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APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY: SECURITIES AND FINANCIAL SERVICES
ISSUE: TAXABLE YEAR OF INCLUSION OF STOCKBROKER'S
COMMISSION INCOME
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SETTLEMENT POSITION
TAXABLE YEAR OF INCLUSION OF STOCKBROKER'S COMMISSION INCOME

STATEMENT OF ISSUE

Whether under IRC Section 451, stockbrokerage houses, using the accrual method of accounting, must accrue commission income on the sale or purchase of securities on the "trade date" as opposed to the "settlement date."

EXAMINATION DIVISION'S POSITION

As stated in Rev. Rul. 74-372, 1974-2 C.B. 147, upon execution of the trade, all the events have occurred that fix the taxpayer's right to receive the commission. All actions that remain to be performed by the taxpayer after this date are of a ministerial nature. Also since the amount of commissions is determined on the basis of the securities sold or purchased on the trade date, the amount of income to be accrued can be determined with reasonable accuracy. Accordingly, the proper time for accruing the commission income on the sale or purchase of securities is the trade date.

Any change to the method of accruing commission income on the trade date is a change in method of accounting within the meaning of section 446 and 481 of the Code and the regulations thereunder.

DISCUSSION

FACTS

The Examination Division's coordinated issue paper sets forth the facts as follows: The taxpayer is a stock brokerage house, using the accrual method of accounting, engaged in the securities business as a member of the New York Stock Exchange. The taxpayer, at the request of the investor, enters into contracts to buy and sell securities. The date on which these contracts are entered into is termed the "trade date." At this time, a confirmation statement, itemizing the transaction and listing the price and quantities of the securities and the amount of commission due, is sent to the investor. Then, pursuant to the rules of the New York Stock Exchange requiring the settlement of customer accounts no later than three business days after the trade date (formally five days), delivery of and payment for the securities is generally made on the third subsequent business day (formally the fifth), which is termed the "settlement date." During the period between the trade date and the settlement date, the taxpayer performs administrative services necessary to effectuate the physical exchange of the securities and payment on the settlement date. The brokerage commission is based upon the sale or purchase of securities, as established on the trade date.

LAW

Application of Section 451

Section 451 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 as of a different period.

Section 1.451-1 of the regulations provides that under the 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. See also section 1.446-1(c)(1)(ii).

Upon execution of the trade, all the events have occurred that fix the right to receive the income, and the amount thereof can be determined with reasonable accuracy. Therefore, brokerage commission income is accruable on the trade date, rather than on the settlement date.

CASE LAW

In The Charles Schwab Corporation and Includable Subsidiaries V. Commissioner, 107 T.C. 282 (1996), an accrual basis taxpayer provided discount securities brokerage services for which it earned a commission fee. As a discount broker, the company did not engage in activities such as research and portfolio management that are normally conducted by a full-service broker. The taxpayer executed customer orders to buy and sell securities on the trade date, but the securities were not actually transferred and payment was not due until the settlement date, which was generally 5 days after the trade date. Between the trade date and the settlement date, the taxpayer performed certain functions to record, confirm, and book the customer's trade.

The Tax Court held that under the "all events" test, the taxpayer must accrue commission income for the purchase of securities on the trade date as opposed to the settlement date. The Court based its holding on the fact that the execution of an order on behalf of a customer is the "essential service" that the taxpayer performs. Any other action that the taxpayer is required to perform following the trade date, such as the delivery of the securities, are merely ministerial in nature and only to serve to confirm the actual date.

As in The Charles Schwab Corporation, supra, and the facts of the coordinated issue paper the right to receive the commission income is on the trade date, not the settlement date. Looking at the entire transaction, the service that the broker performs is the execution of a purchase (or sale) of securities. The execution takes place on the trade date, when a valid, binding contract for purchase or sale is entered into by the broker as agent for the investor (principal). Any remaining services performed, merely serve to complete the mechanics of the physical transfer of the stock by the settlement date. The process of sorting out the trade and forwarding a list of securities traded to the securities clearing corporation are ministerial actions in confirmation of the actual trade executed on the trade date, not actions that are necessary to fix the broker's right to receive the commissions.

REVENUE RULING 74-372

Revenue Ruling 74-372, 1974-2 C.B. 147, holds that a stockbrokerage business using the accrual method of accounting must accrue the commission income on the sale or purchase of securities for a customer on the trade date rather than on the settlement date. This conclusion was reached because all actions after the trade date are of a ministerial nature and are merely in confirmation of the trade.

A change to the method of accruing commission income on the trade date is a change in method of accounting under sections 446 and 481 of the Code and Rev. Proc. 92-20, 1992-1 C.B. 685. The change from a method of accounting which recognizes income from brokers commissions on the settlement date to a method which recognizes such income on the trade date is a change from a Category B method of accounting.

SETTLEMENT POSITION

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