

In-class Questions	Step 5	Step 7 (earlier of:)		Result	Step 9
<p style="text-align: center;">Facts</p> <p style="text-align: center;">Accrual method, calendar year taxpayers</p>	<p style="text-align: center;">When economic performance is met</p>	<p style="text-align: center;">When the event fixing the liability, whether that be the required performance or other event, occurs</p>	<p style="text-align: center;">When payment is due</p>	<p style="text-align: center;">When incurred</p>	<p style="text-align: center;">Deductible?</p>

All of the steps of the flowchart in the economic performance article are important. This exercise focuses on the three steps where the most time is likely to be devoted.

<p>1. Semiannual assessment required to be paid to the Comptroller of the Currency on or before January 31, 2006, for the 6-month period beginning January 1, 2006 and based on the condition reports submitted for the fourth reporting period ending December 31, 2005. [Rev. Rul. 80-230]</p> <p>Let's assume that the bank paid the fee on 12/31/05.</p>	<p>The assessment is to cover costs of bank audits, so sounds like provision of services. EP met as services provided (2006).</p>	<p style="text-align: center;">2006</p>	<p style="text-align: center;">2006</p>	<p style="text-align: center;">2006</p>	<p style="text-align: center;">In 2006</p>
<p>In Rev. Rul. 80-230, the IRS noted:</p> <ul style="list-style-type: none"> ▪ While amount can be determined with reasonable accuracy in 2005, that is not enough to meet the all events test. ▪ "Generally, under section 1.461-1(a)(2), all the events have occurred that determine 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 therefore is due, whichever happens earliest. Although the semiannual assessment is based upon the December 31, [2005], report of condition, it is not payable until January 31, [2006], and is for the 6-month period beginning January 1, [2006]. Thus, all the events that determine the fact of liability for this semiannual assessment occur as of January 1, 1979, and have not yet occurred as of December 31, [2005]. ▪ Also see Rev. Rul 2007-3 in Chapter 3. 					
<p>2. Costs of removing offshore platforms and well fixtures installed pursuant to a long-term oil and gas lease with the federal government; contractually obligated in 2005, work to be performed in 2025. [Rev. Rul. 80-182]</p>	<p>When services provided in 2025. (If the EP requirement had existed in 1980, Rev. Rul. 80-230 likely would not have been issued.)</p>	<p style="text-align: center;">Per IRS, 2025.</p>	<p style="text-align: center;">2025</p>	<p style="text-align: center;">2025</p>	<p style="text-align: center;">In 2025</p>
<p>In Rev. Rul. 80-182, the IRS noted:</p> <ul style="list-style-type: none"> ▪ Taxpayer may not deduct expenses related to a bilateral contractual obligation before the performance of the contracted for services. ▪ The fact of the liability is not fixed until the employees stated to remove the platforms and fixtures. The liability is contingent upon the taxpayer performing the 					

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<p>services. The contractual obligation is not enough to meet the "fixed" part of the all events test.</p> <ul style="list-style-type: none"> ▪ Also see Rev. Rul 2007-3 in Chapter 3. 					
<p>3. On 12/1/05, N pays a \$10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on 2/1/06. [§1.263(a)-4(f) EX(1)]</p>	<p style="text-align: center;">When paid in 2005</p>	<p style="text-align: center;">If due in 2005, then 2005</p>	<p style="text-align: center;">2005 (unless prepaid)</p>	<p style="text-align: center;">2005</p>	<p style="text-align: center;">12-month rule not met because benefit extends beyond the earlier of (ii) below – the benefit extends beyond the end of 2006. So, N must capitalize and amortize this expenditure.</p>
<p>Reg. §1.263(a)-4(f)(1) on the 12-month rule provides: "<i>In general</i>. Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of—</p> <ul style="list-style-type: none"> (i) 12 months after the first date on which the taxpayer realizes the right or benefit; or (ii) The end of the taxable year following the taxable year in which the payment is made." <p>...</p> <p>"(6) <i>Coordination with section 461</i>. In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See §1.461-4 for rules relating to economic performance."</p> <p>"(7) <i>Election to capitalize</i>. A taxpayer may elect not to apply the rule contained in paragraph (f)(1) of this section. An election made under this paragraph (f)(7) applies to all similar transactions during the taxable year to which paragraph (f)(1) of this section would apply (but for the election under this paragraph (f)(7)). For example, a taxpayer may elect under this paragraph (f)(7) to capitalize its costs of prepaying insurance contracts for 12 months, but may continue to apply the rule in paragraph (f)(1) to its costs of entering into non-renewable, 12-month service contracts. A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (f)(7) is revocable with respect to each taxable year for which made only with the consent of the Commissioner."</p>					

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<p>4. Same facts as above, except that the policy has a term beginning on 12/15/05 [§1.263(a)-4(f) EX(2)]</p>	<p style="text-align: center;">When paid in 2005</p>	<p style="text-align: center;">If due in 2005, then 2005</p>	<p style="text-align: center;">2005 (unless prepaid)</p>	<p style="text-align: center;">2005</p>	<p>Now the 12-month rule is met so N can deduct in 2005 when paid.</p>
<p>5. Same facts as above, except that the contract states that the payment is due no later than 12/31/05. If N cancels the policy anytime during the coverage period, N will receive a refund less a service charge. If you determine that the all events test and economic performance are satisfied in 2005, what is the rationale for the treatment of any refund N receives if it cancels the coverage on 3/1/06? (consider whether cancellation is a condition precedent or subsequent – which you need to determine before determining when the all events test is met)</p>	<p style="text-align: center;">Key point here is that the cancellation is most likely a condition subsequent which won't affect the determination of when the item is incurred.</p>				
<p>6. T leases office space from L at a monthly rental rate of \$2,000. On 8/1/05, T prepaays its office rent expense for the first 6 months of 2006 in the amount of \$12,000. For purposes of this question, it is assumed that the recurring item exception provided by §1.461-5 does not apply [§1.263(a)-4(f) EX(10ii)]</p>	<p style="text-align: center;">2006 when the property is used by T</p>	<p style="text-align: center;">2006 – signing the contract in 2005 is not enough to fix the liability</p>	<p style="text-align: center;">2006 – while payment was made in 2005, it was not due in 2005</p>	<p style="text-align: center;">2006</p>	<p>12-month rule is not relevant here because the rent was not incurred in 2005. T will just book the 2005 payment as prepaid rent and then as rent expense in 2006.</p>
<p>7. N pays R, an advertising and marketing firm, \$40,000 on August 1, 2005, for advertising and marketing services to be provided to N throughout calendar year 2006. Assume that the recurring item exception provided by §1.461-5 does not apply [§1.263(a)-4(f) EX(11)]</p>	<p style="text-align: center;">2006 when the services are provided to T</p>	<p style="text-align: center;">2006</p>	<p style="text-align: center;">Perhaps 2005 if payment was really due then.</p>	<p style="text-align: center;">2006</p>	<p style="text-align: center;">Same as answer above.</p>

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<p>8. ABC was sued by an injured customer in 2006. The lawsuit was settled in 2008 and the injured party was paid in 2009.</p>	<p>2009 – this is a payment liability under 1.461-4</p>	<p>2008 when all events had occurred to fix the liability. The pending lawsuit is a contingency.</p>	<p>2009</p>	<p>2009</p>	<p>2009</p>
<p>9. Weber Corporation, an accrual method calendar year taxpayer, has an employee bonus plan. To receive the bonus accrued during a year, the employee must still be employed when the bonus is paid in the subsequent year.</p>	<p>Met when the services are provided. There is a special EP rule for employee benefits (1.461-4(d)(2)(iii)) that EP not met until §404 rule satisfied. So if paid within 2 ½ months of year end, EP met in Year 1.</p>	<p>Year 2 – whether or not the employee is still employed when paid in Year 2 is a contingency that isn't met until Year 2</p>	<p>Year 2</p>	<p>Year 2</p>	<p>Year 2</p>
<p>10. Same as #9 (Weber) except that Weber's bonus agreement with employees states that if the employee is no longer working at Weber when the bonus is paid, the bonus will be donated to charity.¹</p>	<p>This change doesn't remove the contingency that at the end of Year 1, Weber doesn't know how much will be employee bonus and how much will be charitable contribution. Per §1.461-1(a)(2)(iii)(B), a charitable contribution is subject to §170 rather than the timing rules of §461. Thus, since no charitable contribution was made in Year 1, there can be no deduction for it in Year 1.</p> <p>Accrual method C corporations do have an option under §.1170A-11(b) for the Board of Directors to declare a contribution by year end, pay it within 2 ½ months of year end and deduct it in the year declared. However, that also doesn't work here because it wasn't done and even if the Board tried, it would not work because if all employees are still employed when bonuses are paid in Year 2, there would be not charitable contribution. The Board would not be able to declare the proper charitable contribution amount by the end of Year 1.</p>				

¹ While not exactly the same fact pattern, see CCA 200949040.