***Charles Schwab Corp. v. Commissioner, 107 T. C. 282 (1996)***

An accrual basis taxpayer must accrue income when all events have occurred that fix the right to receive it, and state franchise taxes can be accrued when the liability becomes fixed under state law.

**Summary**

Charles Schwab Corp. , an accrual basis taxpayer, contested the IRS's determination that it must accrue commission income on trade dates rather than settlement dates and deduct California franchise taxes in the year they become fixed. The Tax Court held that Schwab's commission income should be accrued on the trade date, as the right to income was fixed upon execution of the trade. Additionally, the court ruled that Schwab could deduct its 1988 California franchise taxes in the same year, as the liability was fixed under pre-1972 California law, unaffected by later amendments.

**Facts**

Charles Schwab Corp. provided discount securities brokerage services, executing customer orders on trade dates but settling them days later. Schwab deducted its 1987 California franchise taxes on its federal return for the fiscal year ending March 31, 1988, and sought to deduct its 1988 franchise taxes on its calendar year 1988 return. The IRS challenged the timing of accruing commission income and the deductibility of the franchise taxes, arguing they should be accrued in the following year.

**Procedural History**

The IRS determined deficiencies in Schwab's federal income taxes for the years ending March 31, 1988, and December 31, 1988. Schwab petitioned the U. S. Tax Court, which heard arguments on the accrual of commission income and the deduction of franchise taxes. The court ultimately ruled in favor of the IRS on the commission income issue and in favor of Schwab on the franchise tax issue.

**Issue(s)**

1. Whether an accrual basis taxpayer must accrue brokerage commission income on the trade date or on the settlement date?
2. Whether Schwab is entitled to deduct its 1988 California franchise taxes on its federal income tax return for the year ended December 31, 1988?

**Holding**

1. Yes, because under the all events test, Schwab's right to receive commission income was fixed on the trade date when the trade was executed.
2. Yes, because under pre-1972 California law, Schwab's franchise tax liability for

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1988 was fixed on December 31, 1988, and thus not accelerated by the 1972 amendment.

**Court’s Reasoning**

The court applied the all events test to determine when Schwab’s right to commission income was fixed. It found that the essential service provided by Schwab was the execution of trades, and thus, the right to income was fixed on the trade date, despite subsequent ministerial acts. The court rejected Schwab’s argument that post-trade services were integral to the commission, classifying them as conditions subsequent. Regarding the franchise taxes, the court analyzed California law pre- and post-1972 amendments. It determined that under the pre-1972 law, which applied to Schwab’s situation due to its short first taxable year, the franchise tax liability was fixed at the end of the income year. Therefore, the 1972 amendment did not accelerate the accrual, and section 461(d) did not apply to disallow the deduction in 1988. The court also found that Schwab’s initial misconstruction of facts based on a revenue ruling did not constitute a change in accounting method requiring IRS approval.

**Practical Implications**

This decision clarifies that for accrual basis taxpayers in the securities industry, commission income must be reported in the year the trade is executed, not when settled. This has implications for cash flow and tax planning, as income must be recognized earlier. For state franchise taxes, the ruling highlights the importance of understanding state law to determine when liability becomes fixed, especially in cases involving short taxable years. This case may influence how other taxpayers with similar circumstances approach the timing of income recognition and deductions. Subsequent cases have cited this decision in addressing the application of the all events test and the impact of state tax law changes on federal tax deductions.

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