



Timing is Everything—IRS Issues Year End Expense Guidance
Podcast of December 23, 2006



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Revenue Ruling 2007-3

We've come close to the end of another year, and for the IRS it's already 2007—at least in terms of dating guidance that is being issued. This week the IRS issued guidance, while carrying a 2007 date, is clearly aimed at influencing calendar year accrual basis taxpayers in handling their expenses properly—at least in the view of the IRS.

The matter being covered in this ruling involving the timing for claiming expense deductions for an accrual basis taxpayer. The ruling gives two fact patterns that are then analyzed under the relevant provisions of Regulations §1.461-1, 4 and 5. The ruling would suggest the IRS believes taxpayers are not properly applying the economic performance test and the recurring item exception.

Deduction Timing

The ruling affects accrual basis taxpayers, since unlike their cash basis brethren, a deduction is not principally triggered by payment. Rather a more nebulous concept applies to determine the timing of expenses on the accrual basis, a concept derived from accounting rules meant to create a proper matching of income and expenses for financial statement reporting.

Unlike the perception that many nonaccountants have, reality is that many concepts in accounting do lead automatically to a “bright line” test that makes a single number the “correct” number or, in this case, a simple test for when an item would be accrued. The regulations referenced above recognize this uncertainty, and seek to provide a set of more concrete rules for when an expense would be recognized on the accrual basis.

Regulation §1.461-1(a)(2)(i) provides a test which allows for a deduction on the date when all three of the following criteria are met:

- all the events have occurred that establish the fact of the liability,
- the amount of the liability can be determined with reasonable accuracy, *and*
- economic performance has occurred with respect to the liability.

The IRS has explained in various rulings¹ its position on the first prong of that test as being met on occurrence of the earlier of the following two events:

- the event fixing the liability, whether that be the required performance or other event, occurs, *or*
- payment is due

The second test does not require that the liability be tied down to the penny, but rather that it be capable of being reasonably estimated. Normally this issue has not been one that is troublesome in most cases, though if the liability is simply too uncertain for any amount to be reasonably estimated that would block the deduction.

The final prong is the economic performance test. We are back to another somewhat nebulous concept, though we have some specific guidance to help with this concept.

Regulation §1.461-4(d)(2)(i) provides that, in general, “if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.” So, for instance, if I contract with an individual to paint a wall in my office, economic performance would occur as the painter actually painted the wall. Similarly, if I contract with an office supply store to provide five boxes of copier paper to my office, economic performance occurs when the office supply store actually provides me with the copier paper.

¹ See Revenue Ruling 80-230 and Revenue Ruling 79-410, as well as the one we are dealing with in this podcast

A special rule applies for insurance, found at Reg. §1.461-4(g)(5) which provides “If the liability of a taxpayer arises out of the provision to the taxpayer of insurance...economic performance occurs as payment is made to the person to which the liability is owed.” Obviously we all hope when we buy most types of insurance that the insurer will, in fact, do nothing except collect the premiums, rather than actually be involved in paying a claim due to, say, a fire at our business.

Recurring Item Exception

Taxpayers may elect to use the “recurring item” exception for certain expenses. This method is meant to provide relief for items that recur from year to year, but which would slip over into the later year under a strict application of the all events test. However, it is a method of accounting, so it must be adopted for the first year in which the expense occurs and, once adopted, must be used each year for that expense.

To qualify for the recurring item exception, the expense must meet the following criteria found in Regulation §1.461-5(b)(1):

- (i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;
- (ii) Economic performance with respect to the liability occurs on or before the earlier of --
 - (A) The date the taxpayer files a timely (including extensions) return for that taxable year; or
 - (B) The 15th day of the 9th calendar month after the close of that taxable year;
- (iii) The liability is recurring in nature; *and*
- (iv) Either --
 - (A) The amount of the liability is not material; *or*
 - (B) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

IRS Ruling Facts

The IRS in Revenue Ruling 2007-3 looked at two specific fact patterns and applied these rules. In both cases the taxpayer had previously elect the recurring item exception for the expenses in question.

Services

The first case deals with a contract for services. The facts are as follows:

On December 15, 2006, X executes a contract with Y for the provision of services. The contract provides for services to begin on January 15, 2007, and end on January 31, 2007. Under the terms of the contract, payment for the services is due to Y on January 15, 2007, and X pays Y for the services on January 15, 2007. X uses the recurring item exception under § 1.461-5.

Obviously, the implication is that the taxpayer would want to deduct the expense of this contract on the taxpayer's 2006 return on the accrual basis, since they have entered into a contract for services for a fixed amount and, in the taxpayer's view, is obligated. Going one step further, the taxpayer would appear to argue that the recurring item exception gets him out of the requirement that the services actually be performed and, since he's not cash basis, the fact it's not yet paid isn't a big deal (he'll pay it when it's due).

Unfortunately, the IRS does not agree. The IRS objects that, at this point, not all events have occurred that establish the fact of the liability. As you'll note above, establishing the fact of the liability is one of the conditions of taking a deduction under the recurring item exception.

The IRS holds:

In Situation 1, the first event that occurs to establish the fact of X's liability for services is that payment is due under the contract on January 15, 2007. See Rev. Rul. 80-230; Rev. Rul. 79-410. Thus, for purposes of § 461, the fact of the liability is established on January 15, 2007. At that time, the amount can be determined with reasonable accuracy. Economic performance with respect to the liability occurs as the services are provided, from January 15, 2007, through January 31, 2007. See § 1.461-4(d)(2). Therefore, X incurs a liability for services in 2007.

The IRS explains that merely signing a contract does not, by itself, establish the fact of the liability when no other event has taken place. Under the contract no payment was due until 2007, no payment was made until then, and no services were rendered before then either. So January 15, 2007 is the date on which, in the IRS's view, the fact of the liability is finally established.

Insurance Contract

The IRS next outlines a fact pattern dealing with an accrual basis taxpayer signing an insurance contract late in the year. In that case, the IRS poses the following facts:

On December 15, 2006, X executes a contract with W, an insurance company regulated under state law, for the provision of insurance. The insurance contract covers the period from January 15, 2007, through December 31, 2007. Under the terms of the contract, payment of the insurance premium is due to W on January 15, 2007, and X pays the premium to W on January 15, 2007. X uses the recurring item exception under § 1.461-5.

Again, we would presume the IRS expects the taxpayer is going to take the position that since they have a binding contract for insurance that this would allow the deduction of the accrual in 2006, rather than having to wait until 2007. And, as before, the IRS disagrees.

In Situation 2, the first event that occurs to establish the fact of X's liability for insurance is that the premium is due under the contract. See Rev. Rul. 80-230; Rev. Rul. 79-410. Thus, for purposes of § 461, the fact of the liability is established on January 15, 2007. At that time, the amount can be determined with reasonable accuracy. Economic performance with respect to the liability occurs as payment is made, on January 15, 2007. See § 1.461-4(g)(5). Therefore, X incurs a liability for insurance in 2007.

Again, the IRS notes that the mere signing of a contract was not enough when the first payment was not due or paid until the following year. The IRS position is that the fact of the liability was not yet established.

In this case, the IRS goes on to explain (and apparently attempt to rebut an argument they expect some taxpayers to raise) that "Although federal or state regulations may impose certain legal obligations on taxpayers, those obligations, without more, do not necessarily establish the fact of a taxpayer's liability under § 461." The IRS cites the case of *Chrysler Corp. v. Commissioner*, 436 F.3d 644 (6th Cir. 2006), a case dealing with warranty obligations, in support of this position.

And, again, the IRS reminds taxpayers that the recurring item exception requires that the fact of the liability be established, and this fact pattern fails that test.

Accounting Method Issue

So what are taxpayers that have been using a more "liberal" view of the recurring item to do? As the regulations note, this is an accounting method and, as we are all aware, taxpayers must have IRS permission to change their accounting method, even if their current method is one not allowed under the IRC.

The IRS has provided an automatic consent procedure in Revenue Procedure 2007-14, which provides in Section 4:

.01 *In General*. A change in the treatment of liabilities for services or insurance to comply with Rev. Rul. 2007-3 is a change in method of accounting within the meaning of §§ 446 and 481 and the regulations issued thereunder. Accordingly, a taxpayer within the scope of this revenue procedure that wants to change its treatment of liabilities for services or insurance to comply with Rev. Rul. 2007-3 must obtain the consent of the Commissioner under § 446(e) and § 1.446-1(e)(3).

.02 *Automatic Change*. A taxpayer within the scope of this revenue procedure that wants to change its method of accounting for liabilities for services or insurance must obtain the consent of the Commissioner by following the automatic consent

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procedures in Rev. Proc. 2002-9 (or its successor). For purposes of section 6.02(4)(a) of Rev. Proc. 2002-9, the taxpayer must include on line 1a of the Form 3115 the designated automatic accounting method change number 106.