Final Regs. On Economic Performance Requirement Resolve Most Issues

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The rules clarify when accrued liabilities are deductible, but questions remain as to the treatment of prepayments to third parties.

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The Service has adopted final Regulations (TD 8408, 4/9/92) under the economic performance requirement of Section 461(h) , which, for purposes of determining when liabilities are deductible by accrual-method taxpayers, provides that the all-events test is not met before economic performance occurs. In addition to the Regulations, Rev. Proc. 92-28, 1992-1 CB 745 , covers an election to ratably accrue real property taxes, and Rev. Proc. 92-29, 1992-1 CB 748 , includes rules applicable to contractually obligated estimated costs of real estate developers.

Scope of Regulations. The Proposed Regulations embodied an expansive philosophy in which a wide range of rules were promulgated in areas not directly addressed by Congress in DRA '84, which added Section 461(h) to the Code.[1] Significant taxpayer opposition greeted these rules, including numerous written comments and complaints at an extensive public hearing about the broad scope of the provisions. Although the Preamble to TD 8408 devotes considerable attention to the comments, they generally are not reflected in the final Regulations.

Thus, while there were some modifications in key areas, the overall approach of the Proposed Regulations generally was carried over to the final Regulations. Among the issues addressed by the final Regulations are:

1. *Basis-related issues.* One of the more controversial provisions in the Proposed Regulations reflected the conclusion that the economic performance requirement, as a modification of the all-events test, would apply not only in determining the timing of expense deductions, but also in determining the components of cost of goods sold, long-term contract costs, and the basis of fixed assets acquired or produced by a taxpayer. In opposition to this conclusion, commenters cited cases holding that the all-events test did not apply other than in determining the timing of expense deductions.[2] Nevertheless, the final Regulations expressly retain the broad interpretation of Section 461(h) that extends the reach of the economic performance requirement well beyond expense accruals for deduction purposes.
2. *Real Estate Development.* One consequence of the Proposed Regulations" expansive approach was to call into question the continued validity of Rev. Proc. 75-25, 1975-1 CB 720 , which was the last in a long-standing line of precedents that allowed real estate developers to deduct the contractually obligated estimated cost of future improvements to lots from the revenue from the sale of the lots. The Proposed Regulations revoked Rev. Proc. 75-25 , but Notice 91-4, 1991-1 CB 315 , temporarily reinstated the Procedure. The final Regulations preserve Rev. Proc. 75-25 treatment for developers, but in a modified form that affords limited benefits. This is reflected in Rev. Proc. 92-29 , under which taxpayers may allocate to the basis of unsold lots the estimated costs of contractually obligated future development costs. When lots are sold, however, the costs that may be deducted with respect to those lots may not exceed the aggregate costs on the project that have satisfied the economic performance requirement. The benefits available to real estate developers under Rev. Proc. 92-29 are far more limited than those under Rev. Proc. 75-25 , as illustrated by the following:

Example: A taxpayer developing 100 lots of equal size is required to make an aggregate of $1 million of improvements, or $10,000 per lot. The taxpayer sells 20 lots when only $100,000 of the $1 million in development costs has satisfied the economic performance requirement. The taxpayer may not deduct the full $200,000 of estimated costs allocable to the lots that have been sold, but is limited to an aggregate deduction of $100,000. The balance of the development costs attributable to the lots that were sold is not deductible until another $100,000 of development costs on the project is incurred and satisfies the economic performance requirement.

LIABILITY TO PROVIDE GOODS, SERVICES, OR PROPERTY

Taxpayer's liability for goods or services. The final Regulations retain the general approach of the Proposed Regulations that, with respect to a taxpayer's liability to provide goods or services, economic performance occurs as the taxpayer incurs the costs of providing the goods or services. Many commenters had suggested that taxpayers should be

permitted to pay a third party to assume the taxpayer's liability and treat that payment as economic performance. The theory was that the impetus for the economic performance requirement was time-value-of-money considerations; payment, therefore, should constitute economic performance.

The final Regulations unequivocally reject the suggestion, except in a few limited circumstances (discussed below). Otherwise, the only time that a taxpayer may shift a liability to a third party and satisfy the economic performance requirement by paying the third party to assume the liability is when insurance is involved. Thus, if a taxpayer can shift its liability to provide goods or services to a third party in a true insurance arrangement, the taxpayer may be able to deduct its liability when the insurance premium is paid. Of course, standard all-events test issues and prepaid expense rules may limit the deductibility of insurance payments that might otherwise meet the requirements of Section 461(h) . In addition, the availability of the insurance alternative will continue to put considerable emphasis on the factors that help to determine whether an arrangement truly is insurance, i.e., risk distribution and risk shifting, and on whether insurance can be acquired after the underlying liability has matured in whole or in part.

Third party's liability for goods or services. Under the Proposed Regulations, if a third party was obligated to provide goods or services to the taxpayer, economic performance occurred as the third party delivered the goods or performed the services. The final Regulations adopt the same rule and preserve three exceptions:

1. 31/2-month rule. In certain limited circumstances, taxpayers may treat advance payments to third parties for goods or services as economic performance. Under Reg. 1.461-4(d)(6)(ii) , the payments reasonably must be expected to be made within 31/2 months of the third party's provision of the goods or services. The final Regulations expressly reject suggestions that the period be extended, and it is not clear why the 31/2-month rule resulted in any significant comments or why it should cause any major concern. A taxpayer that reasonably expects economic performance to occur within 81/2 months of the close of a tax year can get the same earlier-year deduction under the recurring item exception in Section 461(h)(3) and Reg. 1.461-5 without making any payment in the earlier year. Both the 31/2-month payment rule and the 81/2-month recurring item exception require the standard all-events test to be met in the earlier year before permitting the deduction in that year. If the recurring item exception applies, it offers considerably more flexibility than the 31/2-month rule.

2. Long-term contracts. Under Reg. 1.461-4(d)(2)(ii)(B) , payment also may be treated as accelerating performance for long-term contracts, which generally favors the Service. Economic performance by a subcontractor to the taxpayer occurs when the goods or services are provided to the taxpayer or when the taxpayer pays the subcontractor, whichever is earlier.[3] Commenters had criticized this provision as an unfair exception to the general rule that payment is not performance. The rule is retained in the final Regulations, however, because under the percentage-of-completion method in Section 460 , the date that long-term contract costs are incurred establishes the taxpayer's time for accrual of gross receipts.[4] Thus, the earlier that a cost under a long-term contract is deemed incurred, the earlier that revenue is accrued. The IRS was concerned that contractors could circumvent the percentage-of-completion method by subcontracting out work under a long-term contract to an independent third party and taking the position that economic performance (and therefore the incurrence of contract costs) did not occur until the contract was near completion. In the only concession to comments on the payment-equals-performance rule for long-term contracts, the final Regulations delay the effective date of the payment acceleration rule until tax years beginning after 1991.
3. Sale of trade or business. Under Reg. 1.461-4(d)(5) , economic performance also may be accelerated when a taxpayer sells an entire trade or business to a third party and the third party assumes all of the taxpayer's liabilities. In the year of the sale, the taxpayer may deduct all liabilities that otherwise have satisfied the all-events test but for the application of the economic performance requirement. The Regulations strictly limit this exception to sales of an entire trade or business. The Proposed Regulations included a similar provision, but limited its application to payment-type liabilities. The final Regulations have expanded the provision to all liabilities that otherwise have satisfied the all-events test. Thus, the Regulations leave open the current debate as to the proper tax treatment of contingent liabilities assumed in connection with the acquisition of the assets of a trade or business. Since these liabilities ordinarily will not satisfy the all-events test, they are not covered by the trade or business rule in the Regulations and are governed by the existing cases and rules applicable to asset acquisitions.[5]

Employee benefits. The final Regulations clarify the relationship between Section 461(h) and employee benefits. Since compensation for services ordinarily would satisfy the economic performance requirement as the services are provided, employee benefits, whether deferred or current, should not be affected by Section 461(h) . The Proposed Regulations cast doubt on this conclusion, however, because they revoked prior Temporary Regulations indicating that Sections 404 and 419 overrode Section 461(h) . Commenters had questioned, for example, whether a contribution to a voluntary employees' beneficiary association (VEBA) subject to Section 419 (treatment of funded welfare benefit plans) might not be deductible until the benefits under the VEBA were paid out to the beneficiaries. Reg. 1.461-4(d)(2)(iii) indicates that such a result was not intended and that Sections 404 , 404A , and 419 take precedence over Section 461(h) in determining when an expense is incurred.

The only area of employee benefits left open is the interaction of the economic performance standard with Section 83 . Here, too, the Preamble to TD 8408 suggests that the timing of the income inclusion by an employee who receives property as compensation for services rendered to the employer should control the timing of the deduction by the employer/payor. This is the current rule under Section 83(h) . The Preamble also indicates, however, that there may be situations that should not be governed by Section 83(h) , particularly those involving non-employees. As discussed above, the general rule is that payment does not satisfy the economic performance standard for liabilities arising from the provision of services. The Service obviously wants to be sure that Section 83 cannot be used affirmatively to circumvent the policy underlying Section 461(h) . Accordingly, the final Regulations do not contain explicit provisions on the application of Section 461(h) to situations involving Section 83 , and comments are requested on this point.

Use of Property. Under the Proposed Regulations, where the taxpayer's liability was to provide for the use of property, economic performance occurred ratably over the period of use. Although this rule operated in a reasonably fair manner for rentals of real property with level rent payments, in numerous situations rents and royalties are not due ratably over time, but instead are computed based on income derived from the sale or use of the property. In these situations, prior to the enactment of Section 461(h) , such rents and royalties generally were held to be deductible as they were incurred. 6 Although this conclusion seemed questionable under the Proposed Regulations, the final Regulations appear to cure the problem by providing two exceptions from the general rule that economic performance for the use of property occurs ratably over the rental period. Under Reg. 1.461-4(d)(3)(ii), if the rent or royalty varies based on either the frequency of use of the property or the income earned from the property, performance occurs as the property is used or income is earned.

PAYMENT-TYPE LIABILITIES

Another controversial provision in the Proposed Regulations was an expanded category of liabilities where economic performance would be satisfied only by paying the liability. Seven categories of liabilities were identified (in addition to liabilities arising under a workers' compensation act or from any tort) for which payment constituted economic performance. The Proposed Regulations effectively took the position that all liabilities, except those arising from the provision of property or services, would satisfy the economic performance rules only on payment. Reg. 1.461-4(g) adopts this payment rule without significant change.

Definition of payment. Reg. 1.461-4(g)(1)(ii)(A) retains the rule in the Proposed Regulations that "payment" has the same meaning that it has for taxpayers using the cash method. Commenters had suggested that "payment" should include the furnishing of a taxpayer's note or other evidence of debt, but the final Regulations reject this position. For a cash-method taxpayer, however, payment presumably would be satisfied if the taxpayer borrowed money from one

person and used the funds to satisfy its payment obligation to another person. The exact scope of this payment rule in connection with a cash-method taxpayer has not been answered adequately in situations involving a borrowing from one related party and a payment to another related party.

Insurance. Reg. 1.461-4(g)(5) retains the payment rule for insurance liabilities. The Preamble specifically notes that economic performance occurs when a taxpayer pays an insurance premium to cover workers' compensation or tort liabilities.[7] In addition, as discussed above, the Preamble puts taxpayers on notice that merely making a payment under an insurance contract will not necessarily result in the deductibility of the payment. The insurance payment also must satisfy the all-events test and, as illustrated by the examples in Reg. 1.461-4(g)(8) , must not be subject to capitalization or deferral under the general rules of Sections 263 and 461.

Taxes. Taxpayers reacted with considerable outrage to the Proposed Regulations' inclusion of taxes in the category of items for which payment is economic performance. Nevertheless, and despite extensive lobbying, Reg. 1.461-4(g)(6) retains the payment rule for taxes. In the only real concession on this item, Rev. Proc. 92-28 provides a simplified procedure for making or revoking an election under Section 461(c) to accrue real property taxes ratably. The Revenue Procedure is elective for the first tax year beginning after 1989, 1990, or 1991. In addition, the Service is studying whether to extend the ratable accrual election in Section 461(c) to personal property taxes.

The final Regulations also clarify that the payment rule for taxes specifically applies to deductible foreign taxes that are noncreditable because, e.g., such taxes are not an income tax or otherwise fail to satisfy the specific creditability requirements generally provided in Section 901 . In addition, the Preamble specifically provides that foreign taxes creditable by treaty rather than under Section 901 are not subject to the payment rule. Instead, such taxes are controlled by the all-events test under prior law that applies to foreign taxes otherwise creditable under Section 901 .

RECURRING ITEM EXCEPTION

Reg. 1.461-5 makes no significant substantive changes to the scope or application of the recurring item exception, but several issues are clarified.

Election. Many taxpayers had interpreted Section 461(h)(3) as making application of the recurring item exception mandatory, but the Proposed Regulations made the exception elective. Moreover, they required that an affirmative election be made, which posed practical problems for taxpayers who had anticipated that their treatment of a specific type of liability would satisfy the economic performance requirement without regard to the exception. If the Service rejected such a position on audit, the taxpayer faced the additional problem of having failed to elect the recurring item exception even though application of the exception would have prevented the audit adjustment.

Reg. 1.461-5(d) eliminates this problem, but only prospectively. Now, the election to use the recurring item exception is made simply by accruing the expense in the year that it satisfies the all-events test. It is no longer necessary for an electing taxpayer to file a statement identifying the trade or business and the types of items with respect to which the exception is to be used.

The rule on electing the recurring item exception method is effective for the first tax year beginning after 1991. Where an original return already has been filed for 1990 or 1991 tax years without claiming the benefit of the recurring item exception, however, the election can be made by filing an amended return by 10/7/92. For 1991 (if no original return has yet been filed) and 1992, the election may be made by filing the original return accruing the expense in the year that the all-events test is satisfied.

Other liabilities. The Service specifically stated that it may issue alternative or additional rules (by Regulation, Revenue Procedure, or Revenue Ruling) on the interaction of the "other" liability provisions of Reg. 1.461-4(g)(7) and the recurring item exception. Until such additional rules are available, however, "other" liabilities subject to the payment rule cannot benefit from the recurring item exception.

Planning. Reg. 1.461-5(b) follows the rule in the Proposed Regulations that only expenses satisfying the economic performance test by the earlier of 81/2 months after the close of the tax year, or the date that the taxpayer files its tax return, can be treated as incurred for purposes of the recurring item exception. Some taxpayers saw this rule as a problem, since it prohibits the anticipation of economic performance where the tax return is filed before the 8 1/2-month extension deadline.

Many taxpayers are finding the rule significantly advantageous, however, since it allows post-year events and the timing of the filing date to determine the taxable income to be reported on the return. If a taxpayer determines that it wants to report additional U.S.-source income, there might be an advantage to filing a return earlier than .81/2 months after the close of the tax year. This could avoid the deduction of expenses (which otherwise would satisfy the economic performance rule within the 8 1/2-month period) that do not meet the economic performance rule at the time of filing. Thus, the date that a return is filed and the status of the provision of property or services (for property or service liabilities) or the status of payment (for payment liabilities) can have a significant effect on taxable income reported on the return. Furthermore, the final Regulations do not require taxpayers to include on any amended return expenses satisfying the economic performance rule after the filing date but within the 81/2-month period. Any such expenses will be deductible on the succeeding year's return unless an amended return is filed affirmatively moving the deduction to the earlier year.

EFFECTIVE DATES

As provided in the Proposed Regulations, the final Regulations apply to liabilities that, under the law in effect prior to Section 461(h) , would be deductible or otherwise treated as incurred after 7/18/84. For liabilities for which economic performance requires payment (other than workers' compensation and tort liabilities), the final Regulations apply to liabilities that, but for the enactment of Section 461(h) , would be allowable as a deduction or otherwise treated as incurred for tax years beginning after 1991.

As discussed above, the special economic performance rule for long-term contract liabilities also carries an effective date for the first day of the first tax year beginning after 1991. Taxpayers can elect to retroactively apply both the payment liability and long-term contract liability rules to the first tax year beginning after 1989, by filing an amended return by 10/7/92. In addition, taxpayers have the option of making these changes under a cut-off method or, alternatively, under the full-year change in method election (with a requisite Section 481 adjustment) of Temp. Reg. 1.461-7T .

CONCLUSION

Congress enacted Section 461(h) so that the deduction of liabilities by accrual-method taxpayers would take into account the time value of money and when the deduction was incurred economically. It was concerned about the potential revenue loss from economically overstated deductions, e.g., where taxpayers incurred a liability today to pay an expense in the future. Because of the large number of transactions in which deductions potentially could be overstated and the generally high interest rates of the early 1980s, the magnitude of the revenue loss from premature deductions appeared significant.

The final Regulations, adopted some eight years after Section 461(h) was enacted, generally provide unobtrusive rules for ordinary business transactions that can fit within the recurring item exception. Due to the significant latitude given taxpayers under the recurring item rules, the economic performance standard will have little effect on most tax returns. The final rules essentially provide that the time value of money only becomes significant, and deductions are deferred, where economic performance occurs outside of the 81/2-month rule.

The only significant question as to consistency between the statute and the Regulations is the failure of payments to third parties (for assumption of the taxpayer's liability to provide goods or services) to satisfy the economic performance rules. The time value of money does not seem to be of concern, since no overstatement of expenses occurs where payment is made in the year of deduction. The true economic cost of an expense is the payment, and there seems to be little justification for concluding that economic performance might occur in some later period. Other mechanisms, e.g.,

the deferred expense and capitalization rules, address the problem of accelerating deductions, and it is doubtful that Congress ever intended the economic performance rules to replace such rules as a means of dealing with expense prepayments. Unfortunately, taxpayers paying third parties to assume liabilities now will have to litigate the issue or seek remedial legislation or rulings.

1

See Schneider and Solomon, "Do New Prop. Regs. on Economic Performance Mean End of Accrual Method?," .

2

See, e.g., Molsen, 85 TC 485 .

3

See Reg. 1.461-7, Example 3 .

4

See Notice 89-15, 1989-1 CB 634 .

5

See New York State Bar Association Tax Section, Committee on Alternative Minimum Tax, "Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions," 49 Tax Notes 883 (11/19/90).

6

See Associated Patentees, 4 TC 979 .

7

See Reg. 1.461-4(g)(8), Example 6 .

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