Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM 2007-009**

Release Date: 5/11/07
CC:ITA:KLKoch
POSTN-128928-06

UILC: 461.06-00

date: September 01, 2006

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subject: Generic Legal Advice
Application of §§ 1.461-4(d)(6)(ii) and 1.461-5 to service contracts

This memorandum responds to your request for assistance. We understand that the issues in your request have arisen in various industries and derive from a transaction that has been promoted by several accounting firms.

This memorandum is intended for use only by the office that requested it. It may not be used or cited as precedent.

ISSUES

(1) Does the 3 ½ month rule in § 1.461-4(d)(6)(ii) of the Income Tax Regulations apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 3 ½ months of year 2 under a contract that extends beyond that 3 ½ month period?

(2) Does the recurring item exception in § 1.461-5 apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 8 ½ months of year 2 under a contract that extends beyond that 8 ½ month period?

CONCLUSIONS

(1) No, the 3 ½ month rule does not apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 3 ½ months of year 2 under a contract that extends beyond that 3 ½ month period.

(2) No, the recurring item exception in § 1.461-5 does not apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 8 ½ months of year 2 under a contract that extends beyond that 8 ½ month period.

FACTS:

At the end of year 1, the taxpayer enters into a 12-month service contract with X. Under the contract, X will provide services to the taxpayer until the end of year 2. At the end of year 1, when the contract is executed, the taxpayer makes a prepayment to X for a portion of the services to be provided in year 2. On its federal income tax return for year 1, the taxpayer deducted the prepayment as an expense, citing either the 3 ½ month rule or the recurring item exception as authority for the deduction.

LAW AND ANALYSIS:

Section 461 of the Internal Revenue Code and the regulations thereunder provide general rules that govern the taxable year of deduction. Section 1.461-1(a)(2) provides that, under an accrual method, 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 (collectively, the "all events test"). Section 461(h)(1) provides that, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. *See also* 1.461-4(a)(1). The two issues raised in this request for advice relate to the economic performance requirement of the all events test. This advice does not address whether the liability for services would be fixed or determinable with reasonable accuracy.

Section 461(h)(2)(A) provides that if the liability of the taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services. *See also* § 1.461-4(d)(2). Therefore, under this general rule, economic performance would occur for the prepaid services at issue as the services are provided to the taxpayer. Under the facts of Issues (1) and (2), although payment was made in year 1, economic performance generally would not

occur until year 2 when the services were provided. However, there are two exceptions to the general economic performance rule applicable to service liabilities.

The first exception is the so-called "3 ½ month rule" in § 1.461-4(d)(6)(ii). That rule provides that a taxpayer is permitted to treat services or property as provided to the taxpayer (*i.e.*, as economic performance) as the taxpayer makes payment to the person providing the services or property if the taxpayer can reasonably expect the person to provide the services or property within 3 ½ months after the date of payment.

Thus, under the facts of Issue (1), the taxpayer could treat the year 1 prepayment for services as economic performance so long as the taxpayer can reasonably expect the services to be provided within 3 ½ months after the payment. The question is whether this rule contemplates that ***all*** of the services must be provided within 3 ½ months, or whether this rule permits a taxpayer to accelerate into year 1 a deduction for 3 ½ months' worth of services to be provided in year 2.

The liability in the facts set forth above relates to services to be provided both before and after the 3 ½ month period following payment. That liability is not divisible unless different services are required to be provided to the taxpayer under a single contract, in which case economic performance occurs (and any applicable economic performance exception will apply) separately with regard to each service provided. Section 1.461-4(d)(6)(iv). If a single contract does not provide for different services, there is no authority in the § 461 regulations allowing taxpayers to use the 3 ½ month rule for a portion of a liability, even if the taxpayer can reasonably estimate the amount of services that will be provided to it within 3 ½ months.

Although § 1.461-4(d)(6) does not specifically state that ***all*** the services must be provided within 3 ½ months, that conclusion is implicit in the language that requires ***the*** services (not a pro-rata amount, or portion of, services) to be provided within 3 ½ months. (Emphases added). The language of the regulation does not provide that taxpayers may use the rule to meet economic performance for a service liability "to the extent of" services provided. Compare the language of the 3 ½ month rule with the language of the 2 ½ month rule for deferred compensation under § 1.404(b)-1T(b)(1) (providing that a plan, or method or arrangement, is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year ***to the extent that*** compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered). (Emphasis added).

Unlike the deferred compensation rule, the 3 ½ month rule is an "all or nothing" rule with respect to a particular liability. Therefore, the 3 ½ month rule does not apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 3 ½ months of year 2 under a contract that extends beyond that 3 ½ month period.

The second exception to the economic performance rule applicable to service liabilities (as well as other liabilities) is the recurring item exception in § 461(h)(3). Under the recurring item exception, a liability is treated as incurred for a taxable year if—

(i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;

(ii) Economic performance with respect to the liability occurs on or before the earlier of –

(A) The date the taxpayer files a timely (including extensions) return for that taxable year; or

(B) The 15th day of the 9th calendar month after the close of that 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 for that 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.

Thus, with regard to Issue (2), the question is whether economic performance with respect to the liability occurs on or before the 15th day of the 9th calendar month after the close of that taxable year. This advice does not address whether the other requirements of the recurring item exception would be met.

As discussed in connection with Issue (1), economic performance for the liability at issue generally occurs under § 1.461-4(d)(2) as the services are provided to the taxpayer. Therefore, the issue is whether the recurring item exception contemplates that ***all*** of the services must be provided within 8 ½ months, or whether this rule permits a taxpayer to accelerate into year 1 a deduction for 8 ½ months' worth of services to be provided in year 2. Similar to the analysis in Issue (1), the particular liability in this case is for services to be provided both before and after the 8 ½ month period following the end of the taxable year. If a single contract does not provide for different services, there is no authority in the § 461 regulations allowing taxpayers to use the 8 ½ month rule for a portion of a liability, even if the taxpayer can reasonably estimate the amount of services that will be provided to it within 8 ½ months.

Although neither § 461(h)(3) nor § 1.461-5 specifically states that economic performance (the provision of services) must be complete within 8 ½ months, the language of both sections refers to "economic performance with respect to ***the liability***" (not economic performance with respect to a pro-rata amount, or portion of, the liability, nor economic performance "to the extent of" the service liability). (Emphasis added). Similar to the 3 ½ month rule, the recurring item exception is an "all or nothing" rule with respect to a particular liability. Therefore, the recurring item exception does not apply to allow a deduction in year 1 for a prepayment made at the end of year 1 for services to be performed in the first 8 ½ months of year 2 under a contract that extends beyond that 8 ½ month period.

Please call Kim Koch at (202) 622-4800 if you have any further questions.