

WNTS Insight

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Tax Court addresses prepaid service contract issues

A taxpayer that accelerates into the current year a payment under a service contract may be able to deduct the payment in that year in reliance on the "3 1/2-month rule." That rule allows a taxpayer to treat the economic performance requirement as having been met at the time of the prepayment if the taxpayer reasonably expected the services to be provided within 3 1/2 months after the date of payment.

A recent Tax Court decision provides insight on how the IRS and courts may analyze issues under the rule. Taxpayers may need to consider the structure of the service contract and how the 3 1/2-month rule applies in determining the proper tax treatment of payments under the contract.

Background: The 3 1/2-month rule

A liability generally is incurred and taken into account for federal income tax purposes in the taxable year in which:

- 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.

Economic performance with respect to the provision of services generally occurs as the services are provided. A taxpayer may treat services as provided to the taxpayer as the taxpayer makes payment to the service provider if the taxpayer can reasonably expect the person to provide the services within 3 1/2 months after the date of payment. Application of the 3 1/2-month rule has been a subject of controversy between taxpayers and the IRS and raises several issues.



The Caltex decision

In addressing the proper year for claiming certain deductions, the Tax Court in *Caltex Oil Venture v. Commissioner* focused on the economic performance requirement of section 461(h) and the regulations thereunder and considered whether the 3 1/2-month rule may apply.

Caltex, an accrual-basis partnership, entered into a "turnkey" contract in December 1999 for another party to drill two oil and gas wells. Site preparation and other activities occurred in 1999, but actual drilling did not commence within 90 days after the end of that year, as was specified in the contract. Caltex claimed on its 1999 federal income tax return a deduction for the full amount paid under the contract as intangible drilling costs (IDCs). The IRS issued an adjustment on the basis that Caltex was not permitted the IDC deduction because the economic performance requirement had not been satisfied.

The Tax Court agreed with the IRS that under the general rule of section 461(h), the IDCs did not satisfy the economic performance requirement, but considered whether any exception to the general rule applied. First, the court determined that Caltex was not entitled to the special timing rule of section 461(i)(2)(A) (the "90-day rule"). Under that rule for oil and gas tax shelters, a taxpayer may deduct IDCs in full prior to economic performance if "drilling of the well commences" within 90 days after the close of the tax year in which the taxpayer prepaid the IDCs and for which the taxpayer is seeking to claim the deduction.

The court next considered whether Caltex was entitled to a partial deduction for IDCs for 1999 under the 3 1/2-month rule. The IRS asserted that the 3 1/2-month rule could not be invoked, arguing that under a non-severable contract all the services called for must reasonably be expected to be performed within the required time. Caltex, however, contended that it was entitled to a deduction for the portion of the contracted services that was reasonably expected to be performed within 3 1/2 months of payment.

The Tax Court concluded that the 3 1/2-month rule contemplates that all the services called for under an undifferentiated, non-severable contract must be provided with 3 1/2 months of payment. Because the court held that the contract at issue was a non-severable contract and that Caltex did not reasonably expect all services to be performed within 3 1/2 months of payment, Caltex was not entitled to utilize the 3 1/2-month rule and could not treat the economic performance requirement with respect to any of the services due under the contract as having been met in 1999.

Caltex provides useful guidance on when a contract is divisible

The *Caltex* decision makes clear that whether the 3 1/2-month rule applies depends initially on whether the contract is divisible. A divisible contract must be divided into its parts before applying the 3 1/2-month rule. If a part of a divisible contract has been paid for in year one, and the services related to that part of the contract can reasonably expect to be performed within 3 1/2 months of payment, the taxpayer should be permitted to treat the liability for that portion of the contract as incurred at the time of payment.

In analyzing the issue of divisibility, the Tax Court noted that the IRS has acknowledged a distinction between the turnkey contract at issue in *Caltex* and a

contract that provides for differentiated or severable services to be performed under a single contract. The IRS has conceded in this case that for a severable contract, economic performance occurs separately with regard to each distinct service that was contracted for as that service is provided. In a footnote in *Caltex*, the Tax Court stated that, "[w]here several things are to be done under a contract, and the money consideration to be paid is apportioned to each of the items, the contract is ordinarily regarded as severable." Conversely, "if the consideration to be paid is single and entire, the contract will ordinarily be held as entire" even though the subject may consist of multiple distinct and independent items.

Observations

Based on the Tax Court's position in *Caltex*, as expressed in the footnote discussed above, taxpayers that make prepayments for services must determine first whether the prepayment is for a specific service under the contract, and whether money consideration is apportioned to that item. If so, the taxpayer then must determine whether it is reasonably expected that the services that were prepaid for will be provided within 3 1/2 months of payment. If so, economic performance occurs at the time of payment.

Note: Taxpayers that have not previously used the 3 1/2-month rule should analyze whether they must request an accounting method change (on Form 3115, *Application for Change in Accounting Method*) to begin using the 3 1/2-month rule.

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