KINGSLEY SERVICE COMPANY
782 FOXRIDGE CENTER DRIVE
ORANGE PARK, FLORIDA 32065
(904) 272-5999

T

July 2, 1991

910531-WS

Ms. Rhonda Hicks
Tax Department
Florida Public Service Commission
Fletcher Building
101 East Gaines Street
Tallahassee, Florida 32399-0870

Re: Transmittal of a copy of one of the Demand Notes which were entered into at December 31, 1986, along with a copy of Kingsley Service Company's protest to the IRS regarding the proposed deficiencies in Corporate Income Taxes.

Dear Rhonda:

Per your request, I am enclosing herewith a copy of one of the Demand Notes that were entered into at December 31, 1986.

In addition, I am also enclosing a copy of our attorney's "Protest of the Proposed Deficiencies in Corporate Income Tax".

Please advise if you need any further information in this regard.

Very truly yours,
KINGSLEY SERVICE COMPANY

Ray O. Avery

ROA/am
Enclosures

cc: Mr. Steve Tribble, Director
Division of Records & Reporting

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06762 JUL -5 1991
FPSC-RECORDS/REPORTING

Bridgewater Apartments, Phase II

DEMAND NOTE

$ 81,493.00 Orange Park, Florida

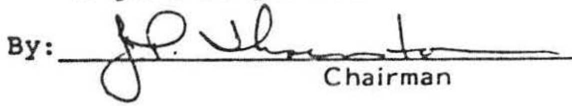
December 30, 1986

FOR VALUE RECEIVED, the undersigned (the Maker) promises to pay to the order of Kingsley Service Company (the "Payee") at 1279 Kingsley Avenue, Orange Park Florida 32073, on demand the principal sum of Eighty-One Thousand Four Hundred Ninety-Three--------AND NO/100 DOLLARS ($ 81,493.00), together with interest thereon at a per annum rate equal to 9.5 %. After maturity, this note will bear interest at the highest legal rate.

This note may be prepaid in whole or in part without premium or penalty. The Maker and each endorser waives presentment, protest, notice of protest and notice of dishonor and agrees to pay all costs, including a reasonable attorney's fee whether suit be brought or not, if counsel shall after maturity of this note or default hereunder, be employed to collect this note.

WELLS CROSSING APARTMENTS, LTD.
a Florida limited partnership

By: The Development Group, Inc.,
a general partner

By: 
Chairman

Maker's address:

% The Development Group
9000 Cypress Green Drive
P. O. Box 19417
Jacksonville, Florida 32245-9417

FRED H. STEFFEY
PROFESSIONAL ASSOCIATION
ATTORNEY AND COUNSELLOR
SUITE 300 SOUTHPOINT BUILDING
6620 SOUTHPOINT DRIVE SOUTH
JACKSONVILLE, FLORIDA 32216
(904) 296-0037

FRED H. STEFFEY
TAXATION

June 13, 1991

District Director
Internal Revenue Service
4613 Phillips Highway, Suite 201
Jacksonville, FL 32207

Attention: 4303: Beatie

Re: Kingsley Service Company
EIN: 59-1037244
Years: 1987-89
Protest of Proposed Deficiencies in Corporate Income Tax

Dear Sir:

This refers to your letter dated April 19, 1991, to the above taxpayer (Letter 950 (DO) (Rev. 6-89) 4303: Beatie) proposing deficiencies in corporate income tax for the taxable years 1987, 1988 and 1989 as set forth in the schedule attached to your letter, a copy of which is enclosed herewith and incorporated herein by this reference, all of which are in dispute. Also enclosed is a copy of a Power of Attorney, Form 2848, from the taxpayer to the undersigned which has previously been filed with your office is enclosed. The purpose of this letter is to protest the proposed deficiencies set forth in your letter and to request a conference with respect thereto with the Regional Office of Appeals. As noted on the enclosed copy of your letter, the due date for this protest has been duly extended from May 19, 1991, to June 14, 1991.

The disputed deficiencies are attributable to one type of item, namely, receipts by the taxpayer during 1987, 1988 and 1989, of payments on negotiable promissory notes delivered in December 1986 (the "1986 Notes") to the taxpayer, a regulated water and sewer utility, by customers as contributions in aid of construction ("CIAC"). The taxpayer treated the 1986 Notes as CIAC payments received in 1986, but exempt from federal income tax under Section 118(b)(1) of the Internal Revenue Code of 1954 ("1954 Code"). The examining agent has determined that the 1986 Notes did not constitute non-taxable CIAC payments in 1986. Instead, according to the examining agent, the payments made to

the taxpayer by the makers of the 1986 Notes in 1987, 1988 and 1989 constituted taxable CIAC payments under Sections 61 and 118(b) of the Internal Revenue Code of 1986 ("1986 Code"). For the reasons hereinafter set forth, it is respectfully submitted that the taxpayer's treatment of the 1986 Notes and the payments thereunder was correct and that no deficiencies in corporate income tax should be assessed against the taxpayer for the years 1987, 1988 and 1989.

Each of the 1986 Notes was an unconditional, demand note for a specific sum which was payable "to the order of" the taxpayer. Accordingly, each of them was a negotiable note under Florida law. F.S. §673.104. Such a negotiable note in the hands of a holder in due course is not subject to any defense other than infancy of the maker; such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the maker a nullity; such misrepresentations as has induced the maker to sign the note with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; the maker's discharge in insolvency proceedings; and any other discharge of the maker of which the holder has knowledge when he takes the note. F.S. §673.305. A "holder in due course" is a holder who takes the note for value, in good faith, without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person. F.S. §673.302. In that connection, knowledge of the fact that a negotiable note was issued or negotiated in return for an executory promise or was accompanied by a separate agreement does not of itself give the purchaser notice of a defense or claim unless the purchaser has notice that a defense or claim has arisen from the terms thereof. F.S. §673.304(4)(b). Further the filing or recording of a document does not of itself constitute notice within the provisions of the Florida Uniform Commercial Code to a person who would otherwise be a holder in due course. F.S. §673.304(b)(5).

Each of 1986 Notes constituted payment of the amount agreed to be paid by the maker to the taxpayer as CIAC under an agreement which obligated the maker to connect the maker's development to the taxpayer's water and sewer systems and obligated the taxpayer to make certain additions to its water and sewer systems in order to provide service to the maker's development. Performance of the agreement by the taxpayer was not, however, a condition of any of the 1986 Notes

and none of them referred to the water and sewer agreements between the makers and the taxpayer.

In keeping with the taxpayer's standard practice, all of the water and sewer agreements with the makers of the 1986 Notes were recorded in the conveyancing records of the county in which the developments involved were located. However, as indicated above, such recording does not of itself constitute notice of such a document to a holder of a negotiable note under the Florida Uniform Commercial Code. Further, as noted above, under Florida law even if a holder of a negotiable note should have actual knowledge of any such document at the time of the negotiation of a note to him, such notice of itself would not constitute notice to the holder of a defense to a claim against the note and would not prevent the holder from being a holder in due course of the note.

At no time did any representative of the taxpayer make any oral or written representation to any representative of any of the makers of the 1986 Notes that the taxpayer would refrain from demanding immediate payment of a 1986 Note or from negotiating the note to a third party. Even if the taxpayer had made third party such representations, however, as noted above, under Florida law they would not have caused a third party to whom a 1986 Note was negotiated for value not to be a holder in due cause unless such third party had actual knowledge of such representations.

To the best of the knowledge and belief of the taxpayer's officers, all of the makers of the 1986 Notes were solvent at the time they delivered their 1986 Notes to the taxpayer. In fact, all of the 1986 Notes were paid pursuant to the taxpayer's demands for payment except those which were returned to the makers for cancellation at the time of the cancellations of the water and sewer agreements giving rise to the CIAC payments represented by the notes. Those 1986 Note cancellations constituted refunds of unused CIAC payments pursuant to the specific authorization of Section 118(b) of the 1954 Code for the return within two years of insured CIAC payments.

The taxpayer maintains its books and reports its taxable income on the accrual method of accounting. In Rev. Rul. 79-292, 1979-2 C.B. 287, and in Rev. Rul. 89-122, 1989-2 C.B. 200, the Internal Revenue Service has ruled that an accrual basis taxpayer's receipt in exchange for property in a transaction which is not eligible for installment sale treatment, of "an

unconditional right to receive money ... is treated as money received to the full extent of the face value of the right rather than as property received," and that "the fair market value of a note is irrelevant in determining the amount realized from the sale or other disposition of property." Rev. Rul. 89-122, supra. at 201.

In Rev. Rul. 79-292, supra, in reaching the conclusion relied upon in Rev. Rul. 89-122, supra, the applicable provisions of the 1954 Code concerning the inclusion of income under the accrual method of accounting, Section 451(a) and the Regulations thereunder, Regs. §1.451-1(a), were reviewed and it was noted that under them under the accrual method of accounting "income is includible in gross income when all events have occured that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Rev. Rul. 79-292, supra at 288. It was further stated in that ruling as follows:

> Rev. Rul. 74-607, 1974-2 C.B. 149, provides that all the events that fix the right to receive income under an accrual method of accounting occur when (1) the required performance occurs, (2) payment therefor is due, or (3) payment therefor is made, whichever happens first.
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> ...
>
> It is the view of the Service that treating a note received as property under Section 1001(b) of the Code and valuing it at fair market value is inconsistent with the well-established principle that an accrual method taxpayer includes in income amounts which it has a right to receive. See Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934) Ct.D. 829, XIII-1 C.B. 281 (1934). Under this principle, the fair market value of a note received from a solvent maker is irrelevant in determining the amount realized from the sale of property. The courts have consistently refused to allow accrual method taxpayers to accrue only the fair market value of notes received upon a sale of

> property, and have sustained the Commissioner's position that such taxpayers must accrue the face amount of notes received. See Jones Lumber Co. v. Commissioner, 404 F.2d 764 (6th Cir. 1968), George L. Costner Co. v. Commissioner, 30 T.C. 1061 (1958), and First Savings and Loan Association v. Commissioner, 40 T.C. 474 (1963) in which the Tax Court of the United States interpreting Section 1001(b), stated that an accrual basis taxpayer does not treat an unconditional right to receive money as property received, but rather as money received to the full extent of the face value of the right. Rev. Rul. 79-292, supra at 288.

The rule set forth in the foregoing revenue rulings with respect to the tax treatment to an accrual basis taxpayer of negotiable notes received in connection with sales and exchanges of property in transactions which are not eligible for installment sale treatment is equally applicable to the tax treatment to such a taxpayer of negotiable notes received in connection with the rendition of services such as the services to be rendered by the taxpayer to the makers of the 1986 Notes. It has been so held specifically be the Supreme Court of the United States in the case of Schlude v. Commissioner, 372 U.S. 128 (1963), 11 AFTR 2d 751, aff'g and rev'g on this point 296 F.2d 721 (8th Cir. 1961), 8 AFTR 2d 5966, which had aff'd 32 T.C. 1271 (1959); on remand from 367 U.S. 911 (1961), 7 AFTR 2d 1648, rev'g 283 F.2d 234 (8th Cir. 1960), 6 AFTR 2d 5683. In that case the taxpayers were partners in an accrual method dance studio that sold dance lessons under a cash plan and deferred payment contracts. Cash plan contracts required full cash down payment, with the balance due thereafter in installments. Deferred payment contracts required a portion of the down payment to be paid in cash, with the remainder of the down payment to be paid in stated installments, and the balance of the contract price to be paid as designated in a negotiable note delivered to the partnership when the contract was made. The partnership created a deferred income account when each contract was signed and delivered to it. At the end of each fiscal year, the partnership reduced the deferred income account by an amount equal to the number of hours taught times an hourly rate. This amount was

reported as income for the fiscal year, while the remainder of the deferred account was carried forward to the following period. The Commissioner rejected this accounting system as not clearly reflecting income and included in the partnership's income all cash payments and the face amount of all negotiable notes received in the year by the partnership. The Supreme Court upheld the Commissioner's inclusion of such cash payments and the face amount of such notes in such years. In so holding the Court stated as follows:

> ... The question remaining for decision, then, is this: Was it proper for the Commissioner, exercising his discretion under §41, 1939 Code, and §446(b), 1954 Code, to reject the studio's accounting system as not clearly reflecting income and to include as income in a particular year advance payments by way of cash, negotiable notes and contract installments falling due but remaining unpaid during that year. We hold that it was since we believe the problem is squarely controlled by American Automobile Association, 367 U.S. 687 [7 AFTR 2d 1618].
>
> The Court there had occasion to consider the entire legislative background of the treatment of prepaid income. The retroactive repeal of §452 of the 1954 Code, "the only law incontestably permitting the practice upon which [the taxpayer] relies," was regarded as reinstating longstanding administrative and lower court rulings that accounting systems deferring prepaid income could be rejected by the Commissioner.
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>> "[T]he fact is that §452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the treasury that the proposed endorsement

> of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes." 367 U.S., at 695.

Confirming that view was the step-by-step approach of Congress in granting the deferral privilege to only limited groups of taxpayers while exploring more deeply the ramifications of the entire problem.

Plainly, the considerations expressed in American Automobile Association are apposite here. We need only add here that since the American Automobile Association decision, a specific provision extending the deferral practice to certain membership corporations was enacted, §456, 1954 Code, added by §1, Act of July 25, 1961, 75 Stat. 222, continuing, at least so far, the congressional policy of treating this problem by precise provisions of narrow applicability. Consequently, as in the American Automobile Association case, we invoke the "long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field" and, as in that case, we cannot say that the Commissioner's rejection of the studio's deferral system was unsound.

The American Automobile Association case rested upon an additional ground which is also controlling here. Relying upon Automobile Club of Michigan v. Commissioner, 353 U.S. 180 [50 AFTER 1967], the Court rejected the taxpayer's system as artificial since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from that very same vice for the studio sought to defer its cash receipts on the

basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without obligations of refund. At the end of each period, while the number of lessons taught had been meticulously reflected, the studio was uncertain whether none, some or all of the remaining lessons would be rendered. Clearly, services were rendered solely on demand in the fashion of the American Automobile Association and Automobile Club of Michigan cases.

Moreover, percentage royalties and sales commissions for lessons sold, which were paid as cash was received from students or from its note transactions with the bank, were deducted in the year paid even though the related items of income had been deferred, at least in part, to later periods. In view of all these circumstances, we hold the studio's accrual system vulnerable under §41 and §446(b) with respect to its deferral of prepaid income. Consequently, the Commissioner was fully justified in including payments in cash or by negotiable note[10] in gross income for the year in which such payments were received. If these payments are includible in the year of receipt because their allocation to a later year does not clearly reflect income, the contract installments are likewise includible in gross income, as the United States now claims, in

the year they become due and payable. For an accrual basis taxpayer "it is the right to receive not the actual receipt that determines the inclusion of the amount in gross income," Spring City Co. v. Commissioner, 292 U.S. 182, 184-185 [13 AFTR 1164]; Commissioner v. Hansen, 360 U.S. 446 [3 AFTR 2d 1690] and here the right to receive these installments had become fixed at least at the time they were due and payable.

We affirm the Court of Appeals insofar as that court held includible the amounts representing cash receipts, notes received and contract installments due and payable. Because of the Commissioner's concession, we reverse that part of the judgement which included amounts for which services had not yet been performed and which were not due and payable during the respective periods and we remand the case with directions to return the case to the Tax Court for a redetermination of the proper income tax deficiencies now due in light of this opinion.

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[10] Negotiable notes are regarded as the equivalent of cash receipts, to the extent of their fair market value, for the purposes of recognition of income. §39.22(a)-4, Reg. 118, 1939 Code; §1.61-2(d)(4), 1954 Code Regulations; Mertens, Federal Income Taxation (1961), §11.07. See Pinellas Ice Co. v. Commissioner, 287 U.S. 462 [11 AFTR 1112].

[11 AFTR 2d at 754-755. Footnotes omitted except footnote 10.]

On the remand of the Schlude case to the Tax Court, the taxpayer's counsel argued that footnote 10 in the Supreme Court's opinion quoted above required the Tax Court, on remand, to hear evidence on the question of and to determine the fair market

value of the notes received by the partnership. The Tax Court rejected this contention on behalf of the taxpayer and held that since the partnership was an accrual basis taxpayer, the full face value of the negotiable notes it received from customers as prepayments was includible in the partnership's income, not the fair market value of the notes. In so holding the Tax Court stated:

> Petitioners, in their brief, seem to be taking a footnote of the opinion out of context and building their case on that footnote. If we accepted petitioners' interpretation of the Supreme Court's footnote 10 to its opinion, we would have to say that an accrual basis taxpayer accrues negotiable notes at fair market value and not face value. This is not the law on this point, Shoemaker-Nash, Inc. [Dec. 11,009], 41 B.T.A. 417 (1940); Warren Co. [Dec. 12,489], 46 B.T.A. 897 (1942), affd. [43-1 USTC Paragraph 9442] 135 F.2d 679 (C.A. 5, 1943); Commissioner v. Hansen [59-2 USTC Paragraph 9553] 360 U.S. 446 (1959); and General Gas Corporation v. Commissioner [61-2 USTC Paragraph 9618], 293 F.2d 35 (C.A. 5, 1961).
>
> The Arthur Murray Studio involved in this case was a partnership using the accrual method of accounting, which fact is stated in our original opinion and we do not understand that fact is disputed. Since it uses the accrual method it would have to include negotiable notes and accounts receivable in income at face value. This is a basic concept of tax law and accrual accounting. The Supreme Court in Spring City Foundry Co. v. Commissioner [4 USTC 1276], 292 U.S. 182, holds to that effect. That case was cited by us in Mark P. Schlude, supra. Consequently, we do not believe that the Supreme Court in Schlude intended to overrule this basic principle of accounting and reverse its own Spring City Foundry Co. case. Certainly, they would not overrule this basic principle merely by the inclusion of a footnote.

> We think a reasonable interpretation of the Supreme Court's decision is that footnote 10 was included merely as illustrative dicta, that even a cash basis taxpayer would have to include negotiable notes in income except that a cash basis taxpayer would include the notes at fair market value whereas (as in the Schlude case) an accrual basis taxpayer would include the notes at face value, which was what the Commissioner did in his determination of the deficiencies in Schlude and that is what the Supreme Court affirmed. Therefore, we think that ground 2 stated in petitioners' motion in paragraph 2 should be and it is hereby denied.

It is respectfully submitted that the principles set forth in the Schlude case, supra, control the tax treatment to the taxpayer of the 1986 Notes with the result that the only proper year for the taxpayer to take them into income if they had represented taxable income payments would have been 1986 and that under those circumstances it would have to have taken them into income at that time at their full face value. The fact that the 1986 Notes constituted payments which were excluded from taxable income by virtue of Section 118(b)(1) of the 1954 Code does not change the year in which they are deemed to have been received by the taxpayer for federal income purposes or the amount deemed to have been received. Accordingly, the full face amount of each of the 1986 Notes constituted a non-taxable CIAC payment made to the taxpayer in 1986.

As an alternative position, the examining agent states that the taxpayer did not have an accounting method with respect to CIAC. It is respectfully submitted, however, that the taxpayer clearly had an accounting method with respect to its CIAC, that such method was the accrual method and that the taxpayer's treatment of the 1986 Notes and its other CIAC payments has been at all times and is consistent with its accrual method of accounting and the decision of the Schlude case, supra.

Respectfully submitted,

Fred H. Steffey

Under penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and, to the best of my knowledge and belief, it is true, correct and complete.

Jimmie R. Rodgers
President
Kingsley Service Company

FHS\pab
c\kingsley.irs

Enclosures