WNTS Insight

A Washington National Tax Services (WNTS) Publication

February 2, 2012

IRS clarifies issues related to recurring item exception to economic performance requirement

Rev. Rul. 2012-1, recently issued by the IRS, clarifies whether certain lease and service contract liabilities are eligible for the section 461(h)(3) recurring item exception to the economic performance requirement regarding when a liability is incurred for federal tax purposes.

Background

Under Reg. sec. 1.461-1(a), a liability generally is treated as incurred for federal income tax purposes when all 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 regulations provide an exception to the economic performance requirement for certain types of liabilities that are recurring in nature.

Under the recurring item exception, a liability is treated as incurred for a particular tax year if:

- All events have occurred that establish the fact of the liability, and the amount can be determined with reasonable accuracy;
- Economic performance occurs on or before the earlier of (a) the date that the taxpayer files a timely return (including extensions) for the tax year or (b) within 8 ½ months after the close of the tax year;
- The liability is recurring in nature; and
- Either (a) the liability is not material or (b) the accrual of the liability for the particular tax 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 tax year in which economic performance occurs ("matching requirement").

With respect to application of the recurring item exception, Rev. Rul. 2012-1 provides guidance as to when a liability is considered material and as to what constitutes a maintenance contract.

Lease liability

In the first scenario examined in the revenue ruling, the taxpayer enters into a one-year lease agreement on July 1, 2011, for the use of the property in its trade or business to generate income over the lease term, July 1, 2011, through June 30, 2012. The agreement requires the taxpayer to pay $50,000, the entire balance of the lease liability, on July 1, 2011, and the taxpayer pays the $50,000 on that date. The taxpayer's financial statements account for the lease agreement by recognizing the $50,000 expense ratably over the one-year period of the lease.

Rev. Rul. 2012-1 concludes that economic performance occurs with respect to the lease payment ratably over the period that the taxpayer is entitled to use the property. That is, the taxpayer's lease liability is incurred over the one-year lease period from July 1, 2011, through June 30, 2012. Therefore, the $50,000 lease liability would be deductible in the year of payment only if the recurring-item exception were to apply. The ruling recognizes that for the recurring item exception to apply to the lease liability, the taxpayer must be able to demonstrate that either the lease liability is not material or that accrual of the liability in the year of payment would result in a better matching of income to expense.

In concluding that the amount was material, the ruling noted that under generally accepted accounting principles, the taxpayer's lease liability was accrued over more than one tax year. The ruling effectively concludes that if a taxpayer accrues an expense over more than one tax year for financial statement purposes, the amount of the expense will be considered material for purposes of the recurring item exception. The ruling also looked to the taxpayer's financial statement treatment of the lease liability to conclude that accruing the lease liability in the year of payment would not result in a better matching of income to expense. Therefore, the IRS concluded that the recurring item exception did not apply; hence, the $50,000 payment was not deductible in the year of payment.

Observations: Generally accepted accounting principles are an important factor in determining the application of the recurring item exception. In particular, the IRS looked to the financial statement treatment of the item to determine whether the item was considered material as well as whether accruing the expense in the prior year resulted in better matching. In effect, the IRS rejected the argument that the concept of a material item under the recurring item exception is something akin to the concept of materiality for financial statement audit purposes. Instead, the IRS concluded that if the taxpayer has determined that the item is sufficiently material to account for the costs over different reporting periods, the item will be presumed to be a material item for purposes of applying the recurring item exception.

Service contract liability

The second scenario described in the revenue ruling addresses a one-year service contract entered into by the taxpayer in conjunction with the lease agreement; the service contract was with a maintenance company unrelated to the lessor of the property. The maintenance service contract covers the same period as the lease (July

1, 2011, 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 the taxpayer under the service contract are general services to be performed on an ongoing and recurring basis. The taxpayer is required to pay $2,400 -- the entire amount of the liability -- on July 1, 2011, and the taxpayer pays the $2,400 on that date. The taxpayer'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. Lastly, the taxpayer reasonably expects that it will enter into similar leases and service contracts on a recurring basis in the future.

When economic performance occurs with respect to the service contract liability described in the revenue ruling depends on whether the liability arises out of the "provision of services" or the "provision of a warranty or service contract." (See Reg. secs. 1.461-4(d)(6), 1.461-4(g)(5).) If the liability arises out of the provision of services, economic performance occurs as the services are performed ("service liability"). In contrast, economic performance occurs as payments are made in the case of a liability that arises out of the provision of a warranty or service contract to the taxpayer ("payment liability").

Rev. Rul. 2012-1 concludes that only liabilities that are similar to insurance contracts and "characterized by the occurrence of unique or irregular circumstances necessitating the repair or replacement of property" may be treated as payment liabilities (that is, liabilities arising out of the provision of a warranty or service contract.) Because the services to be provided to the taxpayer under the facts of the revenue ruling were services to be provided on an ongoing and recurring basis rather than in "specified circumstances," Rev. Rul. 2012-1 concludes that the taxpayer's service contract liability was a service liability, not a payment liability.

Consistent with the IRS analysis of the lease, in order for the recurring item exception to apply to the service contract liability, the taxpayer must, in part, demonstrate either that the service contract liability is not material or that the accrual of the liability in 2011 would result in a better matching of the liability with the income to which it relates than would result from accruing the liability as the services are performed. Because the taxpayer's service contract liability accrues over more than one tax year for financial statement purposes under generally accepted accounting principles, Rev. Rul. 2012-1 concludes that the service contract liability was material for purposes of applying the recurring item exception.

In addition, because of the treatment of the service contract liability on the taxpayer's financial statements and the fact that the services provided to the taxpayer are used in the ongoing operation of the taxpayer's trade or business to generate income over the period of the contract, the revenue ruling also concludes that the accrual of the service 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 tax year in which economic performance occurs. Therefore, the IRS concluded that the recurring item exception did not apply; hence, the $2,400 payment was not deductible in the year of payment.

Observation: The revenue ruling summarily concludes that the types of services provided to the taxpayer under the service contract would not result from the occurrence of "unique or irregular circumstances necessitating the repair or replacement of property." However, taxpayers with service contract liabilities that more closely resemble traditional warranty contracts may meet the economic performance requirement at the time of payment, and thus avoid the need to rely on the recurring item exception.

In certain specified cases (such as with respect to rebates and refunds) in which payment is due in a particular year but not paid until future years, the payor still may be eligible to use the recurring item exception because the better-matching test is deemed to be satisfied for these type of liabilities. Reg. sec. 1.461-5(b)(5)(ii).

For example, while computer software maintenance contracts may provide for services that are performed on an ongoing and recurring basis, such contracts typically also agree to replace or repair the software if it fails to operate based on the occurrence of a unique or irregular circumstance, indicating that such liabilities are more like a warranty or maintenance liability (payment liability) rather than a liability to provide services (service liability). Hence, the taxpayer may be eligible to use the recurring item exception with respect to this liability.

***Observation*:** While the new ruling addresses certain service contracts, it does not address mixed-service contracts in which products and services are provided, and the products provided are "not incidental" to the services performed. Thus the ruling does not eliminate uncertainty regarding the timing of the deduction of costs related to mixed-service contracts.

Accounting method changes

A taxpayer that wishes to change its method of accounting to comply with the holdings described in Rev. Rul. 2012-1 may file an automatic method change under Rev. Proc. 2011-14. The scope limitations do not apply to a taxpayer that wishes to change its method of accounting for the first tax year ending on or after December 13, 2011, provided that the question of whether the all-events test has been met is not an issue under consideration.

For more information, please contact:

Jim Connor	*(202) 414-1771*	*james.e.connor@us.pwc.com*
Jennifer Kennedy	*(202) 414-1543*	*jennifer.kennedy@us.pwc.com*
Dennis Tingey	*(602) 364-8107*	*dennis. tingey@us.pwc.com*

Link to WNTS Insight archive: http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml