Schlude and Section 461(h) in Perspective

The Schlude decision effectively imposes an additional tax on accrual method taxpayers who receive advance payments. As a result, when confronted with Schlude situations, accrual method taxpayer must ask the following question:

Do the non-tax advantages from early receipt of payment outweigh the tax detriment that flows from Schlude?

To illustrate this issue, consider the following problem. Assume that all taxes are due and paid immediately as they accrue on income.

1. Per Schlude, taxpayer will pay tax now of $363.64 on income of $909.09, leaving $545.45 invested at 10% NAI. In one year this will produce $54.55 income subject to $21.82 of tax, leaving $578.18 total ($545.45 + 54.55 – 21.82.)

2. If taxpayer can defer the income (e.g., per Rev. Proc. 71-21 or Artnell or Boise Cascade), the $909.09 will produce $90.91 of income. In year two, taxpayer will pay $400 tax on the total income of $909.09 plus 90.91 interest, leaving $600.

Schlude will always produce this negative tax consequence. Other financial considerations may outweigh the negative tax consequence, however.

For example, taxpayer will feel much more secure by receiving the advance “payment”: deferring receipt risks non-payment by the customer. The resulting $578.18 after tax in one year is better than zero after tax, which is what taxpayer would have if the customer defaulted.

Or, the discount given the customer for early payment may be less than the taxpayer’s return on investment and other cost of capital. For example, to feel neutral, considering the impact of Schlude, the taxpayer would need $566.04 after tax from the customer so that he could generate $600 after tax one year later at a 10% NAI return on investment. ($566.04 invested at a 6% after tax return yields $600 in one year). To get $566.04 after a 40% tax rate, taxpayer would need to receive $943.40 before taxes, rather than the $909.09. This would result from a 6% discount rate offered the customer, rather than the 10%. Stated otherwise, a neutral taxpayer cannot offer the customer a discount rate greater than his after-tax return on investment.
Section 461(h) effectively imposes an additional tax on accrual method taxpayers who “economically perform” after all events have otherwise occurred. As a result, when confronted with consequential § 461(h) situations, accrual method taxpayer must ask the following question:

Do the non-tax advantages from delayed performance (which sometimes means payment) outweigh the tax detriment that flows from 461(h)?

To illustrate this issue, consider the following problem:

Taxpayer will perform for customer, $1200 of services work currently. All events will occur currently such that taxpayer will incur $1000 in costs related to the services; however, economic performance of the costs will not occur for one year.

Because of the delayed performance, the costs will actually involve the expenditure of $1100 one year from now. Current performance, if feasible, would cost $1000.

Taxpayer’s expected return on investment is 10% NAI before tax.

Taxpayer is subject to a 40% tax rate.

Factual situations consistent with this problem would involve, inter alia: tort liability, progressive slot machine costs, oil rig dismantling costs, airline re-commissioning costs, solid waste reclamation costs for mines, nuclear power decommissioning costs for power plants, general cleanup costs for most any business, general delayed maintenance for most any business.

To analyze the situation, taxpayer should consider the following scenarios, each of which has some code support:

1. Pay $1000 now and deduct $1000 now . [general accrual method].
2. Pay $1100 in one year, deduct zero now, and deduct $1100 in one year . [general 461(h) method].
3. Pay 1100 in one year, deduct 1000 now, 100 in one year. [section 467 and effectively section 468A].
4. Pay 1100 in one year, deduct 1000 now, zero in one year. [section 468].
The four alternatives do not create the same after-tax consequences: a point that should enter into taxpayer’s decision making process in evaluating what to do. Consider the following computations:

I. Taxpayer has current gross income of 1200 less 1000 current payment and deduction = 200 current taxable income less 80 tax = 120 plus 12 investment income over the next year = 132 less 4.80 tax (40% of 12) = $127.20.

II. Taxpayer has current gross income of 1200 with no deduction = 1200 current taxable income less 480 tax = 720 plus 72 investment income over the next year = 792 plus $411.20 tax savings \(1\) (40% of 1028 [1100 deduction minus 72 income]) less 1100 payment = $103.20.

III. Taxpayer has current gross income of 1200 less 1000 current deduction (but not payment) = 200 current taxable income less 80 tax = 1120 (the 1000 was deducted but not paid) plus 112 investment income over the next year = 1232 less 1100 payment = 1132 less 4.80 tax (112 income less 100 deduction times 40%) = $127.20.

IV. Taxpayer has current gross income of 1200 less 1000 current deduction (but not payment) less 80 tax = 1120 (the 1000 was deducted but not paid) plus 112 income = 1232 less 1100 payment = 1132 less 44.80 tax (112 times 40%) = $87.20.

\(1\) The $411.20 tax saving is positive because the net loss taxpayer suffers from this activity is deductible against other ordinary income also taxed at the assumed 40% rate. If this assumption does not apply, the computed result would naturally be different.