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Be Wary of Relying on Recent Tax Decisions for Recent Transactions

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At issue in *Continuing Life Thousand Oaks, LLC. v. Commissioner*,[1] affirmed May 21, 2024, was the year of inclusion in gross income of an income item. The disputed years were 2008, 2009, and 2010 -- taxable years that preceded the effective date of the Tax Cuts and Jobs Act of 2017.[2] For these taxable years, an item was included in gross income of an accrual method taxpayer if all events established the right to the income item and the amount of the inclusion could be determined with reasonable accuracy (the "All-Events test").[3] With enactment of the Tax Cuts and Jobs Act, the analysis of inclusion for taxpayers having applicable financial statements changed.

Facts: The taxpayer in *Continuing Life* provided living arrangements for aged persons. An applicant applying for residency was required to pay the taxpayer an upfront entry fee, amounting to several hundred thousand dollars. The agreement between the taxpayer and a resident permitted the taxpayer to retain a portion of the upfront fee when the resident died (the "Deferred Fee"). The amount of the Deferred Fee increased from 0% to a maximum of 25% of the upfront fee after the resident had remained in the facility for four years. The taxpayer was obligated to provide care for the lifetime of the resident. When the resident died, the taxpayer refunded the upfront front fee minus the Deferred Fee to the resident's estate.

Court Decision: The Commissioner asserted that the Deferred Fee – generally 25% of the upfront fee that a resident had remitted on entry – was includable in the taxpayer's income when the resident had been in the facility for four years even though the resident had not died. The Tax Court and Ninth Circuit rejected the Commissioner's argument because until the resident died, the taxpayer had not fulfilled its promise to provide lifetime care, and until that time all events had not occurred to establish the taxpayer's right to any portion of the Deferred Fee.

The Tax Cuts and Jobs Act: The Tax Cuts and Jobs Act amended the rule for income inclusion for tax years beginning on and after January 1, 2021. The amendment may well change the analysis about whether the Deferred Fee is includable in taxable income. The rule now provides that if a taxpayer uses an accrual method of accounting,[4] then the all-events test with respect to any item of gross income (or portion thereof) is not treated as met any later than when such item (or portion thereof) is taken into account as revenue in an applicable financial statement of the taxpayer. An applicable financial statement generally is a financial statement certified as prepared in accordance with generally accepted accounting principles and used for reports to shareholders, partners, or for other substantial nontax purposes.[5]

Continuing Life's Accounting Method: The taxpayer in *Continuing Life* did not recognize any income in its financial statement upon receipt of the upfront fee. But as each year passed, the taxpayer amortized and recognized as income a portion of the Deferred Fee by using the straight-line method and the actuarially determined estimated life of each resident. Since a resident's life expectancy in the current year generally is one year less than the life expectancy in the preceding year, the amount that is deferred is smaller because the resident's life expectancy is one year less. For financial statement purposes, the taxpayer credited income each year in an amount equal to the reduction in the deferred income. When the resident died, the taxpayer recognized the remaining unamortized Deferred Fee as income.

Practice Pointer: Rote reliance on the May 2024 decision in *Continuing Life* to defer income for taxable years beginning on an after January 1, 2021, may be flawed because the issue should be reanalyzed under the financial statement accounting method required by the Tax Cuts and Jobs Act. The Tax Court and Ninth Circuit concluded that

the taxpayer did not have an enforceable right to the Deferred Fee.

Notably, the Committee Report accompanying enactment of the financial statement accounting method provides that the financial statement accounting method was not intended to change the realization rule:

"The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred."[6]

Consistent with the Committee Report, the Treasury Department published a regulation that excludes from financial statement income an item for which the taxpayer does not have an enforceable right:

"If AFS [applicable financial statement] revenue includes an amount the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year (regardless of whether the customer actually terminates the contract), AFS revenue is reduced by such amount."[7]

If the Deferred Income is not realized – meaning no enforceable right – then the taxpayer in *Continuing Life* would appear to be able to exclude it from financial statement income, which, following a convoluted path, takes the taxpayer back to the decisions of the Tax Court and Ninth Circuit.

[1] T.C. memo 2022-47, *aff'd*, 2024-15165 (9th Cir. May 21, 2024).

[2] Pub. Law 115-97, generally effective for purposes of *Continuing Life* for taxable years beginning on and after January 1, 2021.

[3] Treas. Reg. §1.451-1(a) ("General rule").

[4] An accrual method of accounting relies on the All-Events Test, Treas. Reg. §1.446-1(c)(1)(ii).

[5] IRC §451(b)(3); Treas. Reg; §1.451-1(b).

[6] Committee Report for HR115-466, PL115-97 (Conference), Tax Cuts and Jobs Act [H. Rept. 115-466 12/15/2017].

[7] Treas. Reg. §1.451-3(b)(*2*)(i)(A)(2).