Bank Credit Cards And The Timing Of Deductions Under Revenue Ruling 78-38: A Return To Consistency

BANK CREDIT CARDS AND THE TIMING OF DEDUCTIONS UNDER REVENUE RULING 78-38: A RETURN TO CONSISTENCY

Although credit cards have existed more than fifty years, their use as a major instrument did not become significant until the past twenty-five years.[1] In 1950, the Diner's Club, Inc. issued the first multiparty independent credit card,[2] followed by the American Express Company in 1958 and Bank of America in 1959.[3] Since that time the number of cardholder accounts has grown to over fifty million, representing approximately eleven billion dollars of credit.[4] In light of this phenomenal growth, commentators

[1] For a general discussion of the growth and historical development of credit cards, see generally Bergsten, *Credit Cards - A Prelude to the Cashless Society,* 8 B.C. IND. & COM. L. REV. 485 (1967) [hereinafter cited as Bergsten]; Brandel & Leonard, *Bank Charge Cards: New Cash or New Credit,* 69 MICH. L. REV. 1033 (1971) [hereinafter cited as Brandel & Leonard]; Comment, *The Tripartite Credit Card Transaction: A Legal Infant,* 48 CALIF. L. REV. 459 (1960) [hereinafter cited as *Tripartite Credit*]; Survey, *Toward a Less-Check Society,* 47 NOTRE DAME LAW. 1163 (1972) [hereinafter cited as *Less-Check Society*]. For an extensive discussion of the commercial aspects of multiparty credit cards, see generally Clontz, *Bank Credit Cards Under the Uniform Commercial Code,* 87 BANKING L.J. 888 (1970) [hereinafter cited as Clontz]; Davenport, *Bank Credit Cards and the Uniform Commercial Code,* 1 VAL. L. REV. 218 (1967) [hereinafter cited as Davenport].

[2] Bergsten, *supra* note 1, at 485; Davenport, *supra* note 1, at 218-19. A multiparty plan is a credit card plan involving three or more parties. Reference in this article will be made primarily to the tripartite plan (three-party plan) and not to two-party or four-party plans. The two-party plan is based on an agreement between two parties, the merchant and the cardholder. *See* note 17 *infra.* The three-party plan typically involves a cardholder, merchant, and the issuer of the card. *See* text accompanying notes 21-30 *infra.* In the four-party arrangement, the functions of the issuer in the three-party plan are divided between two parties, the entity that issues the credit card and promotes the plan and the bank which acts as a central clearinghouse for the billing and collection of cardholder accounts. Claflin, *The Credit Card - A New Instrument,* 33 CONN. B.J. 1 (1959); *Less-Check Society, supra* note 1, at 1187 n.119.

[3] Bergsten, *supra* note 1, at 485; Davenport, *supra* note 1, at 218-19.

[4] B. CLARK & A. SQUILLANTE, THE LAW OF BANK DEPOSITS, COLLECTIONS, AND CREDIT CARDS 189 supp. (1970 & Cum. Supp. 1977) [hereinafter cited as CLARK & SQUILLANTE]. The volume of business transacted by even a single credit card company can be enormous. The American Express Company has issued over two million cards, honored by more than 140,000 establishments and has accounted for an annual business of approximately $780,000,000. Davenport, *supra* note 1, at 220. This extraordinary growth of bank credit cards is understandable in light of their benefits. For example, the cardholder may carry a single credit card conveniently instead of checks and cash. In addition, he can make large purchases and defer payments over a long period of time. A cardholder may also use the card in literally thousands of establishments around the United States and the world, eliminating the difficulty of check acceptance by merchants. Moreover, the cardholder is protected more fully against loss due to theft or destruction of the card than with checks. Brandel & Leonard, *supra* note 1, at 1039. The acceptance of the credit card by the merchant may even be safer than cash since he is protected against the risk of counterfeit currency. *Id.* at 1040. The merchant also benefits by receiving immediate credit or cash from the deposit of his credit card sales slip at the issuing bank. Davenport, *supra* note 1, at 233. He is protected by the terms of the issuer-merchant agreement from the risks normally associated with accepting payment in a form other than cash, such as check forgery or insufficient funds in the drawer's account. Brandel & Leonard, *supra* note 1, at 1040. Finally, the merchant receives the benefit of widespread

have forecast fundamental changes in the nature of commercial law.[5] For example, commentators note a rapidly increasing movement from a "cash-paying" and "check-paying" society to a credit card society.[6] Despite this trend, no specific body of law presently covers credit cards.[7] In the area of federal income taxation, legislation directly affecting credit cards has been virtually nonexistent.[8]

The Internal Revenue Service (IRS), however, recently has attempted to clarify the application of timing principles with regard to deductions involving the use of credit cards. In 1971, the IRS published Revenue Ruling 71-216[9] which concerned the proper time when a cash basis taxpayer[10] may claim an income tax deduction for a transaction effected by a multiparty credit card payment.[11] Recently, this ruling was revoked by the

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use of the bank card, enabling cardholders to make impulse or spot purchases which would not be possible if they lacked sufficient currency or funds in their checking accounts. *See generally* R. NORDSTROM, HANDBOOK OF THE LAW OF SALES § 117, at 348 (1970) [hereinafter cited as NORDSTROM]; Brandel & Leonard, *supra* note 1, at 1037-40; Clontz, *supra* note 1, at 896; Davenport, *supra* note 1, at 233.

[5] *See generally* Barnes, *The Law, The Credit Card and the Coming of the Checkless Society,* 6 AM. BUS. L.J. 641 (1968); Brandel & Leonard, *supra* note 1; *Less-Check Society, supra* note 1.

[6] J. FREELAND, S. LIND, & R. STEPHENS, CASES AND MATERIALS ON FUNDAMENTALS OF FEDERAL INCOME TAXATION 552 (2d ed. 1977) [hereinafter cited as FREELAND, LIND, & STEPHENS].

[7] The lack of legal guidelines in the area of tripartite credit cards may be explained by the fact that they are a relatively new creation of commercial law. *See* Cleveland, *The Bank, The Merchant and The Credit Card User,* 10 GA. ST. B.J. 17, 20-21 (1973) (first tripartite credit card did not appear until 1950). Although many commentators have called for inclusion, the Uniform Commercial Code contains no provisions concerning the use of credit cards. NORDSTROM, *supra* note 4, § 117, at 347; Davenport, *supra* note 1, at 223-24. Many states have enacted credit card statutes, but their coverage has been limited to theft, forgery, and unauthorized use of tripartite cards. *See, e.g.,* CAL. PENAL CODE §§ 484(e) - 484(i) (West 1970 & Supp. 1978); N.Y. GEN. BUS. LAW §§ 511-517 (McKinney Supp. 1977). Courts also have been ineffectual in providing guidelines in the credit card area. Although the first credit card case was litigated more than sixty years ago, Wanamaker v. Megary, 24 Pa. D. 778 (Phila. Mun. Ct. 1915), subsequent litigation has been confined largely to the issue of consumer liability for unauthorized purchases. *Less-Check Society, supra* note 1, at 1187, 1192.

[8] NORDSTROM, *supra* note 4, § 117, at 347; Davenport, *supra* note 1, at 223-24.

[9] 1971-1 C.B. 96.

[10] Under the cash basis method of income tax accounting, a taxpayer is required to include in gross income all items actually or constructively received during the taxable year. *See, e.g.,* Estate of Geiger v. Commissioner, 352 F.2d 221 (8th Cir. 1965), *cert. denied,* 382 U.S. 1012 (1966) (credit to taxpayer's bank account is constructive receipt); Lavery v. Commissioner, 158 F.2d 859 (7th Cir. 1946) (receipt of a check is constructive receipt). Expenditures must be deducted in the taxable year in which they are actually paid. Treas. Reg. § 1.446-1 (a)(1), T.D. 6282, 1973-2 C.B. 163; *see* text accompanying notes 67-74 *infra.*

[11] 1971-1 C.B. 96. The deduction claimed in Revenue Ruling 71-216 was a charitable contribution. I.R.C. § 170(a)(1) allows a taxpayer to claim certain contributions to qualified charities made during the taxable year as deductions from income. For an extensive discussion of the tax aspects of charitable contributions, see B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 38-124 (2d ed. 1977); Myers, *Charitable Contributions,* 4 IND. L. REV. 217 (1970); Randall, *Charitable Contributions After the 1969 Tax Reform Act,* 11 GONZ. L. REV. 869 (1976).

publication of Revenue Ruling 78-38.[12] The prior ruling held that a deduction from gross income claimed for an expense incurred through the use of a bank credit card was available only at the time the cardholder paid the bank.[13] The new ruling changes the permissible time for claiming a deduction to the time of the credit card transaction.[14] This change in timing principles has a significant impact on the tax accounting aspects of deductions,[15] which is most evident when deductions in the latter part of the taxable year are claimed.[16] To understand the effect and ramifications of the change in the IRS's position, an understanding of the nature and mechanics of credit cards and banking practices is required.

There are two basic types of credit cards: bipartite (two-party) and tripartite (three-party). Under the bipartite plan, a merchant[17] issues a credit card to a customer permitting the customer to make purchases exclusively from that merchant with the card and to complete payment at a later date.[18] This enables the customer to pay his bill in monthly installments, which include a service charge based on the amount of each outstanding monthly balance.[19] Thus, the agreement involves only the seller

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[12] 1978-5 I.R.B. 7.

[13] 1971-1 C.B. at 96.

[14] 1978-5 I.R.B. at 8.

[15] *See* text accompanying notes 90-108 *infra*.

[16] A taxable year is defined as "(1) the taxpayer's annual accounting period, if it is a calendar year or fiscal year; (2) the calendar year . . . ; or (3) the period for which the return is made, if a return is made for a period of less than 12 months." I.R.C. § 441(b). Under Revenue Ruling 71-216, the taxpayer was faced with a confusing situation at the end of the taxable year. If the taxpayer used a credit card to charge a charitable contribution on December 20th of one year, he could not claim a deduction until he received his monthly statement from his issuing bank in January of the subsequent year. Thus, obligations incurred in a previous taxable year were shifted to the following year. In addition, the timing of the taxpayer's deduction was subject to the control of a party other than the taxpayer, namely the merchant. The time at which the merchant sent his sales slips to the issuing bank for credit determined to a large extent the time at which the bank billed the cardholder/taxpayer and, correspondingly, the time when a deduction could be computed and claimed.

[17] Under the Uniform Commercial Code, a merchant is defined as "a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction . . ." U.C.C. § 2-104(1)(1972 version). In the credit card transaction, the merchant is typically a seller of goods or services who receives the customer's credit card charge as payment for the underlying obligation. *See* text accompanying notes 24-30 *infra*. Since credit cards can be used to pay for items other than goods or services, however, the merchant is not the only person who receives payment by a credit card charge. In the case of a charitable contribution, the charity stands in the position of the merchant for purposes of payment by assuming the rights and liabilities of the merchant-issuer agreement. *See* text accompanying notes 31-40 *infra*. Hereinafter, the term "merchant" will refer to any party who receives value or payment by a credit card charge, including a seller of goods or a charitable organization.

[18] Most large department stores and retail chains issue bipartite credit cards to their customers. The majority of credit cards issued by the major gasoline companies fall into this category as well. *See* FREELAND, LIND, & STEPHENS, *supra* note 6, at 553. If the IRS classifies a particular arrangement as bipartite, rather than tripartite, the resulting effects on federal income tax timing principles are significant, especially as to the proper taxable year in which a deduction can be claimed by a charge to a credit card. *See* note 92 *infra*.

[19] *Less-Check Society*, *supra* note 1, at 1188. When a sale occurs with the use of a

and buyer.[20] In contrast, the tripartite bank credit card plan generally consists of three parties and three agreements: (1) an agreement between the issuing bank and the cardholder,[21] (2) an agreement between the issuing bank and the merchant,[22] and (3) an agreement between the cardholder and the merchant evidencing the sale or transfer of value.[23] In the typical three-party credit card transaction involving a sale of merchandise,[24] the cardholder first selects an item from the merchant and then pays for it by using a bank credit card.[25] Upon presentation, the merchant places the credit card into an imprinter, embossing the cardholder information from the face of the card onto a sales slip.[26] After the cardholder signs the sales slip,[27] the merchant is free to deposit the receipt or "chit" with a depositary bank with whom he has an issuer-merchant agreement. The merchant's account is credited immediately for the amount of the cardholder sale, less any discount, upon deposit of the chit.[28] Finally, the issuer will bill[29] the cardholder for payment of this purchase and other transac-

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bipartite card, the arrangement resembles a normal extension of credit by the merchant to the cardholder/buyer. The seller has agreed to deliver the goods to the buyer on the strength of the buyer's credit. In return, the buyer has agreed to pay for the goods within a time period set by the seller, normally thirty days. NORDSTROM, *supra* note 4, § 117, at 347-48.

[20] A seller may enlist the services of a third party, the collection agency, if the buyer defaults on his installment payments for purchases obtained with his bipartite credit card. In this situation, the seller will typically assign the two-party contract to the agency for collection, less an agreed discount. *See* NORDSTROM, *supra* note 4, at §§ 163-66.

[21] For an illustration of an issuer-cardholder agreement, see Clontz, *supra* note 1, at 909; Davenport, *supra* note 1, at 247.

[22] For an illustration of an issuer-merchant agreement, see Clontz, *supra* note 1, at 906-07; Davenport, *supra* note 1, at 248-51. Under the tripartite credit card plan, the term "issuer" is commonly used to denote the corporation that creates and operates the credit card plan and all of the member banks that participate in the particular bank credit card system. Davenport, *supra* note 1, at 225.

[23] *See* CLARK & SQUILLANTE, *supra* note 4, at 189-90.

[24] *See generally* NORDSTROM, *supra* note 4, § 117, at 348.

[25] *See* Clontz, *supra* note 1, at 905; Davenport, *supra* note 1, at 226-27.

[26] For an illustration of a sample sales or cash advance slip, see Clontz, *supra* note 1, at 908; Davenport, *supra* note 1, at 252-53.

[27] In many cases, before a merchant permits the buyer to sign the sales slip, he may be required by the credit card issuer to check the card number against a list of "hot cards" provided by the issuer. Davenport, *supra* note 1, at 227-28 nn. 39-40. A "hot card" is defined as a credit card that has been lost or stolen and reported to the issuer. *Id.* The "hot card" may be distinguished from a "wild card," which is a credit card that has been revoked by the issuer because the cardholder exceeded his approved credit limit. *Id.; Less-Check Society*, *supra* note 1, at 1190 n.127.

[28] The deposit of the chit with a depositary bank can be classified as the sale of an account by the merchant to the issuer of the bank credit card or as an assignment of the contractual right of payment for a discounted price. NORDSTROM, *supra* note 7, § 117, at 348.

[29] The actual billing process can be extremely complicated and can involve more than one bank in the clearinghouse process of charging a cardholder's account. The bank in which the merchant deposits his sales slip from a particular sale to the cardholder may not be the bank involved in the issuer-cardholder contract. If the depositary bank and issuing bank are separated by a great distance, the billing process may involve two or more regional clearing associations and several banks. Brandel & Leonard, *supra* note 1, at 1036.

tions conducted with the credit card on a monthly basis.[30]

The rights and liabilities that exist in the tripartite credit card plan are dependent upon the three separate agreements between the parties involved in the credit card transaction. Under the "issuer-merchant" agreement, the merchant usually agrees to promote the particular credit card plan by displaying the plan's emblem in his establishment[31] and to honor all credit cards which have been presented by cardholders.[32] The merchant further promises to sell to cardholders at the regular price and to record the sale on a sales form which subsequently is sent to the issuer bank.[33] The issuer bank generally will credit the merchant's account with a discounted amount of the total of all sales slips which are sent to the issuer by the merchant.[34] In return for the merchant's promise to honor all valid cards presented by the issuer's cardholders, the issuer also furnishes imprinters, sales slips, credit slips and promotional materials to the merchant.[35]

The second agreement involved in a tripartite plan exists between the cardholder and the merchant and is illustrated by the sales agreement underlying the purchase of the goods or service. This contract is usually one implied by law since the sales slip normally will not embody any terms or obligations concerning the sale of the merchandise or services. Thus, general principles of contract law typically will govern the sales transaction between the merchant and cardholder.[36] If the transaction involves the sale of "goods,"[37] Article 2 of the Uniform Commercial Code applies.[38] In many respects, the merchant-cardholder relationship is similar to that found in

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[30] *See* CLARK & SQUILLANTE, *supra* note 4, at 210-11 supp.; Davenport, *supra* note 1, at 231-32.

[31] *See Less-Check Society, supra* note 1, at 1188.

[32] Davenport, *supra* note 1, at 228 n.41; Comment, *Bank Credit Cards—Contemporary Problems*, 41 FORDHAM L. REV. 373, 374 (1972); Note, *Preserving Consumer Defenses in Credit Card Transactions*, 81 YALE L.J. 287, 291 n.19 (1971) [hereinafter cited as *Preserving Defenses*].

[33] Under the issuer-merchant contract, the merchant generally is required to deliver the sales slip to the issuer within three business days following the sale of the merchandise to the cardholder. Davenport, *supra* note 1, at 228. Following completion of this procedure, the merchant's account is then credited by the issuer. *Id.; Less-Check Society, supra* note 1, at 1188; *see* text accompanying notes 26-28 *supra*.

[34] The actual amount of the discount is usually computed on the basis of volume of sales over a monthly or quarterly time period. Davenport, *supra* note 1, at 228-29 n.45. In some instances, the discount is based on the average purchase amount for sales slips in the merchant's trade. *Id.* The amount of the discount ranges from three percent for most retailers to five percent for grocery stores, barber shops and liquor stores. *Id.*

[35] *Id.* at 230.

[36] NORDSTROM, *supra* note 4, § 117, at 347.

[37] In the commercial sense, goods are defined as "all things . . . which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . and things in action." U.C.C. § 2-105(1)(1972 version).

[38] Davenport, *supra* note 1, at 230 n.53. The sales slip of the credit card transaction between the cardholder and merchant represents a commemoration of the underlying sales contract. *Id.*

a bipartite credit card transaction.[39] There is one significant difference, however. While the cardholder under the tripartite plan promises to pay the third-party issuer of the credit card, the bipartite cardholder is required to pay the merchant.[40]

The "issuer-cardholder" agreement is created when the application by a potential cardholder is accepted by the issuer.[41] The contract authorizes the issuer of the card to pay for all purchases on behalf of the cardholder.[42] The cardholder, in turn, promises the issuer that he will pay for all credit which has been extended by the issuer.[43] The customer further promises that he will make payments to the issuer within the specified time periods set out in the contract,[44] pay for all purchases charged to the card even if there is a dispute with the merchant-seller,[45] retain his outstanding account balance below his approved credit line,[46] reimburse the issuer for all purchases made through the use of the card by any person prior to its surrender, destruction, or receipt of written notice of loss or theft by the issuer,[47] and surrender the credit card on demand.[48]

These agreements between the parties involved in the tripartite credit card plan and the commercial practices governing the use of multiparty bank credit cards have a significant impact on the federal income tax system in the area of deductions. Since 1971, the IRS has responded to the increasing use of credit cards by promulgating Revenue Ruling 71-216[49] and Revenue Ruling 78-38.[50] Revenue Ruling 71-216, issued in 1971, held that the amount of a contribution made to a charitable organization[51] by a

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[39] *See* text accompanying notes 18 & 19 *supra*.

[40] Comment, *Bank Credit Plans: Innovations in Consumer Financing*, 1 Loy. L.A. L. Rev. 49, 58 (1968); *Less-Check Society*, *supra* note 1, at 1190; *see Preserving Defenses*, *supra* note 32, at 292 nn. 21-22.

[41] Clontz, *supra* note 1, at 894; Davenport, *supra* note 1, at 226.

[42] Davenport, *supra* note 1, at 227; *Less-Check Society*, *supra* note 1, at 1190-91.

[43] Davenport, *supra* note 1, at 227; *Less-Check Society*, *supra* note 1, at 1190-91.

[44] The specified time period in which the cardholder will be required to make payment to the issuer depends upon whether he elects to pay the full amount due in a single payment or decides to pay the amount in installments. For example, the cardholder normally has twenty-five days from the date the statement is sent by the issuer to remit the full specified amount. Davenport, *supra* note 1, at 227. Otherwise, the cardholder is permitted to pay a percentage of the total amount billed, usually five to ten percent, or a designated minimum amount each month, usually ten dollars, with interest. *Id.* The rate of interest charged by the issuer is commonly one and one-half percent of the outstanding balance, computed on a monthly basis. *See Less-Check Society*, *supra* note 1, at 1191. The maximum amount allowable under most consumer laws is two percent per month. *See, e.g.*, Uniform Consumer Credit Code § 2.202(3) (1974 version) [hereinafter cited as U.C.C.C.].

[45] Davenport, *supra* note 1, at 227.

[46] *Id.*; *Less-Check Society*, *supra* note 1, at 1191.

[47] A lost or stolen credit card is considered a "hot card". *See* note 26 *supra*. Potential liability of the cardholder to the issuer in this area has been limited to fifty dollars. 15 U.S.C. § 1643 (1976).

[48] The typical contract between the issuer and the cardholder usually provides that the credit card is at all times the property of the issuer. Davenport, *supra* note 1, at 227, 247.

[49] 1971-1 C.B. 96.

[50] 1978-5 I.R.B. 7.

[51] I.R.C. § 170(c).

charge to a bank credit card is deductible in the year the cardholder pays the amount to the issuing bank.[52] In 1978, following criticism of the 1971 ruling by some commentators,[53] the IRS published Revenue Ruling 78-38 which revoked the prior ruling and held that a contribution made by a charge to a three-party bank credit card is deductible in the year the charge is made regardless of when the bank is paid.[54]

Although Ruling 71-216 and Ruling 78-38 refer specifically to charitable deductions, the rationale of the rulings is applicable to all deductions claimed by the use of a bank credit card. The IRS published Revenue Ruling 78-39[55] simultaneously with Ruling 78-38, which holds that the use of a bank credit card to pay an expense for medical care qualifies as the payment of a medical expense deduction[56] in the year the credit card charge is made, regardless of when the bank is paid.[57] Both 1978 Rulings use identical reasoning to reach the same conclusion. In all three rulings the IRS relies on basic principles of cash basis accounting[58] applicable to other deductions besides charitable contributions[59] and medical expenses.[60] Arguably, the IRS meant for the rulings to apply to all deductible expenses incurred by the use of a bank credit card,[61] and not merely to deductions for charitable contributions and medical expenses. This would expand the scope of the new timing principles espoused in Revenue Ruling 78-38 and Revenue Ruling 78-39 to such deductions as business travel expenses,[62] moving expenses,[63] business entertainment expenses[64] and political contributions.[65] This approach is consistent with the phenomenal growth of credit cards in recent years[66] and would evidence IRS recognition that bank credit cards will be used increasingly in claiming deductions under the federal laws of income taxation.

Under section 441 of the Internal Revenue Code (IRC),[67] income taxes are computed on the basis of taxable income[68] received over a twelve

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52 1971-1 C.B. at 96.

53 *See* FREELAND, LIND, & STEPHENS, *supra* note 6, at 552-53; Comment, *The "Instant Deduction Approach" to the Multiparty Credit Card Transaction: A Proposal,* 21 U.C.L.A. L. Rev. 1380 (1974) [hereinafter cited as *Instant Deduction*].

54 1978-5 I.R.B. 7.

55 1978-5 I.R.B. 8.

56 I.R.C. § 213.

57 1978-5 I.R.B. 8.

58 *See* text accompanying notes 67-74 *infra.*

59 I.R.C. § 170; *see* text accompanying notes 67-74 *infra.*

60 I.R.C. § 213.

61 Revenue Rulings 78-38 and 78-39 are expressly limited by the IRS to three party bank credit cards. 1978-5 I.R.B. 7, 8.

62 I.R.C. § 162(a)(2).

63 I.R.C. § 217.

64 I.R.C. § 274(a).

65 I.R.C. § 218. In lieu of taking the § 218 deduction, a taxpayer may elect, however, to take the § 41 credit.

66 *See* note 4 *supra.*

67 I.R.C. § 441.

68 Under I.R.C. § 63(b), taxable income is computed by subtracting deductions from

month period called the taxable year.[69] An individual taxpayer's income can be computed by any method the taxpayer desires so long as the accounting procedure used clearly reflects income.[70] One such method allowed by the IRS under this standard is the "cash receipts and disbursements method,"[71] more commonly referred to as the "cash method."[72] Under this method of accounting, all items which constitute income are included in the taxable year in which they actually are received.[73] A cash method taxpayer may not take advantage of a deduction for tax purposes until actual payment of a deductible expense or contribution is made to the party to whom the obligation is owing.[74] The IRS apparently intended the cash method to apply to credit cards. In Revenue Ruling 71-216, the determinative issue was whether the cardholder had "actually paid" his deduction.[75] This concept of actual payment is a fundamental principle of cash basis accounting[76] which determines when a deduction may be claimed. Therefore, actual payment was a preliminary consideration with respect to credit card analysis in Revenue Ruling 71-216.

The IRS viewed the concept of "payment" differently in Revenue Rulings 71-216 and 78-38, resulting in the different analyses used to support each ruling. Revenue Ruling 71-216 involved a taxpayer who claimed a charitable deduction after having charged a contribution on his bank credit card.[77] The charitable organization received an immediate credit when they deposited the sales slip with the issuing bank,[78] but the cardholder did not pay the issuer of the credit card until he was billed by the

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adjusted gross income. Adjusted gross income is computed by subtracting the deductions found in I.R.C. § 62 from gross income. *See generally* I.R.C. §§ 61-63.

[69] I.R.C. § 441(b); *see* note 16 *supra*.

[70] I.R.C. § 446(b); *see* Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 356 (1st Cir. 1970); Commissioner v. Joseph E. Seagram & Sons, Inc., 394 F.2d 738, 742 (2d Cir. 1968); [1978] 4 FED. TAXES (P-H) ¶ 20,066.

[71] I.R.C. § 446(c)(1); Treas. Reg. § 1.446-1(c)(1)(i), T.D. 7285, 1973-2 C.B. 163. The IRS also permits a taxpayer to use the accrual method of accounting in computing income. I.R.C. § 446(c)(2). Under this method, a taxpayer reports income in the tax year that it is earned, regardless of when it is actually paid. United States v. Anderson, 269 U.S. 422 (1926); Gillis v. United States, 402 F.2d 501 (5th Cir. 1968); Commissioner v. H.B. Ives Co., 297 F.2d 229 (2d Cir. 1961), *cert. denied*, 370 U.S. 904 (1963); *see* 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 12.60 - 12.94 (1974) [hereinafter cited as MERTENS]; [1978] 4 FED. TAXES (P-H) ¶¶ 20,140, 20,570. As a corollary, a taxpayer may deduct expenses only in the tax year in which they are incurred, even if they have not yet been paid. *See* Treas. Reg. § 1.446-1(c)(2), T.D. 7285, 1973-2 C.B. 163; MERTENS, *supra* at §§ 12.86 - 12.94; [1978] 4 FED. TAXES (P-H) ¶ 20,570.

[72] MERTENS, *supra* note 71, at § 12.38.

[73] Treas. Reg. § 1.446-1(c)(1)(i), T.D. 7285, 1973-2 C.B. 163; *see* MERTENS, *supra* note 71, at § 12.39; [1978] 4 FED. TAXES (P-H) ¶ 20,133.

[74] Treas. Reg. § 1.461-1(a)(1), T.D. 6917, 1967-1 C.B. 108; *see* Helvering v. Price, 309 U.S. 409 (1940); Benn v. Commissioner, 366 F.2d 778 (5th Cir. 1966); Perry v. Commissioner, 49 T.C. 508 (1968); MERTENS, *supra* note 71, at § 12.53; [1978] 4 FED. TAXES (P-H) ¶ 20,560.

[75] *See* text accompanying notes 67-74 *supra*.

[76] *Id.*

[77] 1971-1 C.B. at 96.

[78] *Id.*; *see* text accompanying notes 26-28 & 33 *supra*.

bank in the next taxable year.[79] The IRS ruled that the taxpayer was entitled to take the deduction only at that later date.[80] The Service relied on an income tax regulation[81] in reasoning that "a deduction is allowable to an individual under section 170 of the Code only for charitable contributions *actually paid* during the taxable year, regardless of when pledged . . . ."[82] A prior IRS revenue ruling[83] was then cited in comparing payment of a charitable contribution by a credit card charge with payment by a promissory note.[84] That ruling held that since a promissory note evidences a future obligation, the delivery of the note to a charity is not actual payment for the purpose of claiming a charitable deduction.[85] This is consistent with the rule of cash method accounting that a deduction can be claimed by a taxpayer only when payment has been made to the party to whom the obligation is owing.[86] No payment in the tax sense occurs at the time the promissory note is created, but occurs at a later date when the promissor repays the promissee.[87] The IRS construed the concept of payment in a similar manner with respect to the taxpayer's use of a credit card. The credit cardholder apparently was considered to be in the same position as the promissor of the note.[88] Thus, Revenue Ruling 71-216 held that the cardholder had "actually paid" the deduction claimed only when payment was made to the issuing bank.[89]

After its publication, commentators criticized Revenue Ruling 71-216 as being impractical and inconsistent with federal tax theory concerning the timing of deductions in general.[90] In particular, the promissory note analysis was viewed as being incorrect[91] when applied to the three-party credit card arrangement.[92] The ruling misconceived the proper relationship

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[79] 1971-1 C.B. at 96.

[80] *Id.*

[81] Treas. Reg. § 1.170-2(a)(1).

[82] 1971-1 C.B. at 96 (emphasis in original).

[83] Rev. Rul. 68-174, 1968-1 C.B. 81.

[84] 1971-1 C.B. at 96.

[85] 1968-1 C.B. at 83.

[86] The IRS relied on the Tax Court's statement in Petty v. Commissioner, 40 T.C. 521 (1963), that "[t]he general rule has always been that, under the cash method of accounting, there must be actual payment as a prerequisite to a deduction, that is, there must be an outlay of cash or property, and that the giving of a promissory note does not constitute actual payment." *Id.* at 524 (Atkins, J., concurring); *see* Rev. Rul. 68-174, 1968-1 C.B. 81; [1978] 4 FED. TAXES (P-H) ¶ 20,564.

[87] Rev. Rul. 68-174, 1968-1 C.B. at 81.

[88] 1971-1 C.B. at 96.

[89] *Id.*

[90] *See* FREELAND, LIND, & STEPHENS, *supra* note 6, at 552-53. For an excellent discussion of the practical problems of and faulty rationale of Revenue Ruling 71-216, see *Instant Deduction, supra* note 53.

[91] *See* text accompanying notes 94-104 *infra.*

[92] *See Instant Deduction, supra* note 53, at 1392-95. Promissory note analysis is consistent with the two-party credit card. Under the bipartite arrangement, the issuer-merchant extends credit to the cardholder in exchange for the latter's promise to pay at a later date. NORDSTROM, *supra* note 4, § 117, at 347. This agreement is analogous to the promissory note

between the cardholder and the merchant. With the publication of Revenue Ruling 78-38, the IRS now takes the position that the time of payment for tax purposes occurs at the time of the transaction between the merchant and the cardholder and not when the actual cash disbursement is made to the issuing bank following the cardholder's receipt of the bill.[93] The new ruling takes into account the fact that a third party, the issuing bank, pays the obligation owing to the merchant on behalf of the cardholder.[94]

Normally, for a taxpayer to claim a tax deduction under the cash basis method, he must pay the expense himself.[95] Nevertheless, a taxpayer can have a third party make payment for him and properly claim a deduction.[96] Under the tripartite credit card arrangement, the cardholder has authorized the issuing bank to pay the obligation to the merchant for him.[97] The issuing bank is considered to have made a loan to the cardholder between the time the bank pays the merchant and the cardholder repays the bank.[98] Thus, under this "loan theory" the bank is deemed to have "actually paid" the obligation to the merchant enabling the cardholder to claim a deduction under the IRC. In contrast, under the two-party arrangement of the promissory note, the delivery of the note does not constitute actual payment.[99] While the merchant has loaned money to the promissor, a deduction may not be claimed until the merchant is repaid.[100] Revenue Ruling 78-38 adopts the loan theory reasoning that the charge to the bank credit card immediately indebted the cardholder to the bank as a third party, "in such a way that the cardholder could not thereafter prevent the charitable organization from receiving payment."[101] Moreover, the obligation of the

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and its treatment for tax accounting purposes. *See* text accompanying notes 83-87 *supra.* The cardholder, under a bipartite system, may claim a deduction only in the year in which he actually repays the merchant. *See* text accompanying notes 84-87 *supra.*

[93] 1978-5 I.R.B. at 8.

[94] *Id.*

[95] *See, e.g.,* Citizens Nat'l Trust & Sav. Bank v. Welch, 119 F.2d 717 (9th Cir. 1941) (no deduction allowed to state bank where national bank paid debts of state bank according to consolidation agreement).

[96] *See* National Metropolitan Bank v. United States, 345 F.2d 823 (Ct. Cl. 1965) (deduction allowed to bank for payment of gross receipts tax by company to which the bank's assets were assigned); MERTENS, *supra* note 71, at § 12.54; [1978] 4 FED. TAXES (P-H) ¶¶ 20,560, 20,562(10).

[97] The loan theory is consistent with treatment of credit cards under U.C.C.C. § 1.301(25)(a)(ii)(1974 version), which provides that a loan includes:

> the creation of debt pursuant to a lender credit card in any manner, including a cash advance or the card issuer's honoring a draft or similar order for the payment of money drawn or accepted by the debtor, paying or agreeing to pay the debtor's obligation, or purchasing or otherwise acquiring the debtor's obligation from the obligee or his assignees.

[98] 1978-5 I.R.B. at 8; *see* text accompanying notes 41-48 *supra.*

[99] Rev. Rul. 68-174, 1968-1 C.B. 81.

[100] *Id.* at 83; *see* text accompanying notes 84-87 *supra.*

[101] 1978-5 I.R.B. at 8. The apparent adoption of the loan theory by the IRS is further suported by additional language in the ruling: "[t]he use of a bank credit card to make a charitable contribution is equivalent to the use of borrowed funds. . . ." *Id.*

cardholder to the charity is extinguished when the charity deposits the sales slip with the issuing bank and receives payment.[102] In contrast, since a promissory note constitutes a "mere promise to pay at some future date"[103] and the maker of the note may eventually default on this promise, certainty of payment does not exist. Therefore, the obligation owing to the charitable organization that has received a promissory note is not satisfied until actual payment is received.[104]

The use of the loan analysis by the IRS is consistent with accepted principles of cash basis income tax accounting, especially with respect to deductions. Under the loan rationale, deductible expenses paid with borrowed funds by a cash basis taxpayer are deductible at the time they are paid, not when the loan is repaid.[105] The bank credit card arrangement fits logically under this rule. The actual moment at which a cardholder charges an expense or purchase on his bank credit card is a recorded event, evidenced by the credit card sales slip.[106] Thus, the specific time of a claimed deduction is easily ascertainable by both the taxpayer and the IRS. This gives the taxpayer control over the timing of deductions claimed by credit card charges and enables the IRS to match taxpayer payments with claimed deductions conveniently. In contrast, the timing of repayment to the issuing bank may or may not be a specific event, depending upon whether a single reimbursement or a series of installment payments is chosen by the cardholder in repaying the bank.[107] This becomes important near the end of a taxable year when the precise timing of deductions may have a significant effect on the taxpayer's liability for that year.[108]

In addition to an implied analogy to the loan rationale, Revenue Ruling 78-38 also implies that payment by credit card is similar to payment by check.[109] Historically, when a buyer purchased goods or services by check, actual payment to the merchant was not deemed to have occurred until the check was honored on presentment[110] to the depositary bank.[111] Re-

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[102] *See* text accompanying note 92 *supra;* text accompanying notes 103-04 *infra.*

[103] Rev. Rul. 68-174, 1968-1 C.B. at 83.

[104] *Id.* For tax purposes, the deduction can be claimed upon actual payment to the charity by the bank. Under the new revenue rulings, this allows the deduction to be taken when the issuing bank pays the merchant or charitable organization. 1978-5 I.R.B. 7, 8. If the cardholder fails to pay the bank thereafter, the bank bears the risk of nonpayment, not the merchant or charitable organization. *See* note 4 *supra;* text accompanying notes 34 & 35 *supra.* However, the taxpayer/cardholder will lose the deduction. I.R.C. §§ 1311-1314; [1978] 4 FED. TAXES (P-H) ¶¶ 20,619, 20,625.

[105] Granan v. Commissioner, 55 T.C. 753 (1971) (medical expense deduction); Keenan v. Commissioner, 20 B.T.A. 498 (1930) (ordinary and necessary business expenses); Weis v. Commissioner, 13 B.T.A. 1284 (1928) (deduction of losses); [1978] 4 FED. TAXES (P-H) ¶ 20,562.

[106] *See* note 38 *supra.*

[107] *See* text accompanying note 44 *supra.*

[108] *See* note 16 *supra.*

[109] 1978-5 I.R.B. at 8.

[110] Presentment is a demand for acceptance or payment by the depositary bank of the maker's check by the holder. U.C.C. § 3-504 (1972 version).

[111] Dodge v. Commissioner, 13 B.T.A. 201, 220 (1928).

cently, the courts have modified their position and treated payment by check in the same fashion as payment by cash.[112] Under this modified position, unconditional delivery of a check constitutes payment if the bank subsequently certifies the check on presentment.[113] In theory, the check represents a "conditional payment" of the underlying obligation[114] which becomes "absolute payment" when the check is honored on presentment to the bank.[115] Thus, the actual cash disbursement at the time of presentment is deemed to relate back to the actual delivery of the check.[116] The approach of Revenue Ruling 78-38 is consistent with the present principles of tax accounting regarding deduction of payments made by check since it treats the charge of a credit card in a similar fashion to the delivery of a check. This is significant in light of the similarities between tripartite credit cards and checks. A merchant who accepts a bank credit card or check usually thinks of the sale as a cash transaction, not a credit one.[117] Both commercial devices involve forms of payment to the merchant that provide him with significant assurance that he will receive value for the goods sold or services rendered.[118]

Upon publication of Revenue Ruling 78-38, the IRS reversed a seven year policy which had clouded an important area of income tax deductions involving the use of bank credit cards. Since 1971, persons who had used credit cards and then claimed deductions were subject to an IRS policy that fostered theoretical uncertainty concerning the timing of deductions claimed at the end of each taxable year.[119] Revenue Ruling 78-38 presents a more realistic approach to the nature and mechanics of tripartite credit card transactions and gives the taxpayer more control and certainty concerning the effective use of the bank credit card with respect to deductions. More importantly, the ruling recognizes that society has begun to view credit card transactions with the same acceptance as cash or checks.[120]

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[112] FREELAND, LIND, & STEPHENS, *supra* note 6, at 552; *see* cases cited in note 113 *infra*.

[113] *See* Flint v. United States, 237 F. Supp. 551 (D. Idaho 1964); Estate of Modie J. Spiegel, 12 T.C. 524 (1949); Estate of M.A. Bradley, 19 B.T.A. 49 (1930), *aff'd* 56 F.2d 728 (6th Cir. 1932); MERTENS, *supra* note 71, at § 12.54; [1978] 4 FED. TAXES (P-H) ¶ 20,561. *But see* Eagleton v. Commissioner, 97 F.2d 62 (8th Cir. 1938) (deduction denied to cash basis taxpayer where check given with the understanding that it would not be cashed in current tax year); Griffin v. Commissioner, 49 T.C. 253 (1967) (postdated check is the equivalent of a promissory note, thus not deductible on delivery).

[114] Clark v. Commissioner, 253 F.2d 745, 748 (3d Cir. 1958); *see* U.C.C. §§ 2-511(3), 3-802 (1972 version) (acceptance and payment of check occurs on presentment.)

[115] Clark v. Commissioner, 253 F.2d 745, 748 (3d Cir. 1958).

[116] Estate of M.A. Bradley, 19 B.T.A. 49, 51 (1930).

[117] FREELAND, LIND, & STEPHENS, *supra* note 6, at 552.

[118] The credit card actually may be less risky for the merchant. Since a check constitutes conditional payment, *see* text accompanying notes 109-17 *supra*, the possibility of dishonor still exists when the check is presented to the bank for payment or credit. *See* note 110 *supra*. In contrast, the merchant will receive credit for the credit card sales slips delivered to the bank, whether the cardholder eventually pays the issuer or not. *See* text accompanying notes 26-28 & 32 *supra*.

[119] *See* note 16 *supra*.

[120] FREELAND, LIND, & STEPHENS, *supra* note 6, at 553.