Part I

Section 451.--General Rule for Taxable Year of Inclusion

26 CFR 1.451-1: General rule for taxable year of inclusion.

Rev. Rul. 2003-10

ISSUES

(1) Under the all events test of § 451 of the Internal Revenue Code, when does a taxpayer using an accrual method of accounting accrue gross income if the taxpayer ships goods and the customer disputes its liability to the taxpayer because of a clerical mistake in the sales invoice discovered in the next taxable year?

(2) Under the all events test of § 451, when does a taxpayer using an accrual method of accounting accrue gross income if the taxpayer ships the wrong goods and the customer disputes its liability during the taxable year of sale?

(3) Under the all events test of § 451, when does a taxpayer using an accrual method of accounting accrue gross income if the taxpayer ships more items than the customer ordered, the excess quantity is discovered by the customer in the next taxable year, and, in accordance with an agreement with the customer, the taxpayer reduces the quantity that would otherwise have been included in the next shipment?

FACTS

Taxpayer P manufactures products H and M and sells them to retailers for resale. P uses an accrual method of accounting and a calendar taxable year. For federal income tax purposes, P recognizes gross income from sales of products H and M when it ships the product to the retailer.

Situation 1. In October 2002, X, a retailer, orders 1,000 cases of product M from P at a price of $15 per case. In November 2002, P ships 1,000 cases of M to X and sends X an invoice for the 1,000 cases of M. As the result of a data entry mistake, the amount of the invoice is improperly stated as $16,000 rather than $15,000. In January 2003, X notifies P of the erroneous invoice and P acknowledges that it is entitled to receive only $15,000 for the 1,000 cases of M. X subsequently pays the $15,000 to P.

Situation 2. Y is a retailer that purchases product M from P. In September 2002, Y orders 600 cases of M from P at a price of $15 per case. In October 2002, P ships 600 cases of H to Y and sends Y an invoice for $9,000. In November 2002, Y discovers that P

shipped H rather than M and notifies P that it will not pay for the H. In January 2003, P and Y settle the dispute by agreeing that Y will pay P $4,500 for the H.

Situation 3. Z is a retailer that purchases products H and M from P. Each month P ships Z 300 cases of H at a price of $10 per case and 700 cases of M at a price of $15 per case. On December 28, 2002, P mistakenly ships 400 cases of H and 600 cases of M to Z and sends Z an invoice for $13,000. On January 3, 2003, Z discovers that P shipped the wrong amount of H and M and notifies P. Z asks P to correct the situation by adjusting the amount of H and M it ships to Z in January's monthly shipment. On January 28, 2003, P ships 200 cases of H and 800 cases of M to Z to adjust for the amount of H and M mistakenly shipped to Z in December 2002. In February 2003, Z pays P $13,000 for the H and M it received in December 2002 and in March 2003, Z pays P $14,000 for the H and M it received in January 2003.

LAW AND ANALYSIS

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived. Section 1.61-3(a) of the Income Tax Regulations provides that in a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

Section 451 provides rules for determining the taxable year of inclusion for items of gross income. Sections 1.446-1(c)(1)(ii)(A) and 1.451-1(a) provide that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 80-308, 1980-2 C.B. 162.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of a tax liability.

Section 1.451-1(a) provides that if an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. Additionally, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Gould-Mersereau Co. v. Commissioner, 21 B.T.A. 1316 (1931) acq. 1931-2 C.B. 27. If the right to an amount of income is substantially in controversy the income may not be accrued until the controversy is resolved. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932); Jamaica Water Co. v. Commissioner, 125 F.2d 512 (2d Cir. 1942); Rev. Rul. 60-237, 1960-2 C.B. 164.

In Situation 1, P's invoice to X was for an improper amount as a result of a clerical mistake. P may not accrue $16,000 of gross sales in gross income in 2002 because P does not have a fixed right to that amount. Rather, P accrues $15,000 of gross sales and includes $15,000, the correct amount, less the corresponding cost of goods sold, in gross income in 2002. Generally, if P has already filed its income tax return for 2002 when the mistake is discovered, P should, if within the period of limitation, file a claim for refund of any overpayment of tax arising from reporting an improper amount of income on that return. If, however, P has regularly and consistently for a period of two or more taxable years treated invoice amounts as a reasonable estimate of accrued income and, if the exact amount is subsequently determined to be different, has taken the difference into account for the taxable year in which the determination is made, P should seek consent for a change in method of accounting if it wants to begin taking such differences into account in the year of sale.

In Situation 2, the dispute arises in the taxable year of sale. Accordingly, because under § 451 P does not have a fixed right to the income P may not include any amount from that transaction, including the corresponding cost of goods sold, in gross income in 2002. P accrues $4,500 of gross sales and includes $4,500, less the corresponding cost of goods sold, in gross income in 2003, when P and Y settle their dispute by agreeing that Y will pay P the amount of $4,500 for the H.

In Situation 3, P mistakenly ships the wrong amount of H and M to Z in December 2002 and sends an invoice for $13,000 to Z. However, because Z does not dispute the shipment P has a fixed right to income relating to the shipment in 2002. Accordingly, P accrues $13,000 of gross sales and includes $13,000, less the corresponding cost of goods sold, in gross income in 2002 because the all events test of § 451 is satisfied.

HOLDINGS

(1) Under the all events test of § 451, if a taxpayer using an accrual method of accounting overbills a customer due to a clerical mistake in an invoice and the customer discovers the error and, in the following taxable year, disputes its liability for the overbilled amount, then the taxpayer accrues gross income in the taxable year of sale for the correct amount.

(2) Under the all events test of § 451, a taxpayer using an accrual method of accounting does not accrue gross income in the taxable year of sale if, during the taxable year of sale, the customer disputes its liability to the taxpayer because the taxpayer shipped incorrect goods.

(3) Under the all events test of § 451, a taxpayer using an accrual method of accounting accrues gross income in the taxable year of sale if the taxpayer ships excess quantities of goods and the customer agrees to pay for the excess quantities of goods.

REQUEST FOR COMMENTS

The Service requests comment on the application of § 451 to a situation in which P ships defective products to a customer that discovers the defect in the next taxable year and disputes its liability to P. In particular, the Service requests comments concerning: (1) whether P has a fixed right to income within the meaning of § 451 in the taxable year of sale (compare Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988), with Celluloid Co. v. Commissioner, 9 B.T.A. 989 (1927) acq. VII-1 C.B. 6); (2) whether the taxable year concept of accounting requires P to accrue gross income in the taxable year of sale because the dispute did not arise until the next taxable year; (3) examples of situations that should be treated as shipments of defective products (e.g., shipments of damaged goods, shipments of incorrect goods); and (4) whether the analysis is affected by the course of dealing between P and its customer.

Comments should be submitted by April 21, 2003, either to:

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Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU (CC:ITA:7)
Room 5529

or electronically at: Notice.Comments@irscounsel.treas.gov (the Service's comments e-mail address). All comments are available for public inspection and copying. During its review of the comments, the Service will continue to process private letter ruling requests, including requests for consent to change a method of accounting.

DRAFTING INFORMATION

The principal author of this revenue ruling is John P. Moriarty of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Moriarty on (202) 622-4930 (not a toll-free call).