

## Part I

### Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461-4: Economic performance.

Rev. Rul. 2012-1

#### ISSUES

Under the situations described below:

(1) Is the amount of X's liability material for purposes of the recurring item exception in §461(h)(3) of the Internal Revenue Code if the liability accrues over more than one taxable year for financial accounting purposes?

(2) For purposes of the recurring item exception, does the accrual of X's liability over more than one taxable year result in better matching of the liability with related income if X generates the related income in its trade or business over more than one taxable year and the liability accrues over more than one taxable year for financial accounting purposes?

(3) Is X's liability that arises under a service contract properly characterized as a "liability arising out of the provision of services" under § 1.461-4(d)(2), rather than a "liability arising out of the provision of a warranty or service contract" under § 1.461-4(g)(5)?

(4) Does the recurring item exception apply to X's liability to provide services pursuant to a service contract that is characterized as a "liability arising out of the provision of services" under § 1.461-4(d)(2)?

#### FACTS

X is a corporation that uses an accrual method of accounting, including the recurring item exception provided in § 461(h)(3) and § 1.461-5, for federal income tax purposes. X files its federal income tax returns on a calendar year basis and prepares annual financial statements in accordance with generally accepted accounting principles.

On July 1, 2011, X enters into a one-year lease agreement for property it will use in its trade or business to generate income over the period of the lease. The lease of the property begins on July 1, 2011, and continues through June 30, 2012. The terms of the lease agreement require X to pay \$50,000, the entire balance of the lease liability, on July 1, 2011, and X pays the \$50,000 on that date. X's financial statements account for the lease agreement by recognizing the \$50,000 expense ratably over the one-year period of the lease.

In conjunction with entering into the lease agreement, X also enters into a one-year service contract with a maintenance company unrelated to the lessor of the

property. The service contract begins on July 1, 2011, and continues through June 30, 2012. Under the terms of the service contract, the maintenance company will inspect and clean the leased property monthly and provide any necessary repair and maintenance services relating to the normal wear and tear or routine maintenance of the property. The services to be provided to X under the service contract are general services to be provided on an ongoing and recurring basis. The terms of the service contract require X to pay \$2,400, the entire balance of the liability, on July 1, 2011, and X pays the \$2,400 on that date. X's financial statements account for the service contract by recognizing the \$2,400 expense as the services are provided over the one-year period of the contract.

X reasonably expects that it will enter into similar leases and service contracts on a recurring basis in the future.

#### LAW

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and generally taken into account for federal income tax purposes, in the taxable 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 (requirements (1) and (2) are collectively referred to as the "all events test"), and (3) economic performance has occurred with respect to the liability. See *also* § 1.446-

1(c)(1)(ii)(A). All the events have occurred that establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is due, whichever happens earliest. Rev. Rul. 2007-3, 2007-1 C.B. 350; Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, *amplified by* Rev Rul. 2003-90, 2003-2 C.B. 353.

Section 461(h)(1) and § 1.461-4(a)(1) provide that, for purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 1.461-4(d)(2)(i) provides that 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.

Section 1.461-4(d)(3)(i) provides that if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property.

Section 1.461-4(g)(5) provides that if the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances. Section 1.461-4(g)(5)(i).

Section 461(h)(3)(A) and § 1.461-5(b) provide a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a timely return (including extensions) for the taxable year, or (b) the 15th day of the ninth calendar month after the close of the 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 in the 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. Section 461(h)(3)(B) provides that in making a determination under the materiality and matching requirements, the treatment of the liability on financial statements shall be taken into account.

Section 1.461-5(b)(4)(i) provides that in determining whether a liability is material, consideration is given to the amount of the liability in absolute terms and in relation to the amount of other items of income and expense attributable to the same activity. Section 1.461-5(b)(4)(ii) provides that a liability is material if it is material for financial statement purposes under generally accepted accounting principles. Section 1.461-5(b)(4)(iii) provides that a liability that is immaterial for financial statement purposes under generally accepted accounting principles may be material for purposes of the materiality requirement of the recurring item exception.

Section 1.461-5(b)(5)(i) provides that in determining whether the matching requirement of the recurring item exception is satisfied, generally accepted accounting principles are an important factor, but are not dispositive. Section 1.461-5(b)(5)(ii) provides that in the case of a liability described in § 1.461-4(g)(5) (insurance, warranty or service contract), the matching requirement of the recurring item exception is deemed satisfied.

## ANALYSIS

### *Lease liability*

On July 1, 2011, all the events have occurred that establish the fact of X's lease liability (because X's payment is due under the lease agreement on that date) and the amount of the lease liability can be determined with reasonable accuracy. Because the lease liability arises out of the use of property provided to X, economic performance occurs ratably over the period of time that X is entitled to use the property. Section 1.461-4(d)(3)(i). Therefore, unless the recurring item exception applies, X's lease liability is incurred ratably over the one-year lease period beginning July 1, 2011 and ending June 30, 2012.

To apply the recurring item exception to its lease liability, X must, in part, demonstrate either that the lease liability is immaterial or that recognizing the liability in a year prior to the ratable use of the property results in a better matching of the expense to the related income. In determining whether a liability is immaterial, the legislative history of the recurring item exception provides:

If an item is considered material for financial statement purposes, it will also be considered material for tax purposes. For example, assume that a calendar-year taxpayer enters into a one-year maintenance contract on July 1, 1985. If the amount of the expense is prorated between 1985 and 1986 for financial statement purposes, it should be prorated for tax purposes. If, however, the full amount is deducted in 1985 for financial statement purposes because it is not material under generally accepted accounting principles, it may (or may not) be considered an immaterial item for purposes of [the recurring item] exception.

H.R. Conf. Rep. 98-861, at 874 (1984) (original formatting omitted). The example in the legislative history makes clear that a liability is material under the recurring item exception if it is deemed sufficiently material for financial statement purposes so that it accrues over more than one taxable year.

Consistent with the legislative history, and with the directive in § 461(h)(3)(B) that the treatment of a liability on financial statements be taken into account, § 1.461-5(b)(4)(ii) provides that a liability is material if it is material for financial statement purposes under generally accepted accounting principles. Because X's lease liability accrues over more than one taxable year for financial statement purposes under generally accepted accounting principles, the lease liability is material for purposes of applying the recurring item exception. Therefore, to apply the recurring item exception to its lease liability, X must demonstrate that recognizing the liability in a year prior to the ratable use of the property results in a better matching of the liability to the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs.

In determining whether the matching requirement of the recurring item exception is satisfied, the treatment of a liability on financial statements must be taken into

account. Section 461(h)(3)(B). Generally accepted accounting principles are an important factor, but are not dispositive. Section 1.461-5(b)(5)(i). Accruing a liability over more than one taxable year results in better matching than accrual in a single, earlier year if: (1) the liability accrues over more than one taxable year for financial accounting purposes under generally accepted accounting principles; (2) the liability relates to income that a taxpayer generates in its trade or business over more than one taxable year; and (3) there are no overriding facts or circumstances that indicate accrual of the full liability in the earlier year results in a better match with the income.

X has determined that under generally accepted accounting principles, its lease liability should be recognized ratably over the period of the lease, and thus accrues the liability on its financial statements over the period of the lease. Furthermore, X uses the leased property in its trade or business to generate income over the period of the lease. In addition, absent overriding facts or circumstances that indicate that accrual in the earlier year would result in better matching, the accrual of the lease liability in a year prior to the satisfaction of economic performance will not result in a better matching of the liability with the related income as compared to accruing the liability for the taxable year in which economic performance occurs. Because X's lease liability is material under § 1.461-5(b)(1)(iv)(A), and because it does not satisfy the matching requirement of § 1.461-5(b)(1)(iv)(B), X cannot use the recurring item exception to treat its lease liability as incurred in 2011.

*Service Contract Liability*



On July 1, 2011, all the events have occurred that establish the fact of X's service contract liability (because X's payment is due under the service contract on that date) and the amount of the service contract liability can be determined with reasonable accuracy. The applicable economic performance rule depends on whether the service contract liability arises out of the provision of services to X under § 1.461-4(d)(2)(i) (a "service liability"), or whether the liability arises out of the provision to X of a warranty or service contract under § 1.461-4(g)(5) (a "payment liability"). Further, the matching requirement of the recurring item exception applies differently depending on whether the service contract liability is a service liability under § 1.461-4(d)(2)(i) or a payment liability under § 1.461-4(g)(5).

Section 1.461-4(g)(5)(i) defines a warranty or service contract as a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances. The term "specified circumstances" implies the occurrence of a unique or irregular circumstance necessitating the repair or replacement of property. Thus, the warranty and service contracts contemplated in § 1.461-4(g)(5) are similar to insurance contracts, which also are characterized by the occurrence of a unique or irregular circumstance necessitating the repair or replacement of property. The regulations recognize this similarity by treating insurance, warranty contracts, and service contracts collectively as a single category of payment liability under § 1.461-4(g)(5).

The service contracts addressed in § 1.461-4(g)(5)(i) are distinguishable from contracts for general services that are provided on an ongoing and recurring basis. This distinction is reinforced in the deemed matching rule of § 1.461-5(b)(5)(ii), which provides that the matching requirement is deemed satisfied only for certain payment liabilities, including service contract liabilities addressed in § 1.461-4(g)(5). Deemed matching for these types of liabilities is appropriate because a liability is triggered only by the occurrence of a unique or irregular circumstance. In contrast, a deemed matching rule would be inappropriate for services that are performed on an ongoing and recurring basis and contribute to the taxpayer's income-generating activities over a certain period.

The services to be provided to X under the terms of the service contract are general services to be provided on an ongoing and recurring basis rather than services to be provided only in "specified circumstances." Therefore, X's service contract liability is a service liability under §1.461-4(d)(2)(i), rather than a payment liability under §1.461-4(g)(5), for purposes of applying the economic performance rules. Accordingly, under § 1.461-4(d)(2), economic performance of X's service contract liability occurs as the services are provided to X over the term of the contract.

To apply the recurring item exception to its service contract liability, X must, in part, demonstrate either that its liability is not material or that recognizing the liability in a year prior to the performance of the services results in a better matching of the expense to the related income. In determining whether a liability is not material, § 461(h)(3)(B) provides that financial statement treatment is considered, and both the legislative

history of § 461(h)(3) and § 1.461-5(b)(4)(ii) provide that a liability is material if it is material for financial statement purposes under generally accepted accounting principles. Because X's service contract liability accrues over more than one taxable year for financial statement purposes under generally accepted accounting principles, the liability is material for purposes of applying the recurring item exception. Therefore, to apply the recurring item exception to its service contract liability, X must demonstrate that recognizing the liability in a year prior to the performance of the services results in a better matching of the liability to the income to which it relates than would result from accruing the liability in the taxable year in which economic performance occurs. The deemed matching rule for certain payment liabilities in §1.461-5(b)(5)(ii) does not apply to X's service contract liability because X's liability does not arise out of the provision of a warranty or service contract under §1.461-4(g)(5).

In determining whether the matching requirement of the recurring item exception is satisfied, generally accepted accounting principles are an important factor, but not dispositive. Section 1.461-5(b)(5)(i). Under generally accepted accounting principles, X has determined that its service contract liability should be recognized as services are provided over the period of the contract. Furthermore, the services provided to X are used in the ongoing operation of X's trade or business to generate income over the period of the contract. Absent any other overriding facts or circumstances that would indicate better matching, the accrual of the service contract liability in a year prior to the satisfaction of economic performance will not result in a better matching of the liability with the related income as compared to accruing the liability for the taxable year in

which economic performance occurs. Because X's service contract liability is material under § 1.461-5(b)(1)(iv)(A), and because it does not satisfy the matching requirement of § 1.461-5(b)(1)(iv)(B), X cannot use the recurring item exception to treat its service contract liability as incurred in 2011.

Some contracts call for services to be performed on a recurring basis and for additional performance to be provided only in "specified circumstances." This revenue ruling does not address the tax treatment for a mixed service and warranty contract.

#### HOLDINGS

(1) For purposes of the recurring item exception in § 461(h)(3), the amount of X's lease liability is material.

(2) For purposes of the recurring item exception, the accrual of X's lease liability over more than one taxable year results in better matching of the liability with related income.

(3) X's service contract liability is properly characterized as a liability arising out of the provision of services to the taxpayer under § 1.461-4(d)(2), rather than as a liability arising out of the provision to the taxpayer of a warranty or service contract under § 1.461-4(g)(5).

(4) The recurring item exception does not apply to X's service contract liability.

#### APPLICATION

Any change in a taxpayer's method of accounting to conform to any of the holdings in this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer that

wants to change its method of accounting to conform to any of the holdings in this ruling must follow the automatic change in accounting method provisions of Rev. Proc. 2011-14, 2011-4 C.B. 330, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2011-14 do not apply to a taxpayer that wants to make the change for its first taxable year ending on or after December 13, 2011, provided an issue is not under consideration, as defined in section 3.09 of Rev. Proc. 2011-14, regarding whether all the events have occurred that establish the fact of the liability; and

(2) For purposes of section 6.02(4) of Rev. Proc. 2011-14, the taxpayer must include on line 1a of the Form 3115 the designated automatic accounting method change number "161."

#### EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2011-14 is modified and amplified to include this automatic change in section 19 of the APPENDIX.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Charles H. Kim of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Charles H. Kim at (202) 622-5020 (not a toll free call).