DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Area Counsel LMSB
Area 2 (Strategic Litigation)
CC:LM:MCT:SLWAS
Attn:

FROM: Associate Chief Counsel
Income Tax & Accounting

SUBJECT: Timing of accrual for rent liabilities

This Field Service Advice responds to your memorandum dated January 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp X =
Group Y =
Year 1 =
Year 2 =
A Years =
B =
C Years =
Date D =
$E =
$F =
G years =
H% =
$J =
Years K to L =

ISSUES

1. Whether Corp X's accruals of expenses under the lease satisfy Treas. Reg. § 1.461-1(a)(2).

2. Whether the Service may change Corp X's method of accounting for its expenses under the lease under I.R.C. § 446.

CONCLUSIONS

1. Corp X's accruals of rents under the lease does not satisfy either the all events test or the economic performance rule under Treas. Reg. § 1.461-1(a)(2), because the amounts deducted exceed the amounts due for that year and represent the acceleration of future rents due under lease.

2. The Internal Revenue Service may change Corp X's method of accounting for its expenses under the lease to a correct method, because the Corp X's current method does not meet the requirements of Treas. Reg. § 1.461-1(a)(2).

FACTS

Corp X is the parent of a consolidated group of corporations and employs the accrual method of accounting. In Year 1, Corp X acquired land and a newly-constructed building to use primarily as the group's corporate headquarters and to provide office space for several members of the group. Corp X immediately sold the building, at no gain or loss, to an unrelated party and, also in Year 1, Corp X entered into a net lease agreement with the purchaser, which was a limited partnership sponsored by Group Y. Corp X retained ownership of the underlying land and leased it to the new owners of the building. The land transaction is not an issue in this FSA.

On its financial statements and income tax returns Corp X has consistently reported the Lease as an operating lease. However, recently, Corp X has characterized the Lease as a financing transaction. We will not address this attempted recharacterization in this FSA and assume the transaction is in substance a lease.

The lease covers a primary period of A Years with Corp X having an option to extend for B consecutive terms of C Years each. Lease is a "net lease," requiring Corp X to pay all expenses related to the building. It also requires "stepped" rental payments which gradually increase in C-year increments over the primary term. The Lease is structured so as to obligate Corp X to pay the entire A-year rental amount in virtually all circumstances.

The Lease term began on Date D in Year 2. From the beginning, Corp X was obligated to and did make payments under the Lease of $E per month for the first C years and $F per month for the second C years. According to the Lease, the first G years' payments were set below market and considered "interest only" on the "loan" inherent in the stepped lease payments; the remaining years of the primary period would include "interest" and "principal" elements.

At all times, Corp X used the same method of accounting for the Lease for both financial and tax purposes. Corp X claims that its method of accounting was in accordance with generally accepted accounting principles ("GAAP"), specifically, Financial Accounting Standards Board Statement No. 13 Accounting for Leases ("FAS 13") and Accounting Principles Board Opinion No. 21 Interest on Receivables and Payables ("APB 21"). Paragraph 15 of FAS 13 provides:

> Normally, rental on an operating lease shall be chargeable to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used.

And paragraph 11 of APB 11 discusses the imputation of interest on receivables and payables:

> In the absence of established exchange prices for the related property, goods, or services or evidence of the market value of the note, the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest.

The annual accruals under the Lease were determined by Corp X as follows:

> (1) The present value of the total payments due over the primary term of the Lease was determined as of the beginning of the primary term using a discount rate of H%.
>
> (2) Using the above present value of the total payments due over the primary term of the Lease and a H% discount rate, it was determined that equal monthly rent accruals should be $J amount was accrued monthly as "rent"; "interest" was accrued at H% on the difference between the accrued rent and the rent payment required by the Lease.

(3) Interest was also accrued, at H%, on any outstanding balance of accrued rent or interest.

During the last ten years of the Lease, accruals will be less than the Lease payments required during those years. In this manner, Corp X's total rent obligation is "leveled" (although not entirely flattened) over the entire A-year term of the lease.

Altogether, Corp X will, under its "annuity" method of accounting, deduct the same amount it will actually pay over the A-year lease term, although some deductions will be taken in earlier time periods than would be the case under a method of accounting that deducts only the lease payments due each year.

The tax years at issue are Years K to L.

LAW AND ANALYSIS

Issue 1

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Specifically, section 162(a)(3) allows a taxpayer to deduct rentals or other payments required to be made as a condition to the continued use or possession, for purposes of a trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. We foresee no argument that Corp X's deductions for rent are not ordinary and necessary business expenses pursuant to section 162(a)(3).

Section 467 controls the timing of deduction of certain lease payments. We agree that the present case is not subject to the requirements of section 467 because section 467 applies to leases entered into after June 8, 1984.

Generally, under section 461(a), the amount of deduction allowed shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 446(c)(2) allows a taxpayer to compute taxable income by an accrual method of accounting.

Treas. Reg. § 1.461-1(a)(2) provides that 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 liability can be determined with reasonable accuracy, and economic performance as provided in section 461(h) has occurred with respect to the liability.

The economic performance rules found under section 461(h) are generally applicable to deductions taken after July 18, 1984. Under section 461(h)(2)(A)(iii) and Treas. Reg. § 1.461-4(d)(3)(i), if the liability of a taxpayer arises out of the taxpayer's use of the property, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property.

The first two requirements of Treas. Reg. § 1.461-1(a)(2) comprise the all events test, which governed the deductions under the accrual method prior to the enactment of the additional requirement of economic performance. Under the all events test, the rent that accrues each tax year is normally the amount due under the lease for that year. Thus, in Consolidated Foods Corporation v. Commissioner, 66 T.C. 436, 443 (1976), the Tax Court held that "[a]s each...rent payment became due, all events had occurred which established the fact of liability, and the amount of the liability was a fixed sum accurately determinable." See Hess and Culbertson Jewelry Co. v. United States, 61-1 USTC ¶9256 (E. D. Mo.)(estimated future rent not currently deductible); Charles Weisbecker v. Commissioner, 18 B.T.A. 766, 767 (1930)(rent owed for the use of property in earlier years not deductible in current years); Rod Realty Company v. Commissioner, T.C. Memo. 1967-49 (all events which fixed amount of additional rent occurred during the tax year to which the rent is attributable, not in the year it was paid). Therefore, Corp X may not deduct any amount over the amount due each year under the lease, because the all events test has not been met.

In Consolidated Foods, the taxpayer made some of the same arguments that have been raised on behalf of Corp X in the present case. There, a state municipality issued $2 million of industrial development bonds to finance construction of a manufacturing facility. The municipality leased the facility for 25 years to a corporation for which Consolidated Foods was the transferee. Under the lease, semi-annual rent payments due, but the amounts due could be reduced if there was surplus of bond proceeds. Such a surplus occurred and the lessee did not have to pay the full amount of the rent under the lease. The Service argued that the taxpayer could only deduct the net amount, that is the rent payment due less the credit. The Tax Court held that the taxpayer could accrue the full amount of the rent due under the lease each year, but that the taxpayer also had to include the credits in income under the tax benefit rule.

Although the taxpayer in Consolidated Foods was successful in asserting that the full amount of rent due each year was accruable, it had also argued that the lessee had committed itself to a 25 year obligation. As a result, it was asserted that the lessee could deduct in each lease year an allocable part of that total commitment reduced pro rata by allocable part of the surplus bond proceeds credit for each lease year. That is, the taxpayer asserted that the full basic rent due each year was deductible, except for a reduction equal to 1/25 of the surplus bond proceeds.

Although the accruals claimed as rent by the taxpayer in Consolidated Foods differ from those claimed in the present case, some of the issues are the same. Most significantly, in Consolidated Foods, the taxpayer argued that it had assumed a commitment to pay the full amount of the lease payments over 25 years and thus the credits could be spread over that period. As in the present case, the taxpayer relied upon Treas. Reg. § 1.162-11(a), which provides that, if a leasehold is acquired for business purpose for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. The court did not "agree that a lease obligation should be regarded for tax purposes as a 'total commitment....'" 66 T.C. at 443. Instead, the court saw the taxpayer's argument as an attempt to recharacterize the lease as something else. In this regard, the court noted that the lease used lease vocabulary, the lease stated that lease payments were for specified period and the lease was indistinguishable from a traditional lease. 66 T.C. at 443-44. We believe the same conclusions can be reached in the current case.

The taxpayer in Consolidated Foods also relied on cases where prepaid rent had been reallocated to later years, i.e., Southwestern Hotel Co. v. United States, 115 F.2d 686 (5th Cir. 1940), cert. denied, 312 U.S. 703 (1941); Main & McKinney Building Co. v. Commissioner, 113 F.2d 81 (5th Cir.), cert. denied, 311 U.S. 688 (1940); University Properties, Inc. v. Commissioner, 45 T.C. 416, 421 (1966), aff'd 378 F.2d 83 (9th Cir, 1967). The Tax Court found that these cases were not on point. Thus, that prepaid rent may attributed to later years does not mean that rent due in subsequent years can be allocated to current years.

The facts of the present case are distinguishable from circumstances where an amount of rent has accrued under the all events test, but was not paid until a subsequent tax year. An accrual method taxpayer may be entitled to deduct expenses in the year in which they are incurred, even if they are to be paid subsequently. United States v. Hughes Properties, Inc., 476 U.S. 593, 599 (1986). Such circumstances were involved in Illinois Power Fuel Co. v. Commissioner, 87 T.C. 1417 (1986), acq. in result, 1990-2 C.B. 1. There the taxpayer had entered into a purported sale leaseback of nuclear fuel to be used in a power plant. The amount of "rent" due under the sale leaseback agreement for the use of the fuel was determined for each month under formulas found in the agreement. An amount was due for each month, whether the month was before or after the power plant was operating. However, the taxpayer could and did elect to defer the payment of rent until the plant was operating.

The issue was whether the taxpayer could accrue rent in 1981 before the plant was operating and the rent was paid. The Service argued that the taxpayer had merely agreed to become liable for the rent in the event the plant began operating. The court disagreed, finding that the taxpayer had an unconditional obligation to pay the rent that had accrued each month under the agreement and could deduct those amounts even though they had not yet been paid. Therefore, the court in Illinois

Power found that the taxpayer could deduct the amounts due for each month of the tax year under the agreement. In the present case, we are likewise arguing that Corp X may deduct the amounts due for the tax year.

In addition, the court in Illinois Power found that the transaction was not in substance a sale leaseback but a financing. Therefore, the amounts the taxpayer was deducting were not in substance rent but loan payments. In this way, Illinois Power is also distinguishable from the current case, as we have assumed that the transaction here is in substance a lease.

Burnham Corporation v. Commissioner, 90 T.C. 953 (1988), aff'd 878 F.2d 86 (2nd Cir. 1989), is also factually distinguishable from the present case because it does not involve rent, but a liability arising from a settlement agreement relating to patent infringement litigation. In Burnham, taxpayer agreed to pay the beneficiary of the agreement a settlement amount on a monthly basis for life, with the first 4 years of payments (totaling $60,000) guaranteed even if the beneficiary did not survive. After the fourth year, the payments need only have been made if the beneficiary was still alive. At the time of the settlement agreement, taxpayer calculated its liability for the total payments to beneficiary based on the beneficiary's estimated life span. Taxpayer deducted this amount on its return for the year in which it entered into the agreement.

The Commissioner argued that the amounts due after the first four years were not fixed under the all events test because they were subject to a condition precedent. The Service had conceded that the amount could be determined with reasonable accuracy. The Tax Court held, and the Second Circuit affirmed, that the possibility of the beneficiary's death was a condition subsequent and, as a result, the taxpayer's liability for payment under the settlement agreement was fixed upon entry into the settlement agreement. Thus, Burnham dealt with a single set liability that was paid out over a period of years. In such circumstances the taxpayer was allowed to deduct the entire amount at one time. This is distinguishable from rent where amounts attributable to each taxable period accrue over time. Compare Consolidated Foods, 66 T.C. at 443, discussed above, where a similar argument that rent was a single liability was rejected.

The present case should be governed by the principles set forth in precedent cited in regard to rent. Corp X should only accrue the amounts due for each year under the lease agreement. Based on the foregoing, Corp X has not demonstrated that the amount it accrued satisfied the all events test.

In addition, Corp X has not satisfied the economic performance rules which govern the tax years at issue. Economic performance would occur ratably over the period of time Corp X is entitled to the use of the property. I.R.C. § 461(h)(2)(A)(iii); Treas. Reg. § 1.461-4(d)(3).

The legislative history of the economic performance rule indicates its purpose was to account for the time value of money. H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1254 (1984); Joint Committee on Taxation Staff, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 260 (1984).

> 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.

H.R. Rep. No. 432 at 1254; General Explanation, supra, at 260.

Thus, the present situation of deducting rents for future years currently fits within the circumstances the economic performance rules were meant to end. Again, Corp X should only accrue the amounts due for each year under the lease agreement.

Issue 2

If taxpayer's accounting method does not clearly reflect income, the computation of taxable income must be made under an accounting method which, in the Commissioner's opinion, clearly reflects income. I.R.C. § 446(b); Treas. Reg. § 1.446-1(c)(ii)(C). The accounting method used by the taxpayer in determining when income should be accounted for will generally be acceptable if it is in accordance with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. Treas. Reg. § 1.446-1(c)(ii)(C).

However, the Commissioner has broad discretion to determine whether accounting method employed by taxpayer clearly reflects income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979). Significantly, in Thor Power, 439 U.S. at 540, the Service was permitted to change the taxpayer's method of accounting, because it was inconsistent with the regulations, even though the method was consistent with GAAP. Further, an erroneous practice should not be perpetuated for the sake of consistency. See Mountain Fuel Supply Co. v. United States, 449 F.2d 816, 822 (10th Cir. 1971), cert. denied, 405 U.S. 989 (1972); Thompson Electric, Inc. v. Commissioner, T.C. Memo. 1995-292.

Although Corp X has consistently applied its annuity method of accounting for rental payments and its treatment may have been in accordance with GAAP, accrual of payment amounts in excess of those due under the lease agreement did not meet the requirements of Treas. Reg. § 1.461-1(a)(2). For that reason, the Service is not prohibited from changing the Corp X's to a correct method.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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