INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200605011**
Release Date: 2/3/2006
Index (UIL) No.: 446.01-00, 451.13-01
CASE-MIS No.: TAM-139427-04/CC:ITA:B02

Director of Field Operations

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:

Date of Conference:

LEGEND:

Taxpayer =
a =
b =
c =
d =
e =
f =
Form X =

ISSUE:

Whether the Taxpayer may (1) allocate a portion of an airline passenger's payment for a ticket (fare) between the original ticketed flight and an additional "voucher flight" and (2) thereby defer part of its income (fare) until the passenger takes the additional "voucher flight."

CONCLUSION:

The Taxpayer may not defer income from ticketed flights (the fare) until passengers take additional "voucher flights."

FACTS:

Overbooking and Denied Boarding

The Taxpayer is engaged in the commercial airline business, transporting passengers and freight. For both financial and tax accounting purposes, the Taxpayer maintains its books of account on a calendar year basis pursuant to the accrual method of accounting.

Passengers reserve space on one of the Taxpayer's airplanes by purchasing a ticket in advance of the departure. The ticket and reserved space are valid for no more than one year from the date of issuance. The passenger must confirm the reservation generally on the scheduled day of departure; the passenger receives a "confirmed reserved space," which, under Department of Transportation (DOT) regulations (14 CFR Part 250), means "space on a specific date and on a specific flight and class of service of a carrier which has been requested by a passenger and which the carrier … has verified, by appropriate notation on the ticket or in any other manner provided therefore by the carrier, as being reserved for the accommodation of the passenger." 14 CFR 250.1.

It is common industry practice to sell more tickets for some flights to given locations than there are available seats, because often passengers do not use all the tickets that they buy. Consequently, sometimes more passengers check in with a confirmed reserved space for a given flight than there are available seats. The DOT regulations provide rules for handling such oversales:

> (a) In the event of an oversold flight, every carrier shall request volunteers for denied boarding before using any other boarding priority. A "volunteer" is a person who responds to the carrier's request for volunteers and who willingly accepts the carriers' offer of compensation, in any amount, in exchange for relinquishing the confirmed reserved space. Any other passenger denied boarding is considered … to have been denied boarding involuntarily, even if that passenger accepts the denied boarding.
>
> (b) If an insufficient number of volunteers come forward, the carrier may deny boarding to other passengers in accordance with its boarding priority rules….

14 CFR 250.2b. For those passengers who are involuntarily denied boarding, the regulations specify that "denied boarding compensation" will be provided at a rate set forth in the regulations based on the value of the passenger's ticket. The regulations

provide that cash compensation is available, but that the carrier may, instead, offer "free or reduced rate air transportation" of equal or greater value. 14 CFR 250.5.[1]

Further, the regulations require, at 14 CFR 250.11, that air carriers conspicuously post, and include with each ticket sold in the United States (either on the ticket itself, on a separate piece of paper, or on the ticket envelope), the following information:

Notice – Overbooking of Flights

> Airline flights may be overbooked, and there is a slight chance that a seat will not be available on a flight for which a person has a confirmed reservation. If the flight is overbooked, no one will be denied a seat until airline personnel first ask for volunteers willing to give up their reservation in exchange for a payment of the airline's choosing. If there are not enough volunteers the airline will deny boarding to other persons in accordance with its particular boarding priority. With few exceptions persons denied boarding involuntarily are entitled to compensation.

The contractual relationship between the Taxpayer and its passengers is governed by the Contract of Carriage, which incorporates all terms and conditions contained on flight tickets. The Contract of Carriage also provides that the Taxpayer reserves the right to change the terms of the Contract of Carriage, but such changes must be in writing and available for public inspection.

The Contract of Carriage includes provisions that effectively adopt and implement the DOT regulations discussed above (14 CFR Part 250). Tickets sold by the Taxpayer state that if a passenger is denied boarding due to an oversale, the Taxpayer will "compensate" the passenger as contemplated in the DOT regulations.

In light of the DOT regulations, airline industry practices with respect to overbooking are fairly similar. The Taxpayer's operations manual provides the guidelines for handling denied boarding cases. In general, the Taxpayer provides passengers who are denied boarding on their Original Flight with: (1) an Alternative Flight to their original destination and (2) a voucher for additional future air travel. The Voucher is a type of "scrip" redeemable in payment of all or a portion of the fare for future travel with the Taxpayer. The future travel is called the Voucher Flight. The guidelines distinguish between "voluntary" and "involuntary" denied boarding. When there are more passengers than seats on a flight, the Taxpayer first solicits volunteers to relinquish their confirmed reserved spaces on the Original Flight. Those passengers who volunteer are provided with an Alternate Flight, usually later that day, to the same destination and a Voucher. If no volunteers come forward, the Taxpayer denies boarding to passengers according to criteria established in the Taxpayer's priority rules. The Taxpayer also provides a passenger who is involuntarily denied boarding with an Alternate Flight and a Voucher. The Taxpayer encourages passengers to volunteer.

---

[1] Cash compensation is not at issue in this case.

Like other airlines, the Taxpayer provides higher incentives, more valuable Vouchers, to volunteers than to those passengers who are denied boarding involuntarily.

Vouchers are valued as follows:

- If boarding is *voluntarily* denied, the Taxpayer issues the Voucher with a face value equal to the fare paid by the customer for the Original Flight for which boarding was denied plus either a dollars or b dollars, depending on whether space on the next flight departure can be confirmed.

- If boarding is *involuntarily* denied, consistent with DOT regulations, the Taxpayer issues the Voucher with a face value equal to the fare paid by the customer for the Original Flight for which boarding was denied, up to a maximum of c dollars; but if the Alternate Fight will not arrive at the passenger's destination within a certain amount of time of the originally scheduled arrival time, the Taxpayer issues the Voucher with a face value equal to twice the fare paid by the customer for the Original Flight for which boarding was denied, up to a maximum of d dollars.

A passenger who is voluntarily denied boarding is asked to sign the Taxpayer's Form X, to indicate that the passenger has volunteered. Form X states that the Voucher is provided by the Taxpayer as a token of appreciation to the passenger for volunteering. The Voucher also specifies that a passenger who receives a Voucher agrees that receipt of the Voucher satisfies all of that passenger's claims against the Taxpayer and releases the Taxpayer from further liability under the Contract of Carriage.

Vouchers, by their terms, are valid for one year from the date of issuance; a passenger ticket issued upon redemption of a Voucher bears the same expiration date as that of the Voucher. Once issued, the use or non-use of a Voucher lies within the receiving passenger's discretion. Some Vouchers expire unredeemed, and some Vouchers are redeemed for tickets that subsequently expire unused. Also, a passenger who redeems a Voucher for a ticket may subsequently be denied boarding for that flight; that passenger could then receive an Alternate Flight (to the Voucher Flight) and another Voucher.

The DOT regulations (14 CFR 250.10) require air carriers to file, periodically, BTS Form 251. On this form, carriers report the number of passengers who are denied boarding, both voluntarily and involuntarily, and, on line 8, the "Amount of compensation" provided to these passengers. On the forms filed during the years at issue, the Taxpayer reported on line 8 the face value of all Vouchers provided to passengers denied boarding.

Passengers who are denied boarding on their Original Flight use their original tickets to board the Alternate Flight. However, if for any reason a passenger who has been denied boarding decides not to board the Alternate Flight, he or she is entitled to a

refund or credit of the original fare to the extent provided by the Contract of Carriage, and subject to expiration one year from the original purchase.

Taxpayer's Financial Accounting

Upon sale and issuance of a passenger ticket, the Taxpayer treats the fare as deferred revenue. If the passenger takes the flight as scheduled (the Original Flight), the Taxpayer recognizes the revenue at that time.

If boarding is denied on the Original Flight, so that the passenger is given a Voucher and takes an Alternate Flight, the Taxpayer makes numerous accounting entries to effectively defer the revenue (fare for the original ticket) beyond the time the passenger takes the Alternate Flight – often until the time the passenger takes the Voucher Flight or until the voucher or its related ticket expire (unused).

To achieve this deferral, the Taxpayer accounts for denied boarding flights as follows:

- The Taxpayer recognizes the original ticket fare when the passenger takes the Alternate Flight.
- Upon issuance of the Voucher, the Taxpayer .
- When the passenger redeems the Voucher for a ticket for the Voucher Flight, the Taxpayer .
- When the passenger takes the Voucher Flight, the Taxpayer includes in gross revenue an amount equal to e percent and f percent of the face value of the Voucher.[2]

As illustrated in the following example, after the passenger takes both the Alternate Flight and the Voucher Flight, the Taxpayer will have recognized revenue equal to the original fare received from the passenger.

> A passenger pays $100 for a ticket for the Original Flight, but the Taxpayer defers recognition of the income (fare) until it provides the flight to the passenger. If the passenger is denied boarding on the Original Flight and takes the Alternate Flight, the Taxpayer includes the $100 fare in gross income. Almost contemporaneously, at the time of denied boarding, the Taxpayer issues the passenger a Voucher with a face value of . The Taxpayer

[2] The Taxpayer also makes monthly adjustments to its revenue account for the anticipated expiration of unused Vouchers.

. When the passenger takes the Voucher Flight, the Taxpayer books in gross income, . The net result is that the Taxpayer defers the original $100 (fare) income until the passenger takes the Voucher Flight.

Taxpayer's Tax Accounting

On its tax returns for the years at issue, the Taxpayer followed its financial accounting method. It effectively deferred fare income in denied boarding cases until the passenger took the Voucher Flight.

The Taxpayer claimed an immediate deduction under § 162 of the Internal Revenue Code

. The Taxpayer also deducted the full amount of incurred expenses related to providing flights, such as fuel, labor costs, etc.

Examination Response

Examination determined that the Taxpayer's method of accounting was an improper deferral and did not clearly reflect income. Essentially, Examination concluded, in the above example, that the Taxpayer received only $100 income (the fare) when the passenger bought the ticket. In the absence of a specific exception to IRC § 451 allowing further deferral, the Taxpayer should recognize the income when received. Examination considers the reduction and restoration of income attributable to the Voucher Flight to be illusory: No passenger pays . In Examination's opinion, the accounting entries for the Voucher Flight are merely an artificial means to defer the original (fare) income. As explained below, we agree with Examination.

Further, Examination challenged the timing of the Taxpayer's § 162 deduction . Examination concluded that any expense for the Voucher Flight was incurred upon provision of the flight under § 461 and should not be accelerated . Again, we agree with Examination.

Taxpayer's Position in the TAM Proceedings

The Taxpayer has largely conceded that its financial and tax accounting treatment was erroneous. The Taxpayer has advanced other theories for deferral of the fare income beyond receipt. We address the Taxpayer's theories below.

LAW AND ANALYSIS:

Deferral of Advance Payments

Under the general rules for methods of accounting, taxable income is computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books. Section 446(a); § 1.446-1(a)(1) of the Income Tax Regulations. However, a method of accounting is not acceptable unless, in the opinion of the Commissioner, it *clearly reflects income*. Section 446(b); § 1.446-1(a)(2); § 1.446-1(c)(1)(ii)(C).

The Taxpayer's income from ticket sales are advance payments. The amount of any item of gross income is 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 of a different period. Section 451(a); § 1.451-1(a). Generally, a payee recognizes advance payments as income when received. Under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy (the "all events test"). Section 1.446-1(c)(1)(ii). Thus, income is includible in the taxable year (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens first. *See* Rev. Rul. 84-31, 1984-1 C.B. 127; *see also Schlude v. Commissioner*, 372 U.S. 128 (1963).

Rev. Proc. 71-21, 1971-2, C.B. 549, implements an administrative exception under § 446 to allow the deferral of the recognition of advance payments as income under certain specified and limited circumstances. Pursuant to section 3.02 of Rev. Proc. 71-21:

> An accrual method taxpayer who, pursuant to an agreement …, receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services [That is, during the next succeeding taxable year.]….

Section 3.03 of Rev. Proc. 71-21 further provides that income deferral is not permissible if any portion of the services is to be performed after the end of the next succeeding taxable year or is to be performed at an unspecified future date that may fall after the end of the next succeeding taxable year. Section 3.06 also provides mechanisms for determining the amount of an advance payment earned in a taxable year if the agreement "requires the taxpayer to perform contingent services."

Two Contracts with Two Deferral Periods

The ticket fare is an advance payment for services that cannot be deferred under § 451 until the performance of the services. To overcome that bar, the Taxpayer has advanced two theories that attempt to recharacterize the (fare) payment.

The first theory separates the denied boarding transaction from the original ticket purchase. The Taxpayer contends that (going back to the example above) the passenger's payment of $100 for the Original Flight usually constitutes the consideration for a Contract of Carriage for that flight. If the passenger takes the Original Flight, the contract is satisfied. However, if the Original Flight is overbooked and the passenger is denied boarding on the Original Flight, the Taxpayer has effectively breached the Contract of Carriage by failing to provide the exact flight that the passenger purchased. For example, the passenger wanted the 9:00 flight to a particular destination, not an Alternate Flight at another time to that destination. The Taxpayer argues that after the breach, the parties must renegotiate the deal and enter into a new or substitute contract. The Taxpayer characterizes the parties' agreement to take an Alternate Flight and a Voucher Flight, instead of the Original Flight, as the new contract. In effect, the passenger and the Taxpayer "rescind" their original agreement and enter into a "substituted contract" under which the Taxpayer will provide the Alternate Flight and the Voucher Flight. Under this "rescission" theory, the Taxpayer deems the original $100 fare to be refunded to the passenger and repaid for two new flight services, i.e., the Alternate Flight and for the Voucher. The Taxpayer further characterizes the $100 payment in the "substituted contract" as allocable between both flights. For example, if the Voucher Flight's face value was equal to the face value of the Alternate Flight, Taxpayer would allocate $50 of the fare to the Alternate Flight and $50 of the fare to the Voucher Flight.

Taxpayer's theory would result in deferring what was originally a simple advance payment of the $100 fare. Because tickets and vouchers are effectively good for a year after purchase or issuance, the Alternate Flight might occur as late as one year after the passenger paid $100 for the original ticket. Of course, that year could carry over to the Taxpayer's next tax year after receipt. For example, a passenger could purchase a ticket for an Original Flight in December but take an Alternate Flight in March of the Taxpayer's next taxable year. Under the "substituted contract" theory, the Taxpayer could defer $50 dollars of the original $100 into the next taxable year, because the $50 for the Alternate Flight was "deemed" to be paid at the time of rescission (March of the next taxable year). Likewise, a passenger could take a Voucher Flight in February of the following year, i.e., the Taxpayer's second tax year after receipt. The Taxpayer would invoke Rev. Proc. 71-21 to defer the $50 for the Voucher Flight.

We think that the denied boarding transactions are pursuant to a unified, single contract. Therefore, we reject the Taxpayer's "substituted contract" (or two contract) theory and its timing implications. First, the Contract of Carriage clearly provides for the denied boarding procedures. Under that single contract, the passenger pays $100 for a specific desired flight (the Original Flight) *and* for potential "compensation" if the

Taxpayer fails to provide that Original Flight. The potential denied boarding, Alternate Flight, and Voucher Flight are all part of the bargain. The airline industry has adopted the DOT regulation's ambiguous term, compensation, to describe the denied boarding contingencies under the single contract. We think that the "compensation" contemplated in the contract is tantamount to specified damages under the contract for the Taxpayer's failure to provide the specific, Original Flight. The Taxpayer argues that "compensation" connotes consideration and that the new or additional consideration is consistent with the Taxpayer's two contract view. We think that the Taxpayer is defining "compensation" out of context. [3]

Further, the facts do not indicate traditional rescission and substitution. Rescission is an undoing of the original contract. The parties mutually agree to extinguish the original agreement in its entirety and enter into a new agreement that wholly supplants the original agreement. See *Estate of Blount v. Commissioner*, T.C. Memo 2004-116.[4] As explained above, we think that the denied boarding transactions are pursuant to a single contract providing for specified damages in the form of contingent flight services. We think the Taxpayer is stretching the facts to fit its theory by resorting to *deeming* refunds and repayments to find new consideration for a new contract.

Application of Rev. Proc. 71-21

The Taxpayer argues for deferral pursuant to Rev. Proc. 71-21. For the reasons below, we find the arguments unpersuasive.

Under our single contract view, the Taxpayer's advance payment (the $100 fare in our example above) is received for all the flight services, including potential Alternate and Voucher Flights. To qualify for deferral under Rev. Proc. 71-21, the Taxpayer must perform all the flight services, contingent or otherwise, by the end of the next taxable year after receipt of the advance payment. Section 3.02. The time for completion of the services is determined by the terms of the contract on the last day of the taxable year in which the taxpayer receives the advance payment. Section 3.02. As explained above, because the tickets and vouchers are good for a year, the Taxpayer may be required to perform contingent flight services (especially Voucher Fights) well beyond the end of the taxable year after the year in which the Taxpayer receives the advance payment. Section 3.03 clearly conditions any deferral on the completion of *all* services by the next taxable year.

---

[3] During our conferences, the Taxpayer posited that, unless we accept the Taxpayer's interpretation of the term, "compensation" implies that denied boarding contingency flight services are taxable income to passengers. The passengers' cases are not under consideration here. This TAM addresses only the tax consequences to the Taxpayer. However, we volunteer that we do not agree with the Taxpayer's reading. DOT did not use the term "compensation" in the income tax sense.

[4] The Taxpayer also cites a number of treatises and state law cases consistent with the Blount description of rescission. The IRS and the Taxpayer agree on the legal definition of rescission; we disagree over the factual characterization under the legal definition.

Taxpayer also submits that it may be able to defer part of its advance payments for "contingent services" under Section 3.06 of Rev. Proc. 71-21. We are not convinced that the specified damages in the contract are truly contingent services. However, assuming the additional flight services qualify as contingent services, the Taxpayer has not factually demonstrated what part of its advance payments are attributable to such services performed in the next taxable year. That proof would be a factual matter for Examination to review.

The Taxpayer further contends that allocation of the original $100 fare between the Alternate Flight and the Voucher Flight is justifiable without resort to its two contract theory. The Taxpayer submits that allocation is just realistic economics; the income is logically derived from two separate flight services. We think that allocation of the income between flights is artificial. However, even conceding allocation only for the sake of argument, Rev. Proc. 71-21 still prohibits the extended deferral.

Clear Reflection of Income

The Taxpayer also argues that, as demonstrated by data it provided analyzing denied boarding transactions, the deferral arising from its treatment of denied boarding transactions has a *de minimis* effect on gross revenues, and, under *Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970), its treatment of the items at issue should be considered to clearly reflect income. In the case cited, the court found that the Service abused its discretion in disallowing the taxpayer's use of a regulatory accounting method under which capital items costing less than $500 could be expensed; the court found that the total annual amount of these items was so insignificant that the use of the regulatory method should be allowed. The Taxpayer's method is not regulatory. Even if we assume that the Taxpayer's analysis of the available data is accurate,[5] the items at issue here involve large amounts. The

attributable to the issuance and redemption of vouchers are major items. Also, the Taxpayer's analysis indicates that it "defers revenue" with respect to more than one-third of the Vouchers issued during a taxable year. The analysis does not take into account Vouchers issued during the taxable year that expire unused. These factors demonstrate that the Taxpayer's method has more than a *de minimis* effect on gross revenues.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

---

[5] The Taxpayer has provided an analysis of its deferral method based on 200 redeemed Vouchers and related Voucher Flight tickets. However, these documents do not relate to any transactions in the taxable years at issue, there is no indication that the documents represent a valid statistical sample, and the analysis does not take into account Vouchers that expire unredeemed and unused.