement, Letter of U.S. Attorney (S.D.N.Y) to Robert S. Bennett, attorney for KPMG, Statement of Facts at 2, para. 6 (Aug. 5, 2005), available at (Footnote continued in next column.)

nying the shelters took the dubious position that a taxpayer never had to recognize income if the obligation to satisfy the option is assumed by the taxpayer's controlled corporation or partnership.

Under the KPMG BLIPS shelters, the taxpayer both bought options and wrote nearly identical offsetting options. Assume, for example, that a taxpayer who had just recognized \$100 million in compensatory stock options was seeking to buy \$100 million worth of tax losses to shelter the \$100 million taxable income. Under the BLIPS shelters, the taxpayer would buy \$101 million in options and receive \$100 million for writing nearly identical offsetting options for a net cost of \$1 million, which is the only amount the taxpayer paid. The whole set of options was then contributed to a corporation controlled by the taxpayer or to a partnership, and the entity would assume the taxpayer's original obligation to satisfy the options it wrote.

Under the shelter, the taxpayer would take the legal position that his cost basis for shares or partnership interest was \$101 million. As a matter of economics, the taxpayer's true net cost for the entity was \$1 million,12 after reduction by the \$100 million cash received, not the claimed \$101 million. Had the obligation to satisfy the written options been considered a liability, then, under the code, the taxpayer would have had to reduce basis in the stock or partnership interest by \$100 million down to the \$1 million true cost and true value.13 A deferred revenue account resembles a liability in that both deferred revenue and liability journal entry credits will prevent cash received from being considered taxable when received. The deferred revenue account, however, is a "quasi-liability" that sits below liabilities on the balance sheet. Once the taxpayer's basis was stated as \$101 million, there was an artificial \$100 million loss built into both the options and the taxpayer's stock or partnership interest, and the taxpayer recognized the loss by vear-end.

The claimed tax accounting created an artificial \$100 million tax loss and failed to reflect income. The loss is attributable to failing to bring the deferred revenue account into a credit-side revenue account when the

http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgstatementof facts.pdf (BLIPS shelter represents \$5.1 billion tax losses and short option strategy represents \$1.9 billion tax losses).

¹²Even the \$1 million net cost was probably not deductible although lost. Out-of-pocket costs of a transaction that is a sham, has no economic substance, or is not-for-profit are not deductible. *Illes v. Commissioner*, 982 F.2d 163, 165 (6th Cir. 1992); *Marinovich v. Commissioner*, T.C. Memo. 1999-179, *Doc 1999-19167*, 1999 TNT 104-5; Hoffpauir v. Commissioner, T.C. Memo. 1996-41; Guy Farmer v. Commissioner, T.C. Memo. 1994-342. Both individual and corporate federal income taxes are nondeductible (section 275) and fees paid in lieu of taxes are nondeductible too.

¹³Section 358(d), treating a corporate assumption of a share-holder liability as a distribution of money that reduces basis in stock, under section 358(a)(1)(A)(iii); section 752(b) treating assumption of a partner's liability by a partnership as a distribution of money, which reduces basis in partnership interests under section 733.

COMMENTARY / SHELF PROJECT

taxpayer got out of the obligation to satisfy the option. Deferred accounts are not permanent and they need to be closed to revenue at least when the term of the option ends. It is impossible, under the logic of double entry bookkeeping, for a deferred revenue account to disappear with a debit entry, unless the \$100 million shows up as a corresponding credit to a revenue account. The books will not balance if the deferred revenue is not closed to revenue. Current law, read with reasonable loyalty to the tax accounting as a system, creates a credit to revenue when the deferred revenue account is zeroed out by a debit. If nothing else applies, section 1234(b) provides that any termination of a taxpayer's obligation other than by lapse or exercise of the option is to be treated as a short-term capital gain, in the hypothetical, in the amount of \$100 million.

The shelter opinions rely on Helmer v. Commissioner, 14 in which a partnership distributed the premium from writing an option to partners including the taxpayer. The Tax Court, in a (supposedly) nonprecedential memorandum decision, held that a partner has a distribution in excess of basis, generating gain, because the partnership obligation to satisfy the option was not a "liability" that increased partner basis under section 752(a). Helmer is not relevant to the determination of whether the section 1234(b) termination of option obligation has occurred by the partnership's assumption of the obligations; first, because Helmer dealt with liabilities and the taxable event under section 1234(b) concerns obligations. "Obligation" is a broader term than "liability" and covers the obligation to make good exercised options. Secondly, Helmer dealt with the upfront or basis part of the system, not with the back end of an account that the taxpayer has used to avoid tax on the \$100 million cash. In Tufts v. Commissioner, the Supreme Court adopted a principle of consistency under which the taxpayer, having used the deferred account to avoid tax on the \$100 million cash when it is received or when the liability arises, "is not at liberty" to deny his taxable benefit when the deferred revenue account is no longer needed and disappears.¹⁵

- **3. Imperfect remedies.** While both courts and Congress have attempted to end the artificial losses in son-of-BOSS shelters, neither's response is an adequate remedy for the failure to take deferred revenue into income.
- **a. Antiabuse doctrines.** The courts have sometimes fixed the artificial loss in the son-of-BOSS shelters with one or more of the overriding antiabuse doctrines. A loss that is "devoid of economic substance," it is said, "simply is not recognized for federal taxation purposes." The artificial tax losses in the son-of-BOSS shelters have thus been struck down by courts that recognized that the shelters generate "creative tax return[s] full of fanciful numbers" (Judge Frank H. Easterbrook), "absurd re-

¹⁴34 T.C. Memo. 727 (1975).

sults," "purely fictional" claims and are a "scheme to inflate basis." In its agreement to avoid criminal indictment, KPMG itself described the losses from son-of-BOSS as "bogus" losses from a "fraudulent" and "unlawful" shelter. In a recent case (Sala v. United States), however, a Colorado district court refused to strike down the son-of-BOSS tax deductions that arose from failing to properly close the deferred income account. The court found that the shelter's accounting was settled law and that the taxpayer was trying to make a profit from the options even in the absence of tax. In The court in Sala would not deny that the losses were artificial, fictional, absurd, or bogus, but the judge thought the result was required by his reading of current law.

The antiabuse overrides have limitations even in the hands of a court willing to recognize the artificiality of the claimed losses. The antiabuse doctrines are raised only by smart agents in a tax audit and the audit rates are low. If the failure to reverse the deferred income account into income is deeply embedded in a real business or investment activities, the courts might not be able to isolate the error. The Sala court, moreover, refused to correct what it recognized to be an artificial loss even when the transaction was a purchase of tax loss isolated from any real business. Even when the courts strike down the losses, in any event, antiabuse rules should never be the first defense against accounting mistakes that fail to balance the books, especially those mistakes that can be fixed so routinely by reversing the deferred income account into income or cost reduction on the disappearance of the obligation.

b. Inadequate congressional remedies. In 2000 Congress enacted section 358(h) with retroactive application to October 19, 1999, as antiabuse legislation to prevent basis in stock that is higher than true value. Section 358(h) says that if an obligation assumed is not a liability that reduces basis under normal section 358 rules, basis will be reduced to fair market value anyway. The amendment also gave Treasury the authority to write consistent rules when the son-of-BOSS shelter arose from a contribution to a partnership, which assumes the obligation to satisfy the option if exercised.

¹⁷KPMG Deferred Prosecution Agreement, *supra* note 11, at

¹⁵Tufts v. Commissioner, 461 U.S. 300, 308-310 (1983) (footnotes omitted); Rev. Rul. 88-77, 1988-2 C.B. 128 (reducing basis for an obligation assumed if and to the extent the obligation created basis to the partnership).

¹⁶ACM Partnership v. Commissioner, 157 F.3d 231, 245-246 (1998), Doc 98-31128, 98 TNT 202-7 (emphasis added).

^{3,} Appendix C at 2, para. 6 (Aug. 5, 2005).

18 Sala v. United States, 2008-1 USTC para. 50,308 (D.C. Colo. Apr. 22, 2008), Doc 2008-9012, 2008 TNT 80-10, motion for new trial denied, 2008-2 USTC para. 50,452 (July 18, 2008), Doc 2008-15944, 2008 TNT 140-70 (finding that taxpayer had a subjective intent to make money on the options and that satisfied business purpose requirement), but see contra, Stobie Creek Investments v. United States, supra note 1, (finding similar options had no objective realistic expectation of profit). The Sala court seems to have ignored the large fees the taxpayer paid, typically 7 percent of the tax loss (1 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Hearings Before the U.S. Senate, Gov. Affairs Comm., Permanent Subcomm. on Investigations at 159 (Nov. 18, 2003)), which were considerably larger than what appears to be profits of about 1 percent of the tax loss.

¹⁹Community Renewal Tax Relief Act of 2000, section 309.

Section 358(h)'s diagnosis of the son-of-BOSS shelters is accurate because, for example, the stock or partnership interest had a basis of \$101 million and a value of \$1 million. But a value test can be beaten, for instance, because of unrelated appreciation in assets held by the entity, or because unrelated appreciated assets are also contributed to the partnership. The direct remedy is to treat the deferred revenue account as if it were cash received on the contribution, which would reduce basis appropriately in every case.

Section 358(h) as enacted, moreover, created an exception if substantially all the assets the obligation is associated with are also transferred to the corporation.²⁰ In the son-of-BOSS shelters, the full set of written and purchased options was contributed to the corporation. The \$100 million artificial loss in fact arose because of the contribution of both sets of options, not in spite of that. The remedial legislation, thus, had no impact on the shelters that were the target of the legislation.²¹

4. Other deferred revenue accounts. Deferred revenue accounts also arise from short sales and unearned income. Son-of-BOSS shelters have also been sold using short sales as the source of the deferred revenue account.²² If son-of-BOSS shelters can be built with writing options or short sales, they can be built and sold with prepayments that are deferred revenue.

B. Reasons for Change

The marketing of billions of dollars of artificial losses in shelters that arose from the failure to close deferred revenue accounts into revenue accounts and the unsatisfactory remedies used to attack the abuses indicate that there is a need to clarify the law.

The remedies applied in the current controversies over the son-of-BOSS shelters are inadequate, when a simple straightforward remedy is available. The antiabuse remedies adopted by the courts come into play only after a very smart audit, and audit rates are now low. The abuse of failure to close deferred revenue accounts into revenue is especially hard to find and correct when it's buried in complicated transactions or in transactions that in fact might have business or investment meaning. Even legitimate businesses and investments need to treat the disappearance of a deferred revenue account as if it were cash received at the end of the term, or else they will undercount for real income.

²⁰Section 358(h)(2)(B). Section 358(h)(2)(A) also has an exception for transfers of obligations of a trade or business if the trade or business is contributed to the corporation.

²Marriot International Resorts v. United States, Nos. 01-256T, 01-257T (Aug. 28, 2008), Doc 2008-18866, 2008 TNT 173-10; Korman & Associates Inc. v. United States, __ F.3d __, 2008-1 USTC

para. 50,333 (5th Cir. May 12, 2008).

The antiabuse legislation adopted by Congress with the enactment of section 358(h) fails to find its target because value can be inflated by unrelated transactions and because the abuse arises even when all the assets or business inventory is contributed to the entity at the same time. A taxpayer should never be allowed to receive cash, for example, \$100 million, without accounting for the cash when the deferral is no longer appropriate. Treating deferred revenue as if it were always cash received when the deferred revenue account is closed is a simpler remedy than either the judicial or section 358(h) congressional remedy. The proposal here will prevent abuse routinely and uniformly.

C. Explanation of the Proposal

- **1. Framework.** The proposal would treat the taxpayer as having received cash in the amount of the deferred revenue account at the time the deferred revenue account is closed. The proposal is a framework. The appropriateness of the deferral, time of closing, and character would be specified by substantive provisions of tax law outside of the framework of the proposed statute. Section 7872 is a similar "framework" provision. It provides that interest at least at the risk-free rate is in fact paid and reimbursed between some related parties, even if the interest is not specified by the contract between the parties, but section 7872 leaves to substantive tax sections how the interest and the counter-reimbursement will be treated. Similarly, the proposed framework statute for deferred revenue accounts does not specify when a deferred revenue account arises (or is inappropriate). It does not specify all instances when the deferred revenue account closes, even while specifying some deferred revenue account closing events. The proposed framework statute does not specify the tax character of the cash that is treated as received on closing, but requires only that character be determined as if cash were received.
- 2. Deferred revenue account arises. Under current law, deferred revenue accounts arise because a taxpayer receives cash, property, or services and the taxation is deferred. Reasons for deferral include an offsetting obligation to satisfy the option if exercised or an offsetting obligation to purchase replacement shares for shares that were sold short. Current law allows deferral for income not yet earned, but deferral is erroneous when the cash received represents the net present value of the taxpayer's profit and improvement to net worth, so the result will not be codified here. If the prepayment is taxed under current or future law, there would be no deferred revenue account that would arise. Deferred revenue accounts will arise by reasons outside of the proposal. Deferred revenue accounts do not include amounts that are credits to liabilities, taxable income, or basis reductions, nor to items that are explicitly treated as permanent exclusions. The deferred revenue account is a credit-side account that can arise from a debit-side entry to cash, to basis, or to a reduction of a liability.
- 3. Closing of the deferred revenue account. Closure of the revenue account occurs when the deferral is no longer needed. If the obligation to satisfy the option or replace the sold stock is satisfied, disappears, or is no longer needed, the deferred revenue account shall be closed. When a prepayment has been earned, the deferral is no

²¹Section 358(h) is also a remedy directed at shelters such as in Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. Feb. 2, 2006), Doc 2006-2133, 2006 TNT 23-8, in which taxpayer contributed contingent obligations (not yet amounting to a liability) to a corporation. The obligations destroyed value, but were not liabilities that reduced basis under sections 357 and 358. Because of the impact on Black & Decker situations, the proposal here does not amend section 358(h).

COMMENTARY / SHELF PROJECT

longer needed. For instance, when the time for prepaid rent or interest passes, the prepayment is closed to income.

The proposal treats the assumption of the taxpayer's obligations as the closing event. Thus if a partnership or corporation assumes the taxpayer's obligation to satisfy an option, replace short sold stock, or perform the services that earn the prepayment, the deferred revenue account would be closed as to the taxpayer. Under general principles, assumption of a liability by another party is treated as amount realized or income because it is usually tantamount to discharge of the liability as to the taxpayer, even though the taxpayer remains secondarily liable.²³ Treating the assumption as tantamount to discharge or disappearance of the obligation will occasionally mean the original obligor will have to make good if the assuming entity defaults. Default is not the most likely premise, however, and if default happens, the tax effects can be offset with counter entries in the year the default occurs.

If a deferred revenue account remains on the books at the liquidation or death of the taxpayer, the deferred revenue account will be reversed at that time. Death or liquidation is like an assumption of a liability by some other taxpayer. It is also the final closure.

For the liquidation of a partnership, it is anticipated that the partnership would recognize the deferred revenue accounts that remain after liquidation of the partnership, but that a partner will avoid recognizing gain from the liquidation to the extent that the partner takes up the obligation that justifies the deferral. For instance, if the partnership has prepaid salary in its deferred revenue account on liquidation, the partnership would have income as if it had received cash, but the partner who takes up the obligation to perform the services will be able to defer taxable income to him from the cash until the services are performed or time for performance passes.

Basis accounts remain without regard to the statute of limitations. If property acquired in a year long since barred by the statute of limitations is stolen from a taxpayer, the taxpayer gets a deduction for the basis as a theft loss. So similarly, deferred revenue accounts may arise many years before they are closed. If they are not previously closed in fact, they must be closed on death or liquidation, even if they should have been closed before that. Using death or liquidation as a backstop taxable event is necessary because deferred revenue accounts sometimes arise that have sufficiently ambiguous conditions that it is not clear in what year the deferred revenue account appropriately disappears.

4. Consequences of closing. On closing of a deferred revenue account, the taxpayer would be treated as receiving cash equal to the amount of the deferred revenue account at that time. The journal entries would be a debit to offset the deferred revenue account and a credit to some other revenue account. Provisions beyond the proposed framework commonly set the character of the receipt of the deemed receipt of cash, that is, what new credit account the deferred revenue would go to.

Section 1234(b), for instance, provides that the cash would be short-term capital gain if the option lapses or is terminated for any reason other than exercise. If the option is exercised, the cash previously received on writing the option is credited to amount realized on sale of the underlying property.

If a controlled corporation or partnership assumes the obligation to provide services on a prepayment or to satisfy the option or replace the short sale stock, then, in general, that is treated as reduction of the taxpayer's basis in stock or partnership interest.²⁴ If a customer assumes an obligation underlying a deferred revenue account so as to pay for inventory, the cash deemed to be received at that point would be ordinary income to the taxpayer. If a purchaser assumes the obligations underlying the deferred revenue account, that would be an amount realized on the sale which would be capital gain or loss or ordinary gain or loss depending on the nature of the asset sold. If the obligation is assumed in a context requiring exemption, for example, as payment of interest on municipal bonds, the cash shall be treated as tax-exempt income.

5. Effective date. Because the proposal is intended to be a clarification of current law, it would apply to the earliest year not barred by the statute of limitations. However, deferred revenue accounts not in fact closed to some revenue credit in a year now barred by the statute of limitations will be closed in the first year not barred by the statute of limitations in which the deferral is no longer merited. Taxpayers will not be entitled to positive adjustments to basis or other advantageous adjustments if they did not in fact treat the deferred revenue account as cash received.

Appendix: Proposed Section 108A

Section 108A. Reversing Deferred Income Into Taxable Income.

- **(a) General Rule.** Upon the closing of a deferred revenue account, the taxpayer shall be treated as having received cash equal to the amount of the deferred revenue account.
- (1) Expiration or Satisfaction. A deferred revenue account shall be closed when deferral is no longer appropriate, including by satisfaction or disappearance of the obligation that made deferral appropriate.

²³Reg. section 1.1001-2(a)(4) (1980) (liability recourse to the seller is included in amount realized if another party agrees to pay it, whether or not the seller is discharged). *See, e.g.,* Boris Bittker, *Federal Taxation of Income Estates and Gifts*, para. 43.5.1 (1981) (explaining that assumption is usually tantamount to discharge, that it would be administratively difficult to evaluate how likely default by the primary obligor would be, and that we can fix the accounting later if the primary obligor in fact defaults).

²⁴Section 358(a)(1)(A)(ii) and (d) (treating assumptions by a controlled corporation is distribution of money that reduces basis); sections 752(b) and 733 (treating assumption by a partnership as a distribution of money, which reduces basis in partnership interests).

- **(2) Assumption.** If the obligation justifying the deferral is assumed by some other party, the cash shall be treated as coming from that other party.
- **(3) Liquidation or Death.** Deferred revenue accounts will also be closed by death or liquidation of the taxpayer.
- **(b)** Character. The character of the cash deemed to be received in subsection (a) shall be determined under this chapter as if the cash were paid at the time and circumstances of closing.
- (c) Deferred Revenue Account. A deferred revenue account is a credit-side entry that is not taxable to

income, gain, liability, permanently exempt income, or reduction of basis. Deferred revenue accounts arise as the credit when the debit entry is cash, property, services, reduction of liability, or basis in some asset.

The secretary or his delegate is given authority to give examples and solve ambiguities of this statute by regulations.

Effective Date. Section 108A(a) is effective as of the first year not barred by the statute of limitations.