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Economic Performance - It's Only Part of the Picture

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Economic Performance (Part I)

It's Only Part of the Picture

In 1992, final regulations under Sec. 461(h), the economic performance rules, were issued. Because economic performance is part of the picture in determining *when* an accrual method taxpayer may treat an item as *incurred,* with this picture now complete, taxpayers can deal with the entire framework and how it may have changed in light of the economic performance regulations.

This article will explain the sequence of steps an accrual method taxpayer must take to determine whether an item has been "incurred." Although Sec. 461 is typically thought of as dealing with the *timing of deductions,* and in fact is entitled "General Rule For Taxable Year Of Deduction," its application is much broader. Sec. 461(h) serves to determine when a *liability* has been *incurred* so that a taxpayer will know whether to consider it as a deduction (if it is deductible) or to add it to basis (if it is a capitalizable item).[1] The flowchart on pages 196–197 shows how an accrual method taxpayer deals with the question, "When is a liability incurred?" The flowchart is a simplified version of the rules interspersed in the Sec. 461 regulations and the Code. It begins with the steps that are most likely to lead to the answer, "No, not incurred yet," as there is no point going through more complicated steps first, only to reach "no" at a later step. Steps 1 through 6 of the flowchart are covered in Part I, below; Steps 7 through 10 will be discussed in Part II to be published next month.

Sec. 461(h) and the Sec. 461 regulations provide that under the accrual method of accounting, a liability is incurred in the tax year in which:

1. all the events have occurred that establish the fact of the liability;
2. the amount of the liability can be determined with reasonable accuracy; and
3. economic performance has occurred with respect to the liability.

Items 1 and 2 are known as the "all events test" according to Sec. 461(h)(4), or the "fixed and determinable" requirement. Although the above items are not specifically numbered, that sequence is suggested in Regs. Sec. 1.461-1(a)(2)(i). However, the Sec. 461 analysis is simpler if the three items are considered in reverse order. For example, item 1, the "fixed" part, can be a complex determination and has led to many disputes between the Service and taxpayers. However, with the addition of the economic performance requirement in 1984, many of these disputes are less significant. For example, in the 1977 case, *World Airways,*[2] the application of the fixed part of the all events test was in dispute. The Tax Court held that the liability was not fixed for the expected costs of overhauling airplane engines until a certain number of miles had been flown. Thus, the airline was not able to accrue the expected costs as each mile was flown. If the economic performance requirement had been in effect

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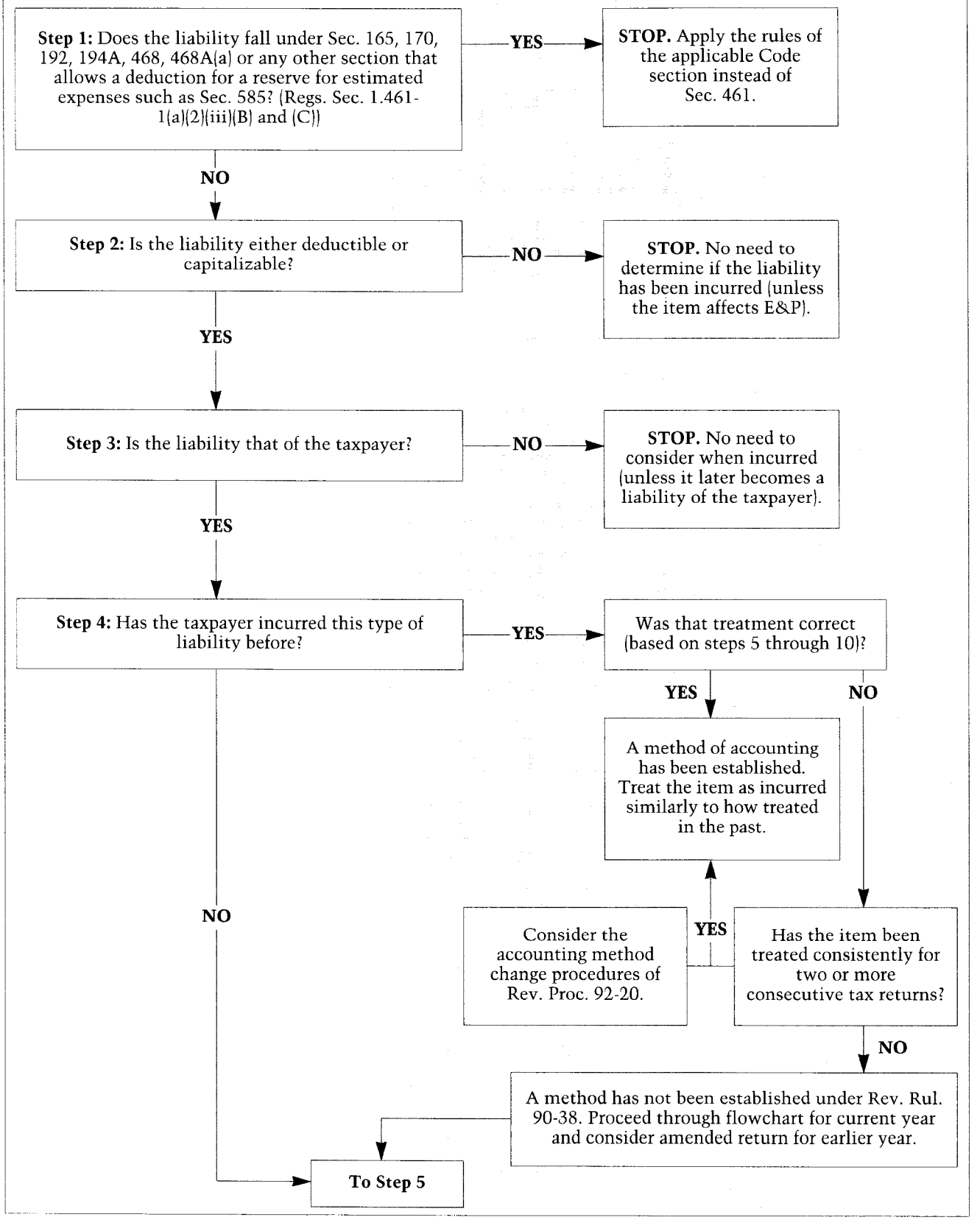
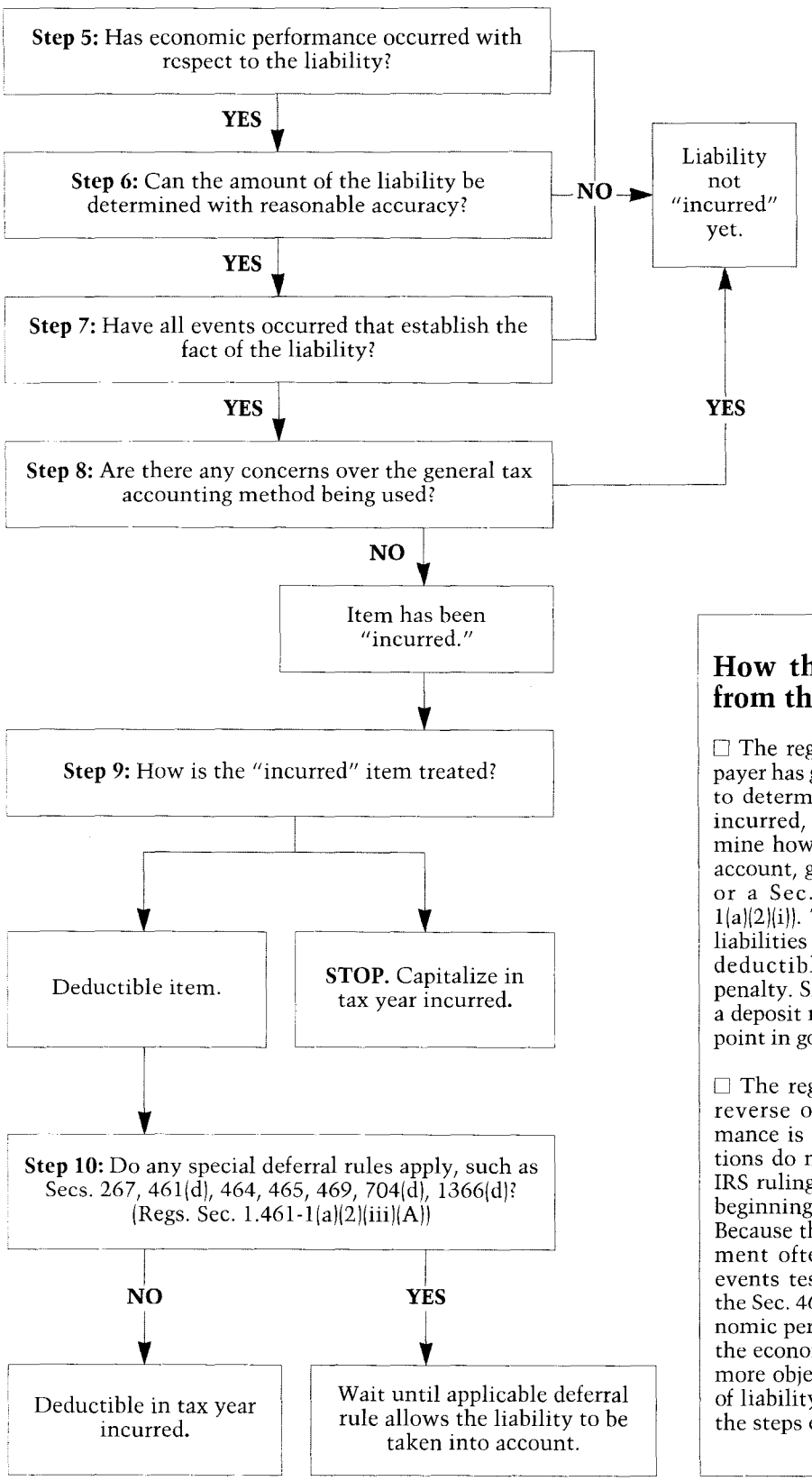
[1] Sec. 461(h)(1); Regs. Sec. 1.263(a)-1, Regs. Sec. 1.263A-1(c)(2)(ii) and Regs. Sec. 1.446-1(c)(1)(ii)(B). See also *Transamerica Corp.,* 670 F Supp 1454 (N.D. Cal. 1986)(58 AFTR2d 86-6166, 86-2 USTC ¶9792).

[2] *World Airways, Inc.,* 564 F2d 886 (9th Cir. 1977)(41 AFTR2d 78-323, 78-1 USTC ¶9149), aff'g 62 TC 786 (1974).

Flowchart: The "Simple" Approach for an Accrual Basis Taxpayer
Has a liability been incurred?





How the Code approach differs from the "simple" approach:

☐ The regulations suggest that after a taxpayer has gone through the Sec. 461 analysis to determine whether a liability has been incurred, the taxpayer would then determine how that liability is to be taken into account, generally as either a Sec. 162 item or a Sec. 263 item (Regs. Sec. 1.461-1(a)(2)(i)). This approach is not efficient for liabilities involving an item that is neither deductible nor capitalizable, such as a penalty. Similarly, if the liability represents a deposit rather than a payment, there is no point in going through the Sec. 461 analysis.

☐ The regulations list Steps 5, 6 and 7 in reverse order; that is, economic performance is listed third. Although the regulations do not specifically number the steps, IRS rulings and court cases apply the steps beginning with the "fact of the liability." Because the economic performance requirement often defers the date when the all events test is met, taxpayers can simplify the Sec. 461 analysis by considering the economic performance requirement first. Also, the economic performance requirement is a more objective determination than the fact of liability step, making reverse ordering of the steps easier.

before 1984, World Airways and the Service would have had no dispute because that requirement would not have been met until the work was actually performed. This outcome is not unusual since the economic performance requirement often serves to delay the time when a liability is incurred. This is why taxpayers can simplify the application of the three items by considering the economic performance requirement first. In addition, the economic performance requirement is a simpler determination than the all events test.

However, the economic performance test does not eliminate the need to consider the all events test. In addition, several other items must be considered, such as whether the timing of the deduction reflects consistent application of a method of accounting, whether the payment involves a related party and whether the expenditure must be capitalized because it creates an asset. All parts of the Sec. 461 analysis must be met before an item is considered "incurred."[3]

Sec. 461 Analysis

The 10 steps of the Sec. 461 analysis (see the flowchart) are explained below and in May, along with examples. According to Regs. Sec. 1.461-1(a)(2)(i), this analysis is also necessary in the determination of a corporation's earnings and profits (E&P).

■ Step 1: Is the liability of a type not subject to the Sec. 461 analysis?

Under Regs. Sec. 1.461-1(a)(2)(iii), the following liabilities are not subject to the rules of Sec. 461 or its regulations; instead, the rules provided in the specified section determine when the amount is considered incurred.

☐ Sec. 165:	Losses.
☐ Sec. 170:	Charitable contributions.
☐ Sec. 192:	Black lung benefit trusts.
☐ Sec. 194A:	Employer liability trusts.
☐ Sec. 468:	Mining and solid waste disposal reclamation and closing costs.
☐ Sec. 468A(a):	Certain nuclear decommissioning costs.
☐ Various:	Amounts allowable under the Code as a deduction for a reserve for estimated expenses, such as Sec. 585.

[3] Regs. Secs. 1.446-1(c)(1)(ii) and 1.461-1(a)(2).

Example 1: W Corporation, an accrual method taxpayer, agreed to make a $12,000 donation to charity within the next three months. *W* would determine the proper time to deduct the $12,000 by following the rules of Sec. 170; Sec. 461 would not apply.

Note that depreciation rules are not part of this list. However, Regs. Sec. 1.461-1(a)(2)(i) states that if an "incurred" item is capitalizable, depreciation rules would then be considered to compute taxable income. Thus, the Sec. 461 analysis is performed first to determine whether an item potentially affecting basis has been incurred; if it has, the Sec. 461 analysis is complete and other rules (such as Sec. 168) may be considered.

An issue that could arise in Step 1 is distinguishing between Sec. 162 deductions and Sec. 165 losses, which is not always an easy task.[4] However, it is necessary because Sec. 165 losses are not subject to the Sec. 461 analysis, while Sec. 162 deductions are. Generally, Sec. 165(a) permits a deduction for the cost of property acquired in carrying on a business that is not deductible under Sec. 162 and not recoverable under disposition or depreciation rules. However, this statement is limited in the case of illegal payments and penalties that would not be deductible or capitalizable.[5]

Example 2: A professional law corporation reimburses a client for a loss it suffered due to an attorney's error. Is this expenditure a Sec. 162 item or a Sec. 165 loss, or neither?[6]

■ Step 2: Is the liability either deductible or capitalizable?

This question is addressed early in the Sec. 461 analysis because if an expenditure is neither deductible nor capitalizable, it is not necessary to know when it is incurred, unless the taxpayer needs to calculate E&P. Sec. 161 permits deductions for items specified in part VI (Secs. 161 to

[4] Rev. Rul. 79-80, 1979-1 CB 86, illustrates the Sec. 162 versus Sec. 165 problem with respect to losses resulting from errors made by securities brokers.

[5] Nondeductible items such as illegal payments may be subtracted from gross sales in computing gross income to the extent they relate to cost of goods sold. Rev. Rul. 82-149, 1982-2 CB 56, and cases cited therein; Regs. Sec. 1.61-3(a).

[6] In Rev. Rul. 81-151, 1981-1 CB 74, a deduction was denied under Secs. 162 and 165 to a taxpayer who reimbursed another party for a fine it paid. See Rev. Rul. 78-141, 1978-1 CB 58, for the Service's position on malpractice losses. See also *Donald F. Campbell*, TC Memo 1987-480, and Price, "Insured Business Losses," 23 *The Tax Adviser* 116 (Feb. 1992). Distinguishing between Sec. 162 and Sec. 165 items is also relevant if the item is against public policy, in which case it would be denied if it were a Sec. 165 loss; Rev. Rul. 77-126, 1977-1 CB 47.

196) of Subchapter B of Chapter 1 of the Code, subject to the exceptions enumerated in part IX (Secs. 261 to 280H). For example, no further analysis is necessary if the expenditure is disallowed under Sec. 265(a)(2) as interest related to tax-exempt income. If an item is not deductible, the next determination is whether it is capitalizable. If it is capitalizable, the Sec. 461 analysis is continued in order to determine basis.

Some expenditures are neither deductible nor capitalizable. For these expenditures, the Sec. 461 analysis ends at Step 2. For example, a fine paid to a government for the violation of any law is not deductible under Sec. 162(f), and thus it is not necessary to analyze when the liability was incurred (unless the taxpayer is measuring E&P). A nondeductible fine is also not capitalized because doing so would result in a tax benefit on disposition.[7] According to the Service, an ordinary and necessary trade or business expense may be capitalized only if it is otherwise deductible under Sec. 162.[8] The Sec. 461 analysis must be continued for expenditures that are partially disallowed, such as meal and entertainment expenses subject to the Sec. 274(n) 50% disallowance.

Deposits: Arguably, if the payee (recipient) has a deposit, rather than income, the payor does not have a deduction. In Rev. Rul. 79-229,[9] the Service held that whether or not an expenditure was a payment or a deposit depended on the particular facts and circumstances. If the expenditure is not refundable and is made pursuant to an enforceable sales contract, it will be considered a payment and not a deposit. If the payment is refundable, it will likely be viewed as a deposit if the payee does not have complete dominion over the funds. Because the definition of a deposit depends on various facts and circumstances, an expenditure that is labeled a "deposit" should be further analyzed to determine its true nature.[10]

■ Step 3: Is the liability that of the taxpayer?

If a taxpayer will be reimbursed for an expenditure, it cannot be treated as a deductible or capitalizable item; rather, the expenditure is viewed as a loan or advance to a third party and not the taxpayer's expenditure.[11] The possibility of reimbursement must be a fixed right with no substantial contingencies; if there is uncertainty about reimbursement and/or no existing legal right to the reimbursement, the item should not be viewed as an advance. In *Alleghany Corp.*, the court stated that a deduction should not be denied "simply for the reason that there was a possibility that at some future date petitioner might receive a reimbursement for some of the expenditures."[12]

Example 3: J Corporation's office lease agreement states that the landlord will be responsible for paying 50% of any repairs. On June 1, 1993, J had $700 of repair work performed. Because J has a right of reimbursement from the landlord, with no substantial contingencies, only $350 is considered to be J's liability. J would continue through the Sec. 461 analysis to determine when the $350 is deductible.

■ Step 4: Has the taxpayer incurred this type of liability before?

Under Regs. Sec. 1.446-1(a)(1), a method of accounting includes not only the taxpayer's overall method, such as cash or accrual, but also the treatment of any item. Generally, consistent treatment of an item from year to year establishes a method of accounting for that item. For example, if a corporation always deducts commissions earned by its sales personnel when the sales contract is signed, such consistent treatment establishes a method of accounting. According to Rev. Rul. 90-38,[13] if the treatment is a permissible method under the rules of Secs. 446 and 461, its use on the first tax return that reflects the item will establish a method of accounting. If the treatment is incorrect, a method is not established until it has been used on two or more consecutive tax returns.

The significance of establishing a method of accounting for items is that if a change in treatment is desired, even to correct an incorrect method, IRS permission must be obtained.[14] This is the reason for Step 4. If the item has been treat-

[7] See note 5 for exception. Also, it is important to determine that the fine or penalty is a true fine or penalty for Sec. 162(f) purposes. For example, in Rev. Rul. 88-46, 1988-1 CB 76, a nonconformance penalty owed to the Environmental Protection Agency was held not to be a penalty.

[8] IRS Letter Ruling (TAM) 8715006 (12/29/86).

[9] Rev. Rul. 79-229, 1979-2 CB 210.

[10] IRS Letter Ruling (TAM) 8642001 (6/19/86) and the cases cited therein. See *Indianapolis Power & Light Co.*, 493 US 203 (1990) (65 AFTR2d 90-394, 90-1 USTC ¶50,007), for the Supreme Court's definition of "deposit" and "complete dominion."

[11] See *Charles Baloian Co., Inc.*, 68 TC 620 (1977); *Glendinning, McLeish & Co., Inc.*, 24 BTA 518 (1931), aff'd, 61 F2d 950 (2d Cir. 1932)(11 AFTR 1025, 1932 CCH ¶9565), and IRS Letter Ruling (TAM) 9143083 (8/1/91), n.1.

[12] *Alleghany Corp.*, 28 TC 298 (1957), at 305. See also IRS Letter Ruling (TAM) 7506309970A (6/30/75) and *The Electric Tachometer Corp.*, 37 TC 158 (1961), acq. 1962-2 CB 4.

[13] Rev. Rul. 90-38, 1990-1 CB 57.

[14] Sec. 446(e). See also Rev. Proc. 92-20, 1992-1 CB 685, for the procedures on how to change a method of accounting.

ed correctly in prior years or incorrectly for two or more years, the remaining steps of the flowchart may not be relevant in the current year. For example, if a corporation has established an incorrect method for sales commissions, it must continue to follow that incorrect method until it obtains permission from the Service to change. The flowchart is still useful, though, in determining whether the taxpayer is treating an item correctly or incorrectly.

If, during a tax year, the Service issues a new accounting method rule, a taxpayer may have to change its treatment of a particular item from what was done in the past. Transitional rules are usually provided in such situations; e.g., the final economic performance regulations provided some new rules that were first effective for tax years beginning after Dec. 31, 1991. Thus, if a taxpayer had one of these items, such as state income taxes, transitional rules were provided for automatic change of their treatment. The taxpayer would then proceed through the flowchart to determine the new treatment for such items.

Errors: Sometimes in preparing a tax return, an item will be found that should have been deducted in a prior year, or that was incorrectly deducted in a prior year. In such a situation, if only an error is involved, rather than an incorrect method of accounting, Regs. Sec. 1.461-1(a)(3) provides that the taxpayer should file an amended return or claim for credit or refund.

Example 4: In preparing its 1993 tax return, *G* Corporation discovers a sales commission that should have been deducted in 1992. Because *G*'s method of accounting requires the item to be deducted in 1992, *G* should file an amended return for 1992; the item cannot be deducted in 1993.

If a taxpayer deducted an item in an earlier year based on application of the Sec. 461 analysis to the facts as they existed at the time, and there is a later change in those facts due to an error by the payee as to the proper amount of the liability, an amended return is probably not warranted. For example, in *Baltimore Transfer Co.*,[15] the taxpayer paid and deducted its state unemployment tax for 19X1. One month after filing its 19X1 tax return, the taxpayer was notified by the state that the state had made an error in the 19X1 tax rate. The Tax Court held that the original amount was still a proper deduction in 19X1 as the all events test had been met; the amount refunded was income in 19X2.

■ Step 5: Has economic performance occurred with respect to the liability?

The economic performance requirement was added by the Deficit Reduction Act of 1984 in response to criticism that the accrual method should consider the time value of money and the time a liability is economically incurred. For example, if a taxpayer met the all events test, but did not have to pay the expense until a future tax year, the taxpayer would benefit since the present value of an amount to be paid in the future is a lesser amount, but the taxpayer could take a current deduction for the stated amount. To avoid complex present value calculations, the economic performance requirement was added, which goes beyond the present value concern because prepayments are still not deductible until economic performance has been met, which might not occur until a later tax year.

Sec. 461(h)(1) states that "the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." If economic performance has occurred and the other requirements of the all events test are met, the amount is treated as incurred for all purposes of the Code.[16] Sec. 461(h)(2) identifies four types of liabilities:

1. Services and property provided to the taxpayer.
2. Services and property provided by the taxpayer.
3. Workers' compensation and tort liabilities of the taxpayer.
4. Other items.

The rules provided in the final economic performance regulations governing these types of liabilities are explained below and in Exhibit 1 on pages 202–205.

Services and property provided to the taxpayer: If the liability is for goods or services provided to the taxpayer, economic performance occurs as the goods or services are provided to the taxpayer. Ser-

Continued on page 206.

[15] *Baltimore Transfer Co.*, 8 TC 1 (1947), acq. 1947-2 CB 1. A similar result was reached in Rev. Rul. 75-562, 1975-2 CB 197, concerning an error by the customs taxing authority, and Rev. Rul. 92-91, 1992-2 CB 49, concerning an error made by a lender on an adjustable rate mortgage. Apparently, based on language in the *Baltimore Transfer* case (at 8), if the taxpayer is notified of the error before filing the return, the overpayment is not deductible. This seems contrary to the general application of the all events test, which looks solely to events known at the end of the tax year.

[16] *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, Staff of the Joint Committee on Taxation, at 261 (hereinafter, the "Blue Book").

Exhibit 1: When Economic Performance Occurs

Type of liability	Economic performance occurs...	Special rules & exceptions	Examples
Services provided to taxpayer Example: Taxpayer hires a management consultant to train new managers.	as services are provided to taxpayer (Regs. Sec. 1.461-4(d)(2)(i)).	Employee benefits (Regs. Sec. 1.461-4(d)(2)(iii)). Except as provided in regulations, revenue rulings or revenue procedures, economic performance is met to the extent the amount is deductible under Sec. 404, 404A or 419. See also Rev. Rul. 88-68, 1988-2 CB 117.	Regs. Sec. 1.461-4(d)(7), Examples 4 and 5
Property provided to taxpayer Example: Taxpayer rents office furniture.	as property is provided to taxpayer (Regs. Sec. 1.461-4(d)(2)(i)). General rule: Economic performance occurs ratably over the time period taxpayer is entitled to use the property. Exception: If liability is determined based on frequency or volume of use of the property or income from the property, follow that use.	Special rules for liabilities for services *or* property provided to the taxpayer: ☐ Long-term contracts (Regs. Sec. 1.461-4(d)(2)(ii)). Special effective date rule (Regs. Sec. 1.461-4(k)(2) and (m)*). For expenses related to long-term contracts accounted for using percentage of completion, economic performance occurs at the earlier of (a) as the service or property is provided or (b) as the taxpayer makes payment to the provider. Thus, prepayment of such expenses will increase the completion percentage and cause revenue to be reported earlier. ☐ 3½-month rule (Regs. Sec. 1.461-4(d)(6)(ii)). Example: Calendar-year taxpayer pays consultant on 11/1/93 for services to be rendered in 1/94. May deduct in 1993 if all events test is met by 12/31/93, because economic performance requirement is deemed met on 11/1/93. ☐ When property or services are provided, see Regs. Sec. 1.461-4(d)(6)(iii). ☐ Single contract with multiple property or services to be provided; see Regs. Sec. 1.461-4(d)(6)(iv). ☐ Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	Regs. Sec. 1.461-4(d)(7) General rule: Examples 6 and 7 Exception: Examples 8 and 9

Services or property provided by taxpayer Example: Taxpayer performs some warranty work on a computer sold to the customer.	as taxpayer incurs costs in connection with the satisfaction of the liability (Regs. Sec. 1.461-4(d)(4)).	Bartering (Regs. Sec. 1.461-4(d)(4)(ii)). Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	Regs. Sec. 1.461-4(d)(7), Examples 1, 2 and 3
Liabilities assumed in connection with the sale of a trade or business Example: Corporation sells one of its operating divisions and the buyer assumes a liability to pay personal property taxes owed by that business at the date of sale.	as amount of liability is properly included in the amount realized by the taxpayer (Regs. Sec. 1.461-4(d)(5)).	Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	
Interest expense	as interest cost economically accrues (Regs. Sec. 1.461-4(e)). See Rev. Rul. 83-84, 1983-1 CB 97.	Recurring item exception *does not* apply to interest (Regs. Sec. 1.461-5(c)).	
Deductions from notional principal contracts	[Reserved] (Regs. Sec. 1.461-4(f)). See TD 8491, 10/8/93 and Rev. Proc. 93-48, IRB 1993-42, 17.		
Other—"payment liabilities" ☐ Regs. Sec. 1.461-4(g)(2): liability arising under workers' compensation act, any tort, contract action or violation of law. Includes liabilities arising out of the settlement of a dispute when a tort, breach of contract or violation of law is alleged.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)).	Special effective date rules apply for liabilities other than workers' compensation and tort liabilities. Regs. Sec. 1.461-4(k)(3) and (m).* Thus, it is important to distinguish between workers' compensation/tort liabilities and other types of Regs. Sec. 1.461-4(g)(2) liabilities. Recurring item exception *does not* apply to this type of liability (Regs. Sec. 1.461-5(c)). See Sec. 468B and final regulations (TD 8459, 12/92), which may apply to payments made into certain settlement funds (Regs. Sec. 1.461-6(b)). Qualified assignments of certain personal injury liabilities under Sec. 130; see Regs. Sec. 1.461-6(a).	Regs. Sec. 1.461-4(g)(8), Example 1—purchase of annuity contract to cover liability arising out of tort is not considered economic performance until payments are actually made to the claimant.
☐ Regs. Sec. 1.461-4(g)(3): liabilities to pay rebates and refunds.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)). Payment includes that made in cash or property or as a reduction in the price of goods or services to be provided in the future by the taxpayer.	Special effective date rules apply; see Regs. Sec. 1.461-4(k)(3) and (m).* Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	Regs. Sec. 1.461-4(g)(8), Example 2

Continued on page 204.

Exhibit 1 continued

Type of liability	Economic performance occurs...	Special rules & exceptions	Examples
☐ Regs. Sec. 1.461-4(g)(4): liability to provide an award, prize or jackpot.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)).	Special effective date rules apply; see Regs. Sec. 1.461-4(k)(3) and (m).* Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	Regs. Sec. 1.461-4(g)(8), Examples 3 and 4
☐ Regs. Sec. 1.461-4(g)(5): liability arises out of the provision to the taxpayer of insurance, or a warranty or service contract.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)).	Special effective date rules apply; see Regs. Sec. 1.461-4(k)(3) and (m).* Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met).	Regs. Sec. 1.461-4(g)(8), Examples 5, 6 and 7
☐ Regs. Sec. 1.461-4(g)(6): liability to pay a tax, including estimated income tax payments and payments of tax when taxpayer subsequently files a claim for credit or refund.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)).	Special effective date rules apply (Regs. Sec. 1.461-4(k)(3) and (m)*). Recurring item exception available, if adopted and if applicable (i.e., item is recurring and other Regs. Sec. 1.461-5 requirements are met). Estimated tax payments are generally considered to be a payment. Licensing fees (Regs. Sec. 1.461-4(g)(6)(ii)). Real property taxes; see Sec. 461(c) and Regs. Sec. 1.461-1(c) (Regs. Sec. 1.461-4(g)(6)(iii)(A)). Certain foreign taxes (Regs. Sec. 1.461-4(g)(6)(iii)(B)).	Regs. Sec. 1.461-4(g)(8), Example 8
☐ Regs. Sec. 1.461-4(g)(7): other liabilities for which economic performance rules are not provided elsewhere in the economic performance regulations or in any other regulation, revenue ruling or revenue procedure.	when payment is made to person to whom liability is owed (Regs. Sec. 1.461-4(g)).	Special effective date rules apply (Regs. Sec. 1.461-4(k)(3) and (m)*). Recurring item exception *does not* apply (Regs. Sec. 1.461-5(c)), although the Service may provide for its application to these types of liabilities by regulation, revenue procedure or revenue ruling.	

Liabilities arising under the Nuclear Waste Policy Act of 1982	as each payment to the Dept. of Energy is made (Regs. Sec. 1.461-4(h)).		
Contingent liabilities	[Reserved] (Regs. Sec. 1.461-4(j)).		
Liabilities of real estate developer with respect to common improvement costs included in the basis of property sold	Special *elective* rules may be available under Rev. Proc. 92-29, 1992-1 CB 748.**		

* Special effective date rules: The economic performance rules were generally effective for liabilities incurred after July 18, 1984. However, certain types of liabilities were not specifically addressed by the statute ("gap" liabilities), such as payment of taxes. Regs. Sec. 1.461-4(k) and (m) provide that for payment liabilities other than those arising out of workers' compensation or tort actions (economic performance rules for these types of liabilities were originally provided at Sec. 461(h)), as well as the special rule for long-term contracts, the economic performance rules are effective for the first tax year beginning after Dec. 31, 1991. For these types of liabilities, taxpayers were granted consent to change their method of accounting for these items and to use either the full-year change method, which should give rise to a Sec. 481(a) adjustment that generally is taken into account over three years, or the cut-off method. The change in method of accounting could also have been made retroactively for the first tax year beginning after 1989 or 1990 if an amended return was filed by Oct. 7, 1992 (applying either the cut-off or full-year change procedure).

** Rev. Proc. 92-29 replaces Rev. Proc. 75-25, 1975-1 CB 720, with limited transitional rules for taxpayers still operating under Rev. Proc. 75-25. Rev. Proc. 92-29 attempts to reconcile the long-established theory allowing developers to include a ratable portion of common improvement costs in units as they were sold, with the fact that the use of estimates in basis is not allowed under the economic performance rules. See, e.g., *Milton A. Mackay*, 11 BTA 569 (1928). The revenue procedure sets out a procedure for real estate developers to obtain permission from the Service to use an "alternative cost method" (ACM) to account for the cost of common improvements, defined as any real property or improvement to real property that benefits two or more properties that are separately held for sale by the developer. Under the ACM, a developer may include in the basis of properties sold its share of the "estimated cost of common improvements" with limited regard to the economic performance rules. The estimated cost of common improvements is defined as the amount of common improvement costs incurred under the economic performance rules as of year-end, plus the amount of common improvement costs reasonably anticipated to be incurred under the economic performance rules during the 10 succeeding tax years (the "ten-tax year horizon"). Under the ACM, the developer includes in the basis of property sold its allocable share of the estimated cost of common improvements. The main limitation is that at the end of any tax year, the total amount of common improvement costs that has been included in basis may not exceed the amount of common improvement costs that has been incurred under the economic performance rules. This limitation is applied on a project by project basis. The revenue procedure explains the exact procedures for obtaining consent and the five conditions a developer must meet, and offers examples of the ACM and the alternative cost limitation rule. A developer using the Rev. Proc. 92-29 method must file an annual statement with the District Director.

vices or property provided to a taxpayer include services or property provided to another person at the direction of the taxpayer.[17] If the taxpayer can reasonably expect the person to provide the property or services within 3½ months after the payment date, the taxpayer is permitted to treat the payment date as the date economic performance is met. The rationale behind this rule is that it relieves the taxpayer of the burden of pinpointing the exact time when property and services are provided.[18]

If the taxpayer's liability arises out of the use of property, economic performance occurs ratably over the time the taxpayer is entitled to use the property. However, if the liability varies with the frequency of the property's use, economic performance occurs as the property is used. For example, if a three-year lease obligates the taxpayer to pay for each use of a machine, economic performance occurs each time the machine is used.[19]

For long-term contracts reported on the percentage of completion method, economic performance occurs at the earlier of the time the service or property is provided to the taxpayer, or the time the taxpayer makes a payment to the person providing the services or property.[20] The effect of this rule is the acceleration of income recognition when a taxpayer prepays its contract expenditures.

Services and property provided by the taxpayer: For liabilities that arise when the taxpayer provides property or services to another party, economic performance occurs as the taxpayer incurs costs in satisfying its liability.[21] For example, for a taxpayer's liability to repair goods sold under warranty, economic performance is met when the taxpayer incurs costs to repair the goods.

Workers' compensation and tort liabilities of the taxpayer: Under Sec. 461(h)(2)(C), economic performance is met for these types of liabilities only when payment is made to the person to whom the liability is owed.

Other items: Sec. 461(h)(2)(D) provides that in the case of liabilities that do not fall into one of the other three categories, the economic performance rule is to be provided in regulations. Regs. Sec. 1.461-4(g) provides that for the following liabilities, economic performance is met only when payment is made to the party to whom the liability is owed; thus, they are referred to as "payment liabilities."

☐ Liabilities arising under a workers' compensation act or out of any tort, breach of contract or violation of law.
☐ Rebates and refunds.
☐ Awards, prizes and jackpots.
☐ Amounts paid for insurance, warranty and service contracts.
☐ Taxes other than creditable foreign taxes.
☐ Other liabilities not specifically provided for in the economic performance rules or any other Code section.

The rules for determining whether a payment has been made are the same as those used to determine whether a cash method taxpayer has made a payment. Thus, issuance of the taxpayer's own note to the payee does not constitute payment. Although the regulations are not clear on this point, it would appear that if a taxpayer is planning on borrowing money to pay the liability, it would be best for the taxpayer to receive the borrowed funds and pay the payee directly rather than have the lender pay the payee directly. In addition, the payment must be made to the person to whom the liability is owed. For example, if a taxpayer settles a product liability claim by depositing money into an escrow account, economic performance has not been met. Instead, economic performance would be met only as payments are made from the escrow account to the claimant.[22]

Recurring item exception: When Congress enacted the economic performance rules, a "recurring item exception" was also added in which the all events test would be the prime determinant of when an item is incurred. Congress realized that for many ordinary business transactions, economic performance might not occur until the year following the year in which the all events test was met. To avoid disrupting normal business practices and "impos-

[17] Sec. 461(h)(2)(A) and Regs. Sec. 1.461-4(d)(6)(i).
[18] Regs. Sec. 1.461-4(d)(6)(ii).
[19] Regs. Sec. 1.461-4(d)(3)(ii). According to the preamble to the final economic performance regulations (TD 8408, 4/9/92), the interaction of Secs. 461(h) and 467 is expected to be addressed under the Sec. 467 regulations.
[20] Regs. Sec. 1.461-4(d)(2)(ii).
[21] Sec. 461(h)(2)(B) and Regs. Sec. 1.461-4(d)(4).
[22] Regs. Sec. 1.461-4(g)(1)(i). Special settlement fund provisions may be available to the taxpayer; see Sec. 468B and its regulations. In determining whether a payment liability has been paid with respect to "self-insured" workers' compensation plans, it is important that the taxpayer distinguish between uninsured plans in which actual payment to the claimant would be necessary and insured plans in which payment to the insurance company would represent payment.

ing undue burdens on taxpayers," the recurring item exception was created.[23] Although the statute makes no mention of this exception being elective, regulations issued soon after the enactment of Sec. 461(h) specified that a taxpayer could adopt the exception by attaching a statement to its tax return. This exception is also a method of accounting for which IRS consent is necessary to use or to stop using, other than in the taxpayer's first tax year.[24] Under Sec. 461(i)(1), the recurring item exception is not available to tax shelters, as defined in Sec. 461(i)(3). Also, the exception does not apply to certain types of liabilities (see Exhibit 1).

The effect of the recurring item exception, when applicable and properly adopted, is to treat a liability for which economic performance is met in year X2 as met in year X1 (the prior year). For the exception to apply, the four requirements in Sec. 461(h)(3) and Regs. Sec. 1.461-5(b) must be met:

1. The all events test must be met by the end of year X1.
2. Economic performance must occur on or before the earlier of the date the timely (including extensions) tax return for year X1 is filed, or 8½ months after the close of tax year X1. Under Regs. Sec. 1.461-5(b)(2), an amended return could be filed to claim the deduction if economic performance occurred after the X1 return was filed, but before the end of the 8½-month period.
3. The liability must be recurring in nature, that is, it must be generally and reasonably expected to be incurred from one tax year to the next.
4. Either the amount of the liability is not material or the accrual of the liability for year X1 results in a better matching of the liability with related income. According to Regs. Sec. 1.461-5(b)(4), materiality is measured in comparison to other items of the taxpayer and considering generally accepted accounting principles (GAAP), although a liability that is not material for financial statement purposes may be considered material for tax purposes. In many situations, taxpayers will find it simpler to meet requirement 4 using the matching alternative. In Regs. Sec. 1.461-5(b)(5), GAAP is relevant (but not dispositive) to determine if better matching results. The regulations provide that better matching is deemed to result with respect to rebates and refunds; awards, prizes and jackpots; insurance, warranty and service contracts; and taxes.

Example 5: *B* Corporation, a calendar-year, accrual method taxpayer, sells widgets to customers under an agreement in which *B* will refund 5% of the purchase price once a customer purchases 5,000 widgets. Payment is to be made through a reduction to future customer invoices. On Dec. 20, 1993, customer *C* purchases its 5,000th widget, entitling it to a refund of $6,000. This refund is paid to *C* by reducing *C*'s invoice of July 1, 1994 by $4,000 and its invoice of Oct. 1, 1994 by $2,000. If *B* has adopted the recurring item exception for refund liabilities and files its 1993 tax return on Sept. 15, 1994, it must treat the $4,000 refund as a 1993 liability because the recurring item exception is met. That is, the all events test was met for the entire $6,000 liability on Dec. 20, 1993 (discussed at steps 6, below, and 7, in Part II, in May); economic performance was met before the filing of the 1993 return with respect to $4,000 of the liability when it was credited to *B* on July 1, 1994; the liability is recurring in nature because *B* incurs this type of liability each year; and because it is a refund liability, better matching is deemed to result. Thus, under the recurring item exception, $4,000 of the liability for which economic performance was met in 1994 is actually deductible in 1993. If *B* had filed its 1993 return before July 1, 1994, it could file an amended return and treat the $4,000 refund of July 1, 1994, which occurred within 8½ months after 1993, as a 1993 deduction. There is no requirement that *B* file an amended return; the choice is up to *B*.[25]

Practice tip: As illustrated in Example 5, the recurring item exception may allow a taxpayer to have some control over the timing of deductions for recurring items to the extent it has control over the return filing date and the date economic performance is met. For example, if *B* settled refund liabilities by writing a check to customers rather than reducing future customer invoices, it would have greater control over the date that economic performance was met. In such a case, if *B* wanted the entire $6,000 liability to be a 1993 deduction, it would just have to pay *C* before the 1993 return's filing date.

Taxpayers who file their return before the extended due date must consider the recurring item exception if the return is later amended.

Example 6: Assume that *B*, from Example 5, filed its 1993 return before July 1, 1994 and deducted the entire refund liability owed to *C* in 1994. In October 1995, *B* discovers an error on its 1993 return and amends it. Must *B* also deduct the $4,000 refund liability paid on July 1, 1994 on

[23] Blue Book, at 261.

[24] Temp. Regs. Sec. 1.461-7T, Q&A-7 (TD 8024, 5/17/85); Regs. Sec. 1.461-5. Special rules allowed taxpayers to adopt or expand a recurring item exception for the first tax year beginning after Dec. 31, 1991.

[25] Regs. Sec. 1.461-5(b)(2).

the amended 1993 return? If yes, then *B* would also have to file an amended return for 1994 to remove the $4,000 deduction. It is not clear whether this is the correct answer because the IRS cannot force a taxpayer to amend a return and this would be the effect if *B* were required to deduct the $4,000 on the amended 1993 return. Hopefully, the Service will clarify what *B* should do in this situation.

For taxpayers who adopted or expanded a recurring item exception on the return for the first tax year beginning after Dec. 31, 1991 that is filed before the due date, proper treatment of recurring items on an amended return is very important.

Example 7: In 1992, *B*, from Example 5, had followed the automatic consent rule to apply the recurring item exception to refunds (see Exhibit 1), and filed its 1992 return on June 1, 1993. If *B* amends the 1992 return in October 1994, and does not deduct the July 1, 1993 $4,000 refund from 1992 on that amended return, the Service might later argue that *B* did not properly adopt the recurring item exception for refund liabilities. In such a case, *B* would then have to obtain permission from the Service to apply the recurring item exception to that item, as it would be too late to obtain automatic consent under the final economic performance regulations.

Deferred compensation: Under Regs. Sec. 1.461-4(d)(2)(iii), the economic performance requirement is generally satisfied to the extent that any amount is deductible under Secs. 404 (deferred compensation plans), 404A (foreign deferred compensation plans) and 419 (welfare benefit funds). The deferred compensation rules of Sec. 404 are discussed further as they are likely to be encountered by many accrual method businesses.

Under Sec. 404(a)(5) and (b) and the related regulations, deferred compensation includes both formal and informal arrangements. Compensation is presumed to be deferred if it is paid more than 2½ months after the payor's year-end. Generally, for nonqualified plans, the payor may not take a deduction until the tax year in which the recipient includes the payment in income. Thus, wages and bonuses that a calendar-year employer wants to deduct in 1993 must be paid by Mar. 15, 1994. A taxpayer may rebut the presumption that compensation is deferred if the preponderance of the facts and circumstances shows that it was impracticable, either administratively or economically, to avoid deferral of the employee's compensation or benefits beyond the 2½-month period. Such impracticability must have been unforeseeable at year-end.[26] For example, if the information needed to compute an employee's 1993 bonus is still not available by Mar. 15, 1994, and it was not foreseeable by Dec. 31, 1993 that it would not be available by Mar. 15, 1994, this administrative impracticability may allow a deduction in 1993, even though payment is not made until after Mar. 15, 1994.

Two recent cases illustrate the strictness of the impracticability and foreseeability factors. In one, *National Medical Financial Services*,[27] the Tax Court found that payment was not impracticable within the 2½-month period because the taxpayer chose to use available funds for investments, diversification and owner salaries, rather than paying the prior year bonuses. Also, the Service and the court looked closely at the taxpayer's financial records, such as working capital levels and noncritical uses of cash, to determine whether the taxpayer's argument of unforeseeable financial impracticability was justified.

The deferred compensation rule also applies to services provided by a cash method independent contractor.

Example 8: H Corporation, a calendar-year, accrual method taxpayer, hires a cash method management consultant to perform work in 1993. *H* does not pay the contractor until June 1994 and cannot show that it was impracticable to pay by Mar. 15, 1994. Even though the all events test was met and all services were provided in 1993, *H* may not deduct the liability until 1994 because that is the tax year in which the contractor will include the payment in income.[28]

If the employee or independent contractor is related to the payor (e.g., an employee who owns over 50% of the corporate stock of the payor), the stricter timing rules of Sec. 267 apply (Step 10, in Part II).

■ Step 6: Can the amount of the liability be determined with reasonable accuracy?

This is the second prong of the all events test. The amount of the liability need not be known with certainty; reasonable accuracy is all that is required. For example, in the *Burnham Corp.*[29] case, the court did not question the second prong

[26] Temp. Regs. Sec. 1.404(b)-1T, Q&A-2(b)(1 and 2).

[27] *National Medical Financial Services, Inc.*, TC Memo 1992-178. See also *Truck and Equipment Corp. of Harrisonburg*, 98 TC 141 (1992).

[28] Sec. 404(d) and Rev. Rul. 88-68, 1988-2 CB 117. Rev. Rul. 88-68 was recently cited in IRS Letter Rulings (TAMs) 9203002 and 9203003 (4/11/91). Query: How is this revenue ruling to be followed since a taxpayer is unlikely to know what method of accounting an independent contractor uses? Is the Service considering this revenue ruling in examinations?

[29] *Burnham Corp.*, 878 F2d 86 (2d Cir. 1989)(65 AFTR2d 90-684, 89-2 USTC ¶9419).

of the test when the amount of the liability was determined using life expectancy tables. If the exact amount of a liability cannot be determined, the taxpayer should still review the liability to determine if any part of it is determinable with reasonable accuracy.

Example 9: T, a temporary employment agency, provides services to *Y* Corporation, charging *Y* $5,000. *Y*, however, believes it owes *T* only $3,000 in the year the services were rendered. Due to the dispute, *Y* has met the first prong of the all events test only with respect to the $3,000 (see Step 7, in Part II). As that amount is also known with reasonable accuracy, under Regs. Sec. 1.461-1(a)(2)(ii), the second prong is satisfied with respect to the $3,000.

Various courts have allowed estimates of liability if they are shown to be reasonable based on industry and scientific data. Later justification of the amount based on hindsight has also been an important, but not conclusive, factor. For example, in *ESCO Corp.*,[30] the court found that the taxpayer satisfied the reasonable accuracy prong for workers' compensation claims. The estimates were found to be "based on reasonable, commercially accepted standards and that they were more accurate than the industry norm in Oregon."

In addition, the reasonable accuracy prong of the all events test can be satisfied using aggregate estimates of a liability. For example, in *Kaiser Steel Corp.*,[31] the court held that it was not necessary to have reasonable accuracy for each individual workers' compensation claim; an aggregate estimate was allowable.

The Service does not agree with these court decisions and similar decisions in which the second prong was held to be satisfied because a reasonable estimate existed. The Service has stated that the second prong of the all events test can be met only when all the necessary facts about the amount of the liability are known. For example, the Service has ruled that when a taxpayer was obligated to perform reclamation work, but had not yet performed it itself or contracted for another party to do so, insufficient facts existed to have reasonable accuracy as to the amount of the liability. The Service does acknowledge, though, that there is a fair amount of case law contrary to its interpretation of the reasonable accuracy standard.[32]

In practice today, the second prong of the all events test is usually not significant because it tends to be overshadowed by the "fixed" prong and the economic performance requirement, which are so strict that when they are finally met, the second prong is also likely satisfied. For example, the second prong is no longer an issue with respect to workers' compensation liabilities because economic performance does not occur until payment is actually made to the claimant; thus, there is no point in estimating such liabilities. (Also, the recurring item exception does not apply to workers' compensation liabilities.)

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[30] *ESCO Corp.*, 750 F2d 1466 (9th Cir. 1985)(55 AFTR2d 85-798, 85-1 USTC ¶9147), rev'g and rem'g 578 F Supp 738 (DC Ore. 1983)(53 AFTR2d 84-381, 83-2 USTC ¶9714). See also *Kaiser Steel Corp.*, 717 F2d 1304 (9th Cir. 1983)(52 AFTR2d 6091, 83-2 USTC ¶9621). The results of these cases would be different in light of the economic performance requirement. As noted by the *ESCO* court, the special economic performance rule for workers' compensation claims was not motivated by concern that estimates of liability were inaccurate, but because of the time value of money concerns (9th Cir., 85-1 USTC 87,178).

[31] *Kaiser Steel Corp.*, id.

[32] IRS Letter Ruling (TAM) 7831003 (4/13/78).