Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:[redacted]:[redacted]:TL-N-6991-00
[redacted]

date:

to: [redacted]

from: Area Counsel
LMSB([redacted]), [redacted]

subject: [redacted]
Customer Advances for Construction

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ISSUE

Whether certain payments received by the taxpayer as advances for construction are includible in income when received.

CONCLUSION

The taxpayer must include such amounts in income when received.

FACTS

The taxpayer is in the business of providing electrical power to its customers. Customers frequently desire the taxpayer to make capital expenditures that will be of particular benefit to them. Two situations are particularly common. One involves a developer of residential real estate, who naturally desires that sufficient infrastructure is in place to provide electrical power to the units to be built. The other involves a business wishing to move or increase its operations, with similar desires to ensure a sufficient supply of electrical power. In such situations, it is common for the taxpayer and the customer to enter into an agreement providing for payments "[redacted] construction" of such facilities. [redacted]. Another standard feature of such agreements is for reimbursements to the customer if certain events occur in the future. For example, in the case of a real estate developer, such agreements normally provide for reimbursements if more than a certain number of units are built during a certain period of time. The reason for such a provision is that the building of more than a minimum number of units allows the taxpayer to receive additional revenue from the development, thereby making it less necessary for the developer to contribute the entire cost of the taxpayer's facilities.

The taxpayer has historically included such advances in income when received, and has deducted any refunds paid at the time paid. Starting with [redacted], the taxpayer has discontinued including such customer advances in income when received, under the theory that such advances constitute customer deposits as described in Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203 (1990). You believe that such amounts constitute income when received, and that in any event, the taxpayer has improperly changed its method of accounting for the treatment of such items.

DISCUSSION

I.R.C. § 118(b) provides that contributions in aid of construction (CIAC) are not contributions to the capital of a corporation, and are therefore, not excludible from income under the provisions of I.R.C. § 118(a). We initially note that both form agreements used by the taxpayer state that the amounts paid by the customer to the taxpayer under such agreements are "in aid of construction."

Going beyond this characterization by the taxpayer, however, you have noted the legislative history indicating the congressional intent that payments such as these be included in

income. Such history indicates that a utility is to report as income the value of any property (including money) received to provide or encourage the provision of services to or for the benefit of the person transferring property. A contribution is considered to provide or encourage provision of services if it is a prerequisite to the provision of services, speeds up the provision of services, or otherwise causes the contributor to be favored in any way. H. Rept. No. 99-426 (PL 99-514), pp. 644-645. Looking again at the taxpayer's form agreements, the agreements plainly state that the amounts paid are consideration for construction of certain facilities, and are in aid of the construction of such facilities.

The taxpayer has argued that such payments, rather than being contributions in aid of construction, are actually in the nature of refundable deposits as described in Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203 (1990). In this case, the Court held that the receipt of a deposit is generally not taxable to an accrual basis taxpayer absent complete dominion over such funds. The deposits in that case, however, greatly differ in character from the payments at issue. The deposits in Indianapolis Power and Light Co. were for the purpose of securing future income; the payments made to your taxpayer were expressly described as consideration for services to be performed. The deposits in Indianapolis Power and Light Co. were collected to ensure that the utility would not be left holding the bag if the customer failed to pay future bills; the payments to your taxpayer were to provide the taxpayer incentive to perform acts specifically benefitting the payor, for which the parties agreed to an amount of compensation. An in-depth review of the facts reveals that the taxpayer accurately described these payments in its agreements as consideration rather than as deposits. We believe that the taxpayer's assertion that payments under these agreements are customer deposits is meritless, and is contradicted by the plain language of the taxpayer's agreements for consideration "[redacted] construction."

We anticipate that the taxpayer might also argue that if the payments were not deposits, the possibility of refund nonetheless rendered the taxpayer's right to such funds sufficiently uncertain so as to allow exclusion from income. As you know, for accrual basis taxpayers, items are included in income when all events have occurred fixing the right of the taxpayer to receive such income. Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932); Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 32 (1988); Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.451-1(a). This so-called all events test is satisfied when all events have occurred fixing the right to receive income, and the amount is determinable with reasonable accuracy. Helvering v.

Enright, 312 U.S. 636, 645 (1941). It is not necessary that the exact amount of income be known, so long as the amount of the item can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii); Resale Mobile Homes v. Commissioner, 965 F.2d 818, 823 (10th Cir. 1992). The possibility of refund of a portion upon the occurrence of subsequent events should not allow the taxpayer to exclude these entire payments from income. As explained in Flamingo Resorts, Inc. v. United States, 664 F.2d 1387, 1390 (9th Cir. 1982), any uncertainty as to the taxpayer's right to the income must be substantial, and not simply technical in nature. We are unaware of any showing by the taxpayer to date that the likelihood of any particular refund was substantial at the time of receipt; in any event, a substantial likelihood of a refund of a portion, if such likelihood existed, should not entitle the taxpayer to exclude the entire payments. In the present case, the taxpayer had actual possession of the funds, and has not demonstrated that its right to such funds was in significant jeopardy. We therefore, believe that the taxpayer should not be allowed to assert that the chance of refunds allows exclusion of CIAC from income.

Finally, you have suggested that the taxpayer's excluding such income from its [redacted] return after including similar items on prior returns constitutes a change of accounting method for which the taxpayer has failed to obtain the requisite approval. As we believe that the income at issue was properly includible in [redacted] it should be unnecessary to address this issue. Nonetheless, I.R.C. § 446(e) requires a taxpayer to secure the consent of the Service before changing its method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the treatment of any material item, and that a "material item is any item which involves the proper time for the inclusion of the item or the taking of a deduction." The taxpayer contends that its actions constituted a change in treatment from taxable to a nontaxable deposit, and that it was therefore, not a change in the timing of inclusion. For the reasons described in more detail above, we consider such assertion to be meritless. The facts, and indeed the language chosen by the taxpayer in its form agreements, indicate that the funds at issue represent consideration from the payor for the taxpayer's promise to construct certain facilities. Unlike a nontaxable deposit, the purpose of which is to secure future payment of amounts owed by a customer, the payments from customers at issue here were not intended to secure future compliance from customers, but instead constituted the taxpayer's compensation for its promised performance. We assume that the taxpayer would ultimately be forced to admit that any amounts not refunded at the end of the contract period would constitute income, so that the issue is in fact one of timing (whether to

include now or at the end of the contract) rather than one of character. We therefore agree that the taxpayer's recent treatment of these items constitutes a change in accounting method for which the taxpayer failed to obtain the required approval.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Division Counsel (Large and Mid-Size Business) an opportunity to comment. If you have any questions regarding the above, please contact the undersigned at [redacted].

[redacted]
Area Counsel
([redacted])

By: _____
[redacted]
Attorney

CC: Division Counsel (Large and Mid-Size Business)