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Internal Revenue Service

Department of the Treasury

Index Number: 451.13-01

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:IT&A:05-PLR-102566-99

Date: NOV - 3 1999

Taxpayer =

a =

b =

c =

d =

e =

f =

g =

h =

i =

Date 1 =

$x =

$y =

Federal Agency =

Year 1 =

This responds to your request dated January 19, 1999, for a ruling on the federal income tax treatment of Taxpayer's prepaid membership fees. Specifically, you have asked for a ruling that Taxpayer's prepaid membership fees constitute income from services of a type that may be included in gross income ratably over the membership year under the provisions of Rev. Proc. 71-21, 1971-2 C.B. 549, rather than upon receipt.

FACTS

The facts, as represented by Taxpayer, are as follows. Taxpayer is engaged in the a segment of specialty retailing, and operates a chain of membership b in various locations. Taxpayer sells a variety of merchandise including c, etc., at substantial discounts. Taxpayer also offers discounted services which are either provided by Taxpayer's employees (d services, for example) or by independent third parties (e services, for example). Taxpayer's operations are based on the concept that offering very low prices on a limited selection of products will produce rapid inventory turnover and high sales volume. By displaying products in a f setting, Taxpayer's overhead is lower than that of other retailers, which allows Taxpayer to sell at substantial discounts. At least 90% of Taxpayer's income (exclusive of membership fee income) is derived from the sale of goods, and the remainder from the provision of services.

Access to Taxpayer's f locations and the discounted merchandise and services is limited to members who have paid a flat annual fee and obtained a membership identification card. The annual fee is valid for one year after payment and is refundable in full, without proration, at any time during the membership period. Although there are three types of memberships (g, h and i), each type of membership entitles the member to gain access to Taxpayer's b and discounted merchandise and services, and all members pay the same prices for the discounted merchandise and services they purchase regardless of the type of membership they hold. The membership fee varies with the type of membership purchased, but does not vary with the number of visits made by a customer or the amount of discounted goods or services purchased by the customer. Both g and h memberships can be upgraded to i, which allows the member to access additional benefits or "services." Most of Taxpayer's profit is derived from the membership fees. In other words, without the membership fees, the mark-up on the goods sold would not be sufficient to produce a profit for Taxpayer. For Taxpayer's fiscal year ending Date 1, membership fees totaled approximately $x million. About $y of the $x million (a *de minimis* amount) was refunded in the fiscal year ending Date 1.

Taxpayer uses an accrual method of accounting on a fiscal year basis, and is subject to regulation by the Federal Agency. Historically, Taxpayer included membership fees in gross income upon receipt for both financial accounting and tax purposes. Following discussions with the Federal Agency, Taxpayer publicly announced in Year 1 that beginning with its fiscal year ending Date 1, Taxpayer will change its financial accounting method for membership fee income in anticipation of the future issuance of a new Federal Agency Staff Accounting Bulletin. Taxpayer believes that the new Staff Accounting Bulletin will require membership fee income to be recognized on a deferred basis, as opposed to the cash basis historically used by Taxpayer, which has always been consistent with generally accepted accounting principles and industry practice. Under the new financial accounting method, Taxpayer anticipates it will include membership fees in gross income ratably over the membership year.

In order to reconcile the tax and financial accounting treatment of its membership fee income, Taxpayer would like to include membership fees in gross income ratably over the membership period for tax purposes pursuant to the provisions of Rev. Proc. 71-21. Taxpayer argues that the primary service it provides in exchange for the membership fee is access to the discounted merchandise and services in the Taxpayer's b. According to Taxpayer, members receive services every time they shop at Taxpayer's b during the term of the membership period. These services are provided throughout the membership period and include access to the b and sales associates who are available to assist members in locating and purchasing merchandise and services, making merchandise available to members, and identification and negotiation of new member benefits with third party service providers. Taxpayer's position is that even if 100% of its income (exclusive of membership fee income) is from the sale of goods, deferral should be permitted under Rev. Proc. 71-21.

LAW AND ANALYSIS

Section 446(a) of the Internal Revenue Code provides that 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. Section 446(b) further provides that a taxpayer's right to adopt a method of accounting is subject to the requirement that the method must clearly reflect income.

Section 451(a) of the Code provides that the amount of any item of gross income shall be included in 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 in a different period.

Section 1.451-1(a) of the Income Tax Regulations provides, in part, 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 such 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 occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 74-607, 1974-2 C.B. 149.

Rev. Proc. 71-21 implements an administrative decision made by the Commissioner in the exercise of the Commissioner's discretion under § 446 of the Code to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for federal income tax purposes of advance payments for services. Specifically, Rev. Proc. 71-21 provides that an accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement to be performed by him before the end of the next succeeding taxable year, may include such payments in gross income as earned through the performance of the services, subject to the limitations provided in sections 3.07, 3.08, and 3.11.

The general rule, as set forth by the Supreme Court, is that a taxpayer using an accrual method of accounting who receives advance payments for services to be performed in the future must include such payments in gross income in the year of receipt. See Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Ass'n. v. Commissioner, 367 U.S. 687 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). Rev. Proc. 71-21 provides, however, that a taxpayer on the accrual method of accounting who receives payments in advance for services to be provided before the end of the next succeeding tax year may defer the inclusion of income over the time in which the services are provided, rather than including the entire amount in income upon receipt.

In Signet Banking Corp. v. Commissioner, 118 F.3d 239, 242 (4th Cir. 1997), the Court, in discussing whether the taxpayer's annual membership fee for a credit card was income from services under Rev. Proc. 71-21, stated:

> "Revenue Procedure 71-21 represents an attempt to balance the straightforwardness of a report-upon-receipt requirement with some sense of fairness to taxpayers receiving payment for services rendered by the close of the

succeeding tax year. The Procedure, however, is a strictly limited exception. It does not sanction open-ended efforts to fine-tune fairness, a step that would threaten to sacrifice the benefits of simplicity entirely. The Commissioner is correct to underscore the presumption that accrual method taxpayers are to recognize payments for future services as income when those payments are received. Revenue Procedure 71-21 represents a limited exception to this rule, one for which the annual fee income at issue does not qualify."

In order to defer inclusion of membership fees in gross income under Rev. Proc. 71-21, Taxpayer must demonstrate initially, among other requirements, that the advance payments are for services. Under the facts presented and representations made, we conclude that Taxpayer's membership fees are not payments for services to be provided by Taxpayer within the meaning of Rev. Proc. 71-21. The membership fees are simply payments for the right to enter Taxpayer's premises and gain access to discounted goods and discounted services. Although Taxpayer is under a continuing obligation to provide access during the membership period, the provision of access is not a service under Rev. Proc. 71-21.

Payment of the membership fee does not entitle customers to any discounted goods or services. If a customer chooses to purchase discounted goods or services, additional payments must be made for those goods or services. Moreover, even if services were being provided, there is no evidence that the amount of the membership fee has any correlation to the amount of services Taxpayer argues are being provided. The fact that most of Taxpayer's profit is derived from membership fee income suggests that the membership fee payments are essentially prepaid discounts for goods or services to be purchased at a later date, rather than payments for services. See Signet Banking Corp., 118 F.3d 239 at 241 (in concluding that bank did not receive annual credit card membership fee as payment for services under Rev. Proc. 71-21, the Court observed that the annual fee represented a general revenue raising measure as opposed to an attempt to charge users for the costs of any services rendered). Taxpayer's right to receive the membership fee income is not contingent on the performance of any service after the year of receipt within the meaning of Rev. Proc. 71-21.

Accordingly, on the facts presented, Taxpayer's membership fee income does not qualify for deferral under the provisions of Rev. Proc. 71-21.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

David L. Crawford
Chief, Branch 5

cc: