REPORT #673

TAX SECTION

New York State Bar Association

Report on Proposed Regulations
Relating to
Economic Performance Requirements

November 7, 1990

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TAX SECTION

New York State Bar Association

November 14, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington", D.C. 20024

Dear Commissioner Goldberg:

I enclose our Report on the Proposed Regulations Relating to the Economic Performance Requirements of section 461(h). The principal authors of the Report are David H. Bamberger and Franklin L. Green, Co-Chairmen of the Committee on Tax Accounting Matters.

Our Report recommends, for a number of reasons, that economic performance should always be deemed to occur no later than the time of payment. We believe this recommendation is consistent with and supported by the legislative history of section 461 (h) of the Internal Revenue Code.

The Report also makes a number of other comments including, among others, suggestions relating to (i) clarification and expansion of the scope of the deemed payment rule of section 1.461-4(g) (1) (ii) (C) (1) of the Proposed Regulations, (ii) the application of the economic performance rules to section 461 (f) funds and the taxation of those funds and (iii) the definition of payment for purposes of the economic performance rules.

We trust that this Report will be useful to you in preparing final Regulations pursuant to section 461 (h).

Very truly yours,

Arthur A. Feder
Chair

Enclosure

Identical letter to:

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON TAX ACCOUNTING MATTERS

Report on Proposed Regulations Relating to Economic Performance Requirements

November 7, 1990

I
INTRODUCTION

This Report of the Committee on Tax Accounting Matters (the "Committee") of the Tax Section of the New York State Bar Association[1] comments on the proposed regulations with respect to section 461(h)[2] which were issued with a notice of proposed rulemaking published in the Federal Register on June 7, 1990.

1. Proposed Regulations Summary. On June 7, 1990, the Internal Revenue Service (the "Service") published in the Federal Register (55 Fed. Reg. 23,235 (1990)) a notice of proposed rulemaking (the "Notice") and proposed regulations (the "Proposed Regulations") under section 461(h), relating to the economic performance requirement, added to the Code by the Tax Reform Act of 1984 (the "1984 Act").

Section 461(h) established an economic performance standard as a third requirement to the "all events test" for determining the taxable year in which an item may be treated as incurred by a taxpayer using the accrual method of accounting. Before the 1984 Act, the all events test was satisfied when all the events occurred that determined the fact of a liability and the amount of liability could be determined with reasonable accuracy. Section 461(h) added the requirement that the all events test will not be treated as satisfied prior to the taxable year in which economic performance occurs with respect to the liability. This requirement apparently applies to any item allowable as a deduction or capitalized in the

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[1] The members of the Committee principally involved in the preparation of this Report were David H. Bamberger and Franklin L. Green, Co-Chairmen; and Doron I. Loeser and Elliot Pisem. Helpful comments were received from Arthur A. Feder, Kendyl K. Monroe, James M. Peaslee and Richard L. Reinhold.

[2] Except as otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to proposed, temporary, or final regulations thereunder.

taxable year incurred, except for certain items for which the Code provides alternative timing rules.

The Proposed Regulations modify and clarify the statutory rules concerning when economic performance occurs in the case of property, services or the use of property provided to or by a taxpayer. In the case of property or services provided to or for use by a taxpayer by another person, the statutory rule provides that economic performance occurs as the property or services are provided by that other person or as the taxpayer uses the property. The Proposed Regulations contain provisions designed to facilitate a taxpayer's determination of when property or services are provided to the taxpayer. For example, a taxpayer may treat property or services as provided to the taxpayer as the taxpayer makes payment for the property or services, provided that the taxpayer can reasonably expect the property or services to be provided within 3-1/2 months after payment is made (the "Prepayment Exception"). Prop. Treas. Reg. § 1.461-4(d)(5)(ii). The Proposed Regulations also provide that in the case of a taxpayer's liability arising out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to use the property. Prop. Treas. Reg. § 1.461-4(d)(3).

In the case of a taxpayer's liability to provide property or services, the statutory rule provides that economic performance occurs as the taxpayer provides such property or services. The Proposed Regulations provide that economic performance occurs in that event as the taxpayer incurs costs in connection with the liability. Prop. Treas. Reg. § 1.461-4(d)(4)(i). An example in the Notice specifies that an equipment manufacturer who contracts to provide a machine to a corporation is to treat the costs of property, services and the use of property necessary to make the machine as economically performed as those costs are incurred, rather than when the manufacturer provides the machine to the purchasing corporation. The rationale for this rule, the Notice states, is that these costs, and not the underlying liability to provide the property or services, are generally I allowable as an expense for Federal income tax purposes.

The Proposed Regulations provide special rules for the occurrence of economic performance in the cases of longterm contracts, Prop. Treas. Reg. § 1.461-4(d)(2)(ii), barter transactions, Prop. Treas. Reg. § 1.461-4(d)(4)(ii), and services or property provided as an incident to other services or property, Prop. Treas. Reg. § 1.461-4(d)(5)(iv). In the case of interest, the rules provide that economic performance occurs as the interest expense economically accrues, in accordance with the principles of other relevant Code provisions. Prop. Treas. Reg. § 1.461-4(e). The Service, how-ever, reserved as to the treatment of prepaid interest, Prop.Treas. Reg. § 1.461-3, and liabilities under notional principal amount contracts, Prop. Treas. Reg. § 1.461-4 (f)[3] .

The statute provides that economic performance will not occur with respect to workers' compensation or tort liabilities before such liabilities are paid. The Proposed Regulations identify specific types of liabilities, in addition to workers' compensation act or tort liabilities, for which payment must also, be made for economic performance to occur. Prop. Treas. Reg. § 1.461-4(g). These liabilities include: liabilities arising out of a breach of contract or a violation of law; rebates and refunds; awards, prizes and jackpots; amounts paid for insurance, warranty and service contracts; and taxes and licensing fees, other than certain real

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[3] Notice 89-21, 1989-1 C.B. 651, issued on February 21, 1989, states that regulations will be issued under section 461 (along with other Code sections) requiring taxpayers to amortize payments made with respect to a notional principal contract over the life of the contract under methods to be prescribed by such regulations. Under Notice 89-21, payments with respect to notional principal contracts entered into before the effective date of the regulations (which will generally be prospective) will be treated as being accounted for under a method of accounting which clearly reflects income (as required by section 446(b)) only if such payments are taken into account over the life of the contract using a reasonable method of amortization.

estate taxes and creditable foreign taxes. Prop. Treas. Reg. § 1.461-4(g)(2)-(6). In addition, a "catch-all" rule provides that economic performance occurs as payment is made to the person to whom the liability is owed with respect to any liability not otherwise covered by section 461(h) or the regulations thereunder. Prop. Treas. Reg. § 1.461-4(g)(7).

For the purposes of determining the time of payment relating to (i) the Prepayment Exception and (ii) liabilities with respect to which economic performance occurs only upon payment, and for all other purposes of section 461(h) and the regulations thereunder, "payment" has the same meaning as for a cash-method taxpayer and includes the furnishing of cash or cash equivalents but not the furnishing of a note or other evidence of indebtedness of the taxpayer (regardless of any guarantee by any other instrument or third party) or a promise of the taxpayer to provide property or services in the future. Prop. Treas. Reg. § 1.461-4(g)(1)(ii)(A). Under the rules, a payment has not been made to another person unless a cash basis taxpayer in that person's position would be treated as having actually or constructively received payment under the principles of section 451. Prop. Treas. Reg. § 1.461-4(g)(1)(ii)(B).

The Proposed Regulations also provide that payment to a trust, escrow account, fund or any person other than the person to whom the liability is owed does not constitute economic performance. Prop. Treas. Reg. § 1.461-4(g)(l)(i). Exceptions, however, treat as economic performance payments to designated settlement funds under section 468B, certain "qualified funds" in cases of certain tort, workers' compensation or breach of contract liabilities, and assignees of certain personal injury liabilities under section 130. Prop. Treas. Reg. § 1.461-6.

The Proposed Regulations provide that if a purchaser of a taxpayer's "trade or business" (as defined using principles of section 355(b)) agrees to assume a liability of the business, the taxpayer is treated as making deemed payments of the liability for purposes of section 461(h) as the amount of the liability is included in the amount realized as a result of the sale by the taxpayer (the "Deemed Payment Rule"). Prop. Treas. Reg. § 1.461-4(g)(1)(ii)(C).

The Proposed Regulations modify the section 461(h)(3) "recurring item exception" to the general rule that economic performance must occur before an item may be treated as incurred. The statutory exception permits a taxpayer to treat an item as incurred during a taxable year if (i) the all events test (without regard to economic performance) is satisfied, (ii) economic performance occurs within the shorter of (a) a reasonable period after the close of the taxable year or (b) 8-1/2 months after the close of such taxable year, (iii) the item is recurring in nature and consistently treated as incurred in the taxable year in which the all events test is satisfied, and (iv) either (a) the item is not material or (b) the accrual of the item in the taxable year in which the all events test is met results in a better matching of the item with its related income item.

The Proposed Regulations modify the statutory exception by requiring that economic performance occur by the earlier of (i) 8-1/2 months after the close of the taxable year in which the all-events test is met or (ii) the date the taxpayer files a timely return for that taxable year (including extensions). Prop. Treas. Reg. § 1.461-5(b)(1). The Proposed Regulations permit an item to be deemed incurred if economic performance occurs after the return is filed but within the 8-1/2 month period and an amended return is filed after such economic performance. Prop. Treas. Reg. § 1.461-

5(b)(2). The Proposed Regulations also list liabilities (including therein those liabilities subject to the "catchall" rule of section 1.461-4(g)(7)), in addition to the statutory exceptions for workers' compensation and tort liabilities, to which the recurring item exception does not apply. Prop. Treas. Reg. § 1.461-5(c). The Proposed Regulations provide special rules defining the materiality and matching requirements. Prop. Treas. Reg. § 1.461-5(b)(4)-(5).

Finally, the Proposed Regulations provide rules for economic performance with respect to liabilities arising under the Nuclear Waste Policy Act of 1982, Prop. Treas. Reg. § 1.461-4(h), as well as provisions for the taxation of amounts transferred to an escrowee, trustee or court in connection with a contested liability under section 461(f), Prop. Treas. Reg. § 1.461-2(f). In addition, the Notice provides that estimated costs of future improvements to subdivided real estate may not be added to the basis of lots sold if economic performance has not occurred with respect to such costs before the sale. The Notice and Proposed Regulations also establish various effective dates and transitional rules.

2. Summary of Committee Recommendations. This Report contains the following principal recommendations:

a. Employee benefits. In the case of qualified and non-qualified deferred compensation plans and arrangements, the final regulations should explicitly provide that economic performance will be deemed to occur not later than the time contributions are made (qualified plans) or the time compensation income is realized (non-qualified arrangements). Also, the final regulations should permit the seller of a business to claim a compensation deduction for non-qualified deferred compensation liabilities assumed by the purchaser in connection with the sale of a business.

b. Clarification of the Deemed Payment Rule of Section 1.461-4(g)(1)(ii)(C)(1). While the Report does not address the tax treatment of the assumption of contingent liabilities in connection with a sale of a business, the Committee believes that> to the extent such contingent liabilities are included in the amount realized on the sale, the seller should be allowed to take those liabilities into account as an offsetting deduction or as an increase in basis. Alternatively, the final regulations could contain an explicit reservation as to the treatment of such assumed liabilities. The Committee also recommends that the Deemed Payment Rule be made expressly applicable to liabilities of the seller to provide property or services. Lastly, the Committee recommends that the scope of the Deemed Payment Rule be expanded to cover assumptions of liabilities in connection with any sale or exchange of business assets where the seller is required to include the assumed liabilities in income.

c. Interrelationship of section 461(h) and section 467. The provisions relating to the use of property are ambiguous and may be inconsistent with section 467 of the Code and the legislative history of section 461(h). The final regulations either should explicitly negate any implication that section 461(h) overrides section 467, at least in the case of leases of tangible property, or should discuss the interrelation between those two sections.

d. 461(f) funds. These provisions of the Proposed Regulations appear to achieve results which are either unwarranted or, at least, counter-intuitive. The Committee recommends that the final regulations should be considerably expanded to, among other things, explicate more clearly the principles involved so as to enable taxpayers to make rational tax planning decisions in dealing with contested liabilities.

e. Application of section 461(f) to tort claims and similar items. Section 1.461-2(a)(5) contains a reservation as to the issue of the application of section 461(f) to tort claims and other liabilities dealt with in section 1.461-4(g). The Committee recommends that the final regulations provide more specific guidance.

f. Third party payments. For a number of reasons, the Committee believes that, in the case of services or property to be provided to the taxpayer, economic performance should always be deemed to occur no later than payment by the taxpayer to the service or property provider. Similarly, in the case of services or property to be provided by the taxpayer, economic performance should always be deemed to occur no later than payment by the taxpayer to the persons who provide those services or property particularly where such payment operates to relieve the taxpayer of the-related obligation.

g. Definition of "payment". The Committee believes that furnishing a negotiable note is in many cases the economic equivalent of borrowing funds and making a cash payment and, accordingly, should also be treated as payment for purposes of section 461(h). The principles of section 1274 are readily available for the purpose of present valuing the amount of a payment represented by a negotiable note.

A number of other recommendations and suggestions are also contained in this Report.

II
DISCUSSION

1. Interaction between economic performance requirement and employee benefit provisions, including sections 83, 404 and 419 of the Code.

The Notice invites comment on this subject.

There is a tension in the Code between (i) section 461(h) and the Proposed Regulations which allow the cost of services provided to the taxpayer to be taken into account when the services are rendered[4] and (ii) section 83 (dealing with compensation paid in property other than cash), section 404 (dealing with deferred compensation), and section 419 (dealing with welfare benefit plans) (together, the "Compensation Sections") which often require payment before the payor may take into account otherwise accrued items[5]

The legislative history of section 461(h) indicates that it was not intended to override the Compensation Sections. H.R. Rep. No. 861, 98th Cong., 2d Sess. 877 (1984) (cited hereinafter as the "1984 Conference Report"); Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of H.R. 4170, 266-67 (Joint Comm. Print 1984)(cited hereinafter as the "1984 Blue Book"). Accordingly, section 1.461-l(a)(2)(iii)(A) appropriately provides in effect that any deferral rules of the Code (including explicitly section 404) take precedence over section 461(h). The Committee

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[4] Unless otherwise noted, it is generally assumed in the discussion in this Report that the other requirements of the "all events" test have been satisfied before "economic performance".

[5] Certain amounts payable to accrual method payees are taken into account without regard to the time of payment. Sections 83(h) and 404(a)(5) of the Code generally defer the time a payor of an item of compensation can take it into account until the year the payee takes it into income.

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suggests in this regard that the final regulations should contain an explicit statement similar to that now contained in section 1.461(h)-4T of the Temporary Regulations to the effect that economic performance will always be deemed to occur not later than (i) in the case of qualified plans, the time contributions are made to the plan and (ii) in the case of non-qualified arrangements (including section 404(a)(5) plans), the time the employee realizes compensation income. Transfers of property subject to section 83 probably should also be included in the latter category.

The Committee further believes that the section 461(h) final regulations may be utilized to deal with the following problem. Frequently when a business is sold (in either an asset sale or a stock sale with a section 338 election), employees are transferred to the purchaser (or deemed purchaser) who assumes economically accrued but unpaid nonqualified deferred compensation liabilities

("Assumed Compensation Liabilities") which because of the Compensation Sections have not yet been taken into account by the seller. It is possible, at least in some circumstances, that in this situation neither seller nor purchaser will ever be entitled to deduct the Assumed Compensation Liabilities[6]. The seller may not be able to deduct the Assumed Compensation Liabilities because the service providers have not yet taken the compensation into income. See TAM 8939002 (June 15, 1989); Sol Jacobs, Jr. v. Commissioner, 45 T.C. 133 (1965)[7]. See also TAM 8741001 (June 16, 1987) (issue 2) . On the other hand, the Assumed Compensation Liabilities may well be treated not as expenses incurred by the purchaser in the operation of the business but rather as part of the consideration paid by the purchaser for the business. David R. Webb Co. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983) . Cf. Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir.1973).

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6 The problem discussed below apparently does not arise with regard to qualified plans. The Service has consistently issued private letter rulings allowing the purchaser to deduct contributions to a qualified pension plan which the purchaser assumed from the seller, even if at the time of the purchase of assets the seller had substantial unfunded past service liabilities to the plan. For a discussion of this issue, see Ginsburg & Levin, "Mergers, Acquisitions and Leveraged Buyouts," H 304.03 (CCH, 1990).

7 These authorities deal with cases in which the seller was liquidated before the purchaser's payment of Assumed Compensation Liabilities. The problem discussed in this section may well not arise where the seller stays in existence until the payment is made to the service provider. In such event, the seller could claim a deduction at the time of the purchaser's payment. However, even this result seems harsh since mismatching would occur if the Assumed Compensation Liabilities were required to be included in the amount realized on the sale, especially where the taxable year of sale is closed or a loss carry-back to the year of sale is not available. Stated another way, the seller has transferred a portion of the assets in exchange for the buyer's assumption of the Assumed Compensation Liabilities.

The Committee, recommends that the final regulations deal with this problem with respect to nonqualified plans or obligations covered by section 404(a)(5). It is submitted that it would be appropriate to allow the seller to deduct the Assumed Compensation Liabilities at the time of the asset sale (or deemed, sale under section 338) even where the service provider has not yet recognized income. This treatment should be allowed because (i) the Assumed Compensation Liabilities may well be required to be included (in full without discounting for present value) in the amount realized by the seller under section 1.1001-2 of the regulations, (ii) in essence the seller has borne the Assumed Compensation Liabilities as an economic matter (as a reduction of the price the buyer would otherwise be willing to pay)[8], (iii) as indicated above, the buyer may not be allowed a deduction when it pays the Assumed Compensation Liabilities, and (iv) allowing the seller to take into account the Assumed Compensation Liabilities (as deductions or increased basis amounts) is consistent with the policy of section 1.461-4 (g) (1) (ii) (C) (_!) and with existing authority in other contexts. <u>See James M. Pierce Corp. v. Commissioner</u>, 326 F.2d 67 (8th Cir. 1964)("recapture" of unearned subscription reserve on sale of business offset by corresponding deduction). See also Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981), acq. 1986-1 C.B. 1; Cooledge v. Commissioner, 40 B.T.A. 1325 (1939), acq..1940-1 C.B. 2 (allowance of deductions to cash basis taxpayers upon the assumption of their liabilities)[9].

The Deemed Payment Rule of section 1.461-4(g)(1)(ii)(C)(1) in effect treats the assumption of a liability by the buyer of a

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[9] An example of another area in which the Service has held that deductions for assumed liabilities are not lost is in the context of section 351 exchanges. See Rev. Rul. 80-198, 1980-2 C.B. 113 (deductions for trade accounts payable assumed in a section 351 exchange permitted to transferee corporation when payments are made); Rev. Rul. 83-155, 1983-2 C.B. 38 (successor corporation permitted to deduct amounts paid to previously retired partner or spouse of deceased partner of a predecessor partnership following incorporation of the partnership's business).

business as payment by the seller to the person to whom the liability is owed, thereby allowing the seller to achieve economic performance for items that require payment to be deductible under section 1.461-4(g) . The apparent policy underlying section 1.461-4(g) (1) (ii) (C) (_l) (to allow the amount realized resulting from the assumption of a liability to be offset by the expense represented by that liability) is equally applicable to Assumed Compensation Liabilities. Without' section 1.461- 4(g) (1) (ii) (C) (_!) , assumed section 1.461-4(g) items could go into limbo on the sale of a business because the seller would never make payment to the person to whom the liability is owed. The final regulations should provide a remedy, similar to section 1.461-4 (g) (1) (ii) (C) (_l) , for Assumed Compensation Liabilities. For this purpose, the seller should also be expressly required to include the Assumed Compensation Liabilities in the amount realized.

The potential for abuse (which might be viewed to exist where the service recipient is allowed to take an item into account before the service provider must recognize income) is essentially nonexistent under this proposal because the accelerated accrual, consistent with the general rule of section 1.461-4(g)(1)(ii)(C)*(1),* would be allowed only in connection with the sale *&t* a trade or business and would be matched by an amount realized.

2. Circumstances in which additional clarification of the Deemed Payment Rule of section 1.461-4(g)(1)(ii)(C)(1) should be provided.

The Notice also invites comment on this subject.

a. Contingent liabilities assumed in a sale of a trade or business. By its terms, the Deemed Payment Rule applies only to liabilities which the seller "(but for the economic performance requirement) would have been entitled to incur as of the date of the sale." Thus, the Deemed Payment Rule does not appear to apply to contingent liabilities.

The tax treatment of the assumption of contingent liabilities by purchasers of assets (or deemed purchasers of assets in section 338 elections) is complex and as a general matter beyond the scope of our Report[10]. Indeed, it is a subject which should probably be addressed in a separate set of regulations, including regulations under section 461(h) of the Code. However, to the extent contingent liabilities increase the amount realized under section 1.1001-2 of the regulations, it seems clear as a policy matter that the Deemed

[10] See New York State Bar Association Tax Section, Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions (October 16, 1990). A recent discussion of this complicated and controversial area also appears in Crane, "Accounting For Assumed Liabilities Not Yet Accrued By The Seller: Is A Buyer's Deduction Really Costless?", 48 Tax Notes 225 (1990).

Payment Rule should be expanded to allow the seller of a business to take that liability into account as an offsetting deduction or increase in basis. (See letter from Peter C. Canellos to Thomas Wessel, summarized in 39 Tax Notes 931 (1988), and letter from John L. Sterling to D. Kevin Dolan, summarized in 37 Tax Notes 684 (1987), criticizing TAM 8741001 (June 16, 1987), which denied such an offsetting amount in the context of a section 338 election.) Fundamentally, the same policy considerations underlying our proposal with regard to Assumed Compensation Liabilities (item 1 above) support this proposal with regard to contingent liabilities.

If the Service is not yet ready to address the treatment of the assumption of contingent liabilities, an explicit statement to that effect should be made in the section 461(h) regulations. In particular, it would seem appropriate to indicate in section 1.461-4(g)(1)(ii)(C) that the treatment of contingent liabilities is reserved.

b. Liabilities to provide services or property assumed in a sale of a trade or business. The Deemed Payment Rule appears in section 1.461-4(g) of the Proposed Regulations and thus would apparently be applicable only to items where economic performance generally occurs only upon payment to the person ~.o whom the liability is owed.

We suggest that the final regulations expressly state that the Deemed Payment Rule is also applicable to liabilities of the taxpayer to provide property or services ("Provider Liabilities")[11]. For reasons similar to those discussed above (with respect to item 1) where Provider Liabilities of the seller are assumed in the sale (or a section 338 deemed sale) of a trade or business, the seller should be allowed to treat them as incurred to the extent they relate to income recognized on or before the sale. The amount so taken into account should be equivalent to the amount realized as

[11] Ordinarily, under section 1.461-4(d)(4), those liabilities are taken into account when the taxpayer incurs costs to provide the property or services.

the result of the assumption of these Provider Liabilities. This approach was approved by the United States Court of Appeals for the Eighth Circuit in James M. Pierce Corp. v. Commissioner, supra, with respect to deferred subscription obligations. See also Rev. Rul. 68-112, 1968-1 C.B. 62.

It is submitted that unless on the sale the seller is deemed to incur assumed Provider Liabilities, which are allocable to income recognized by it (such as prepaid income), there will be a mismatching, contrary to the Pierce case, of income and expense for the seller which is inconsistent with the policy underlying section 461(h) and with sound tax accounting. In addition, continued deferral of the Provider Liabilities would impose burdensome compliance requirements on the seller to establish the time, after the sale, when the goods or services are in fact provided. Moreover, under certain circumstances, there may be no time after the sale at which the seller could take the Provider Liabilities into account. See TAM 8741001, supra.

c. The scope of the Deemed Payment Rule. As drafted, the Deemed Payment Rule applies only in the case of a sale of a trade or business as that term is used in the context of section 355. The Committee sees no apparent reason to so narrow the scope of the Deemed Payment Rule and suggests that it be expanded to cover an assumption of liabilities in connection with any sale or exchange of business assets where the seller is required to include the assumed liabilities in income[12].

3. <u>The provisions relating to the use of property are ambiguous and may be inconsistent with section 467 of the Code and the legislative history to section 461 (h).</u>

Section 1.461-4 (d) (3) provides that with respect to the use of property by the taxpayer, "economic performance occurs <u>ratably</u> over the period of time the taxpayer is entitled to the use of the property." (emphasis added) Section 467 (also adopted by the 1984 Act) specifies when lessors and lessees of tangible property to take into account certain rents. Section 467 (b) provides that rents to which section 467 applies should be allocated in accordance with the applicable rental agreement except in specified cases in which a "constant rental" amount" is required to be accrued for each period in a lease term.

Section 461(h) (2) (A) (iii) provides that with respect to the use of property by the taxpayer, "economic performance occurs as the taxpayer uses such property." Nothing in the legislative history of section 461 (h) indicates that it was intended to override section 467 or provide; *a* general rule that rents must be allocated ratably among all the periods in a lease term. It is more

[12] See item 6 below for a more expansive recommendation that economic performance should be deemed to occur, even if not in connection with a sale or exchange of assets, whenever payment is made to an unrelated third party to assume a liability.

supportable that Congress simply intended to provide that the rent allocable to a period (with such allocation being determined by the lease except as otherwise provided in section 467) may not be taken into account before that period. Indeed, the legislative history of section 467 makes clear that the amount of the rent deduction as determined under section 467 and the timing of such deduction under the accrual method (requiring economic performance) are two separate questions. "The parties under a section 467 rental agreement must report rental income and deductions on an accrual basis. The amount of rent accrued for a particular period is 'determined by allocating rents in accordance with the agreement,'. ..." 1984 Blue Book, at 287. See also 1984 Conference Report, at 891 (to same effect).

The Committee recommends that the final regulations either should explicitly negate any implication that section 461(h) overrides section 467, at least in the case of leases of tangible property, or should discuss the interrelation between those two sections. For example, the final regulations might provide that, in the case of leases of tangible property to which section 467 applies, economic performance would be deemed to occur at the time the rents payable under such leases would otherwise be accrued under section 467[13].

In any event, the final regulations should explain the application of section 461(h) to percentage rents and royalties as to which the Committee believes a ratable inclusion rule is unwarranted and unworkable.

4. The rules of section 1.461-2(f) of the Proposed Regulations with respect to contested liabilities can result in double taxation of the same income and in taxation of unrealized income.

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13 In this regard, the Committee would welcome the issuance of proposed regulations under section 467.

Section 1.461-2(f), relating to contested liabilities, is ambiguous and difficult to understand. Section 1.461-2(f) reaches certain conclusions that are counterintuitive, particularly in the case of a return to the taxpayer of appreciated property previously transferred to a 461(f) fund (which is treated as a recognition event) and insofar as it treats amounts paid from the fund to the taxpayer as income to the taxpayer, regardless of the amount or the circumstances giving rise to such return. Also, as illustrated by the example included in section 1.461-2(f)(3), section 1.461-2(f) appears to require a taxpayer to be taxed twice on the income of a 461(f) fund, once when it is earned and again when it is repaid to the taxpayer from the fund.

In the example, X, an accrual basis, calendar year taxpayer, deducts $9,000 in 1991 for a transfer to a 461(f) fund in January, 1991 of property with a fair market value of $9,000. X must include in income the $600 earned by the 461(f) fund in 1991 but is also allowed under the special rules of section 1.461-2(f)(2)(v) a deduction for its taxes (apparently paid with funds not in the trust) with respect to that inclusion[14]. 14 The example goes on to assume that in 1992 the contest is settled with the claimant receiving $8,000 and X receiving the remaining $1,600 in the fund. The example concludes that this $1,600 should be includible in X's income for 1992. This result taxes to X again in 1992 the $600 amount that was taxable to X in 1991. While it seems justifiable for X to be taxed in 1992 on $1,000 of this amount (representing the excess of its 1991 deduction of $9,000 over the $8,000 amount paid to the claimant in 1992), taxing X again on the remaining $600 on its face appears to double count.

Aside from this problem, however, is a potentially more serious problem which can best be illustrated if it were assumed in the example that the property previously transferred to the 461(f) fund had appreciated in value to $12,000 at the time the claim was settled (for $8,000) and the excess amounts in the fund ($4,000) were returned to the taxpayer. Read literally, the provisions of section 1.461-2(f) would require recognition of $2,000 of gain by the taxpayer on the transfer of fund assets to the claimant in settlement of its claim (Prop. Treas. Reg. § 1.461-2(f)(2)(i), second sentence), and additional gain of $1,000 on the return of the remaining fund assets to the taxpayer (id.), and, assuming the return of the fund assets to the taxpayer also constitutes a "payment from a 461(f) fund" for purposes of section 1.461-

[14] The details of the deduction for income taxes are not explained in the example. The treatment of income taxes with respect to the income of a 461(f) fund is one of the matters that needs clarification. For example, does a reduction of a net operating loss carryforward resulting from the inclusion of fund income in the loss year give rise to a deductible tax payment when taxes are later paid on income which otherwise would have been sheltered but for the prior inclusion of fund income?

2(f)(2)(iv), ordinary income of $4,000, thereby resulting in total income to the taxpayer of $7,000. The approach taken in section 1.461-2(f), as drafted, appears to be based on an unstated premise that a taxpayer who contributes to a 461(f) fund should incur a tax detriment in the year of settlement if property in the fund is returned to it, since, under a "time value of money" analysis, the taxpayer (at least arguably) overfunded the liability in the first place[15]. This rationale is not supported by the legislative history of section 461(h) and is not articulated in either the Proposed Regulations or the Notice[16]. Even if it were to be assumed that the Service has the authority to impose such a tax treatment on the taxpayer (a matter that also should be addressed explicitly by the Service), the final regulations should be expanded so as to explicate more clearly the principles involved to enable taxpayers to make rational tax planning decisions. More fundamentally, the Committee feels strongly that there is no basis for taxing a taxpayer on unrealized appreciation of contributed property in excess of any amounts previously claimed as a deduction on the contribution of the property to the fund.

5. Rules should be provided for the application of section 461(f) to tort claims and similar items.

Section 1.461-2(a)(5) reserves the issue of the application of section 461(f) to liabilities (such as those arising from torts) for which payment is required for economic performance. In the absence of guidance in the regulations, it appears that taxpayers will have to assume that, based on explicit statements in the legislative history, a transfer to a 461(f) fund would not constitute payment

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[15] See Tax Notes, September 17, 1990, p. 1463, quoting from interview with Kenneth Kempson, Esq., Acting Deputy Associate Chief Counsel (Technical), Internal Revenue Service.

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[16] Any analogy to the treatment of Nuclear Decommissioning Reserve Funds under Section 468A would be flawed since such a Fund is treated as a corporation and, in addition, specific rules are provided as to the amounts which can be contributed to the Fund.

for purposes of the economic performance rules. See 1984 Conference Report, at 876. The Committee recommends that the Service give consideration to exercising its general regulatory authority under section 461(h)(2) to issue the reserved regulations contemplated by section 1.461-2(a)(5) in order to establish circumstances under which transfers to section 461(f) funds would be considered economic performance with respect to tort claims and other section 1.461-4(g) items. Without these regulations, section 461(f) will have little if any application in actual practice.

6. Payment to an unrelated third party should always be viewed as economic performance.

Under the Proposed Regulations, in cases of general application[17], payment constitutes economic performance only in the cases of (i) items listed in section 1.461-4(g) for which payment is by definition economic performance and (ii) to a limited extent under section 1.461-4(d)(5)(ii), items involving the provision of services or property to the tax- payer where the taxpayer has made a prepayment not reasonably expected to exceed 3-1/2 months[18].

The Committee believes that in the case of services or property to be provided to the taxpayer, economic performance should always be deemed to occur no later than payment by the taxpayer to the service or property provider. Similarly, in the case of services or property to be provided by the taxpayer, economic performance should always be deemed to occur no later than payment by the taxpayer to third parties to provide those services or property particularly

[17] Additional specific instances identified in the Proposed Regulations where payment constitutes economic performance includes payments with respect to certain liabilities that are assigned or extinguished by the establishment of a fund (section 1.461-6).

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[18] This Prepayment Exception presumably is authorized by the introductory language of section 461(h)(2) of the Code, which provides that the timing rules set forth in that section apply "except as provided in regulations." It is submitted that this statutory language is also sufficient authority for the Treasury to adopt the more expansive proposal set forth in this item 5.

where such payment serves to relieve the taxpayer from its obligation to provide the services or property[19].

The reasons supporting these recommendations are set forth below:

a. Section 461(h) was not aimed at prepayments. , Section 461(h) was passed to deal with the perceived opportunity for abuse under prior law which allowed the accrual of deductions and costs many years before payment. The purpose of section 461(h) was summarized as follows in the Reports of the Ways and Means Committee and Senate Finance Committee:

> The committee believes that the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money. Recent court decisions in some cases have permitted accrual method taxpayers to deduct currently expenses that are attributable to activities to be performed or amounts to be paid in the future. Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent the time value of money is not taken into account; the deduction is overstated by the amount the face value exceeds the present value of the expense.
>
> The committee is concerned about the potential revenue loss from such overstated deductions. In many everyday business transactions, taxpayers incur liabilities to pay expenses in the future. The committee believes that because of the large number of transactions in which deductions may be overstated

[19] As contemplated under the Proposed Regulations, in both cases items which are actually provided before payment would still be taken into account before payment.

> and because of the high interest rates in recent years, the magnitude of the revenue loss may be significant.

H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1254 (1984) (cited hereinafter as the "1984 House Report"); S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 266 (1984) (cited hereinafter as the "1984 Senate Report") (emphasis added).

Thus, allowing payment to constitute economic performance would not in any way contravene the concerns underlying the enactment of section 461(h).

b. <u>Acceleration of accrual is better tax accounting than continued deferral</u>. Congress recognized that as a theoretical matter it would be better tax accounting to allow a current deduction for the present value of an expense satisfying the "all-events" test even though that expense would be paid in the future. However, that approach was rejected as involving too much complexity. The following statement from the 1984 House Report and the 1984 Senate Report summarizes these views:

> The committee recognizes that in the case of noncapital items, <u>a taxpayer, theoretically, should be allowed a deduction for either the full amount of a liability when the liability is satisfied or a discounted amount at an earlier time.</u> However, the committee also recognizes that determining the discounted values for all kinds of future expenses would be extraordinarily complex and would be extremely difficult to administer. For instance, a system that allowed current deductions for discounted future expenses would have to include a complex set of rules for recalculating overstated and understated deductions when the future liabilities are reestimated or are actually satisfied

> at a time, or in an amount, different from that originally projected[; a complex recapture mechanism would be required]. Furthermore ... an appropriate discounting system may be equally complex. Therefore, in order to prevent deductions for future expenses in excess of their true cost while avoiding the complexity of a system of discounted valuation, the committee believes that expenses should be accrued only when economic performance occurs.

1984 House Report, at 1254-55; 1984 Senate Report, at 266-67 (emphasis added; bracketed language in 1984 House Report only).

It is submitted that instead of further deferring an item it is theoretically sounder, consistent with the legislative history, to allow the item to be taken into account no later than actual payment to an unrelated third party. Moreover, allowing accrual at the time of, and in the amount of, such payment in effect automatically results in discounting to present value without the complexity feared by the tax-writing committees.

c. <u>A presumption of economic performance upon payment would reduce compliance burdens</u>. Congress was also concerned that the imposition of the economic performance requirement of section 461(h) would pose burdensome compliance problems for taxpayers. In particular, the 1984 Conference Report included the following statements:

> The conferees intend that enforcement of compliance with the economic performance standard be carried out in a manner that does <u>not impose substantial additional recordkeeping burdens on taxpayers.</u>

* * *

> The conferees expect that regulations to be prescribed by the Treasury Department will provide that economic performance will be treated as having occurred by a particular date if the best available evidence indicates that it has so occurred.

1984 Conference Report, at 876-77 (emphasis added). See also 1984 Blue Book, at 266 (to same effect)[20]

Obtaining and maintaining evidence of the time of the delivery of goods and services, especially overseas, may often prove to be difficult and costly. It is submitted that; providing an absolute presumption that economic performance occurs no later than payment would allow taxpayers, consistent with the concerns expressed by the Conference Committee, to reduce their compliance burdens without undercutting the purposes of section 461(h). This appears to be a good opportunity to advance tax simplification.

d. <u>The law already adequately deals with prepayments</u>. Deeming economic performance to occur no later than payment would not allow taxpayers inappropriate deductions for prepayments. This is the case because a deduction would still have to pass muster under section 1.461-l(-a) (2) of the Proposed Regulations, which provides the following rule for accrual basis taxpayers:

> Under an accrual method of accounting, a liability ... is incurred, and generally is 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. . . [U]nder section 263 or

[20] Indeed, the very reason given in the Notice for the existence of the Prepayment Exception is to "lessen the burden on a taxpayer incident to determining when property or services are provided to the taxpayer." 55 Fed. Reg. 23,235 (1990).

263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization .... (emphasis added.)

Moreover, the Service currently has authority under section 446(b) to prevent abusive transactions involving prepayments[21].

Even if this recommendation is not adopted, notwithstanding the foregoing reasons, those reasons also support our alternate and less encompassing recommendations (item 7 below) for expanding the circumstances under which payment should be deemed to constitute economic performance.

7. The 3-1/2 month prepayment rule of section 1.461-4(d)(5)(ii) of the Proposed Regulations should be expanded.

Generally, under section 1.461-4(d)(2) of the Proposed Regulations, with respect to property or services to be provided to a taxpayer, economic performance occurs as the property or services are so provided. As noted above, section 1.461-4(d)(5)(ii), however, provides an exception to this general rule. Under this Prepayment Exception, a prepayment to the service or property provider in effect is treated as economic performance "if the taxpayer can reasonably expect the person to provide the property or services within 3-1/2 months after the date of payment." Examples 8 and 9 of section 1.461-4(d)(6) note the existence of a contractual or lease obligation, but no specific guidance is given in the Proposed Regulations as to the circumstances which would allow a taxpayer to "reasonably expect" performance by the expiration of this 3-1/2 month period.

[21] The recommendation contained in this section is inconsistent with Section 1.461-4 (d) (6) Example 2_. However, it is believed the authorities cited in the text would justify a denial of a current deduction in this Example, either through a requirement that the amount in question be capitalized or that it simply be deferred until the services are rendered.

In the 1984 Conference Report, as noted above, the conferees explicitly expressed the intention "that enforcement of compliance with the economic performance standard be carried out in a manner that does not impose substantial additional recordkeeping burdens on taxpayers." 1984 Conference Report, at 876. We recommend that in furtherance of the policy of reducing the burdens of compliance, the 3-1/2 month permissible prepayment period be extended, at least to six months. It seems obvious that this extension would increase the circumstances in which the taxpayer could "reasonably expect" actual performance to take place within the grace period.

In addition to the benefits of reducing the compliance burdens of the taxpayer, the other reasons discussed above with respect to item 6, a much more expansive alternative, also support this more limited proposal. In particular, it should be emphasized that prepayments were not the concern which lead Congress to enact section 461(h). Prepayments are already dealt with by section 1.461-1(a)(2) of the Proposed Regulations which provides that "creation of an asset having a useful life extending substantially beyond the close of the taxable year" has to be capitalized. A modest extension of the prepayment period (for example, to six months) of the Prepayment Exception should not contravene section 1.461-l(a)(2).

Section 1.461-5 provides an exception (the "Recurring Item Exception") to implement section 461(h)(3) of the Code. Where applicable, section 1.461-5 provides that a liability may be accrued at year-end if economic performance occurs, generally speaking, within the following 8-1/2 months. Nothing in the Proposed Regulations indicates that the Prepayment Exception is inapplicable for the purpose of determining whether economic performance has occurred within the 8-1/2 month period. Accordingly, it appears that if a prepayment is made at the end of the 8-1/2 month Recurring Item

Exception period, an additional 3-1/2 months for the actual provision of the property and services to the taxpayer would be allowed. In other words, the combination of the Prepayment Exception and the Recurring Item Exception may allow a liability with respect to services or property to be provided to the taxpayer to be taken into account at year-end as long as the services or property are actually provided any time during the following year. If there is a concern that the maximum period resulting from the combination of these exceptions should not exceed 12 months, the final regulations could so state but nevertheless could allow a prepayment period of more than 3-1/2 months for the genera purposes of the Prepayment Exception.

8. <u>The Proposed Regulations should be clarified as to whether the consistency requirements of the Recurring Item Exception extends to the filing of amended returns pursuant to section 1.461-5(b)(2).</u>

Under section 1.461-5 of the Proposed Regulations, a taxpayer may adopt the Recurring Item Exception as a method of accounting. Accordingly, that exception, once adopted, must be used consistently every year.

Where applicable, the Recurring Item Exception in effect allows a taxpayer to treat economic performance to have occurred at year-end with respect to an item for which the all-events test has been otherwise satisfied (a <u>"Year-End Item")</u> if economic performance in actuality occurs by the earlier of the date the taxpayer files its return for that year or 8-1/2 months after the close of that year. In addition, under section 1.461-5(b)(2), a taxpayer "may file" an amended return to treat economic performance to have occurred with respect to a Year-End Item if economic performance in actuality occurs after the time the taxpayer files its return but within 8-1/2 months of the close of the year. Clarification is needed as to whether such filing of amended returns is part of the method of accounting and, accordingly, is covered by the consistency requirement, so that filing amended returns to extend the performance period either would always be required or alternatively would never be permitted. We believe that administrative convenience justifies a rule that amendment of returns should not be included in the consistency requirement.

9. The Service should retain discretionary authority to grant advance rulings to allow the Recurring Item Exception to be elected in the case of catch-all items described in section 1.461-4(g)(7) of the Proposed Regulations.

Under the Proposed Regulations, any item not dealt with elsewhere falls within the catch-all provision of section 1.461-4(g)(7), which provides that economic performance occurs upon payment. The Notice indicates that the Service anticipates that only a few items "will fall into this catch-all category." 55 Fed. Reg. 23,235. Section 1.461- 5(c) of the Proposed Regulations provides that liabilities covered by section 1.461-4(g)(7) (“(g)(7) Liabilities") are not eligible for the Recurring Item Exception. Almost by definition, the (g)(7) Liabilities will be items which were not focused on by the regulation writers. It is submitted that the Service should retain discretion to grant advance rulings allowing the election of the Recurring Item Exception with respect to particular (g)(7) Liabilities to maintain flexibility to deal with specific issues when they arise. This flexibility appears substantially preferable to a hardand- fast blanket disqualification of (g)(7) Liabilities for the exception.

10. Economic performance when certain liabilities are assigned or extinguished by the establishment of a fund.

Section 1.461-6 provides that in certain circumstances economic performance is deemed to occur at the time the taxpayer makes "approved payments" to a "qualified fund" in satisfaction of liabilities described in section 1.461-4(g)(2) (relating to payments under workers' compensation acts or in respect of tort or breach of contract claims or violations of law). The rules as to what constitutes a "qualified fund" are similar to but not exactly the same as the rules applicable to "designated settlement funds" under section 468B. The apparent authority for authorizing the use of such a "qualified fund" is section 468B(f). While it is not clear why the rules applicable to qualified funds differ from the rules applicable to designated settlement funds, the Committee believes that this is a useful concept as a general rule. The Committee would suggest, however, that the final regulations state with more specificity what type of claims may be dealt with by means of a qualified fund. For instance, could a taxpayer use a qualified fund to take into account for tax purposes liabilities arising out of a class action for damages under the federal securities laws?

11. <u>The definition of "payment" In the regulations should be expanded.</u>

Section 1.461-4(g)(1)(ii)(A) explicitly excludes from the definition of payment "the furnishing of a note or other evidence of indebtedness." The Committee believes that furnishing a negotiable note is in many cases the economic equivalent of borrowing funds and making a cash payment and, accordingly, should also be treated as payment for purposes of section 461(h). Delivery of a note has been considered as payment under other Code provisions that involve similar policy considerations[22]. Moreover, the Committee believes the principles of section 1274 are readily available for the purpose of present valuing the payment represented by a negotiable note.

[22] See, e.g., <u>Musselman Hub-Brake Co. v. Commissioner</u>, 139 F.2d 65 (6th Cir. 1943) (deduction under statutory predecessor of section 267(a)(2) allowed to accrual-basis corporation in the year of issuance for the cash par value of demand promissory notes "paid" (within the meaning of the statute) to cash-basis controlling stockholder in satisfaction of debt for patent royalties and interest); <u>Anthony P. Miller, Inc. v. Commissioner</u>, 164 F.2d 268 (3rd Cir. 1947), <u>cert. denied</u>, 333 U.S. 861 (1948) (same result where negotiable demand promissory notes were "paid" to controlling stockholder in satisfaction of salary obligation) ; <u>Fetzer Refrigerator Co. v. United States</u>, 437 F.2d 577 (6th Cir. 1971) (following <u>Musselman</u>); and Rev. Rul. 55-608, 1955-2 C.B. 546 (Service accepted issuance of notes or other evidences of indebtedness by solvent taxpayer as "payment" under statutory predecessor of section 267(a)). <u>Cf. Don E. Williams Co. v. Commissioner</u>, 429 U.S. 569 (1977) (<u>Musselman and Miller</u> cases distinguished in case involving delivery of demand promissory notes to qualified employee profit-sharing trust because policy of matching income and deductions underlying section 267(a) not present under section 404(a) where trust is tax-exempt)
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12. <u>Example regarding vacation pay should be corrected.</u>

There is a technical error in example l of section 1.461-4(d)(6) which should be corrected.

Section 1.461-4(d)(2)(iii) cross-references to example 1 of section 1.461-4(d)(6) for an "illustration of the interaction between section 461(h) and employee benefit provisions including sections 404, 404A and 419." Example 1 involves a vested vacation pay plan entitling employees to vacation pay based on the amount of work performed during a taxable year. In the example, the employees of X earned $150,000 of vacation pay in 1990, $25,000 of which is paid by X before March 15, 1991, and the remainder paid subsequent thereto. The example notes that although, under the economic performance rule, the $150,000 is incurred by X for the 1990 taxable year, $125,000 of that amount may be deferred compensation and, therefore, subject to the rules of section 404(a)(5). The example then goes on to cite the wrong rule, stating that the vacation pay is not deductible until includible in the gross income of the employees. In actuality, under an exception to the general rule of section 404(a)(5), enacted by the Revenue Act of 1987 as an amendment to that section, vacation pay which constitutes deferred compensation is deductible in the taxable year of the employer j.p which it is paid to the employee.