INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 01, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200619022**
Release Date: 5/12/2006
Index (UIL) No.: 162.07-27, 461.01-00
CASE-MIS No.: TAM-142230-05

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Parent	=
Corp A	=
Corp B	=
LLC A	=
LLC B	=
Corp C	=
Corp D	=
State X	=
State Y	=
Month 1	=
Year 1	=
Year 2	=
State Act	=
$p	=
$q	=

ISSUES:

(1) Whether Parent had a fixed liability under § 1.461-1(a)(2)(i) of the Income Tax Regulations for driver services in Year 1.

(2) Whether Parent properly applied the 3 ½ month rule in § 1.461-4(d)(6)(ii) of the Income Tax Regulations to its liability for driver services.

CONCLUSIONS:

(1) Parent did not have a fixed liability for driver services in Year 1.

(2) Parent did not properly apply the 3 ½ month rule to its liability for driver services.

FACTS:

Parent is a publicly traded State X transportation company primarily engaged in hauling shipments of general commodities in both interstate and intrastate commerce. Parent owns a majority of the trucks it uses to haul merchandise from various locations throughout the United States. Parent also engages the services of independent contractors, who own and operate their own trucks, to haul merchandise throughout the United States. For federal income tax purposes, Parent files a consolidated income tax return on a calendar year basis and uses an overall accrual method of accounting.

In Month 1, Year 1, Parent altered its organizational structure. In this restructuring, Parent changed the entity form and legal domicile of two of its subsidiaries, Corp A and Corp B. Prior to the restructuring, Parent owned 100 percent of Corp A and Corp A owned 100 percent of Corp B. The restructuring is described in further detail below.

Corp A, a State X corporation, was a first-tier, wholly owned subsidiary of Parent. Corp A owned or leased a number of terminals and employed individuals who performed maintenance services on Parent’s trucks and trailers. In Year 1, Corp A changed domiciles from State X to State Y and converted from a corporation to a single-member limited liability company. All of the operations, assets, and liabilities of Corp A transferred to the successor, LLC A. For federal income tax purposes, LLC A is treated as a division of Parent, as single member LLCs are disregarded entities. As such, all income and expense items of LLC A are combined with Parent’s income for federal income tax purposes.

Corp C, a new State Y corporation, was formed during the restructuring. It is a first-tier subsidiary of LLC A. The sole asset of Corp C is a one percent (1%) interest in the capital and profits of LLC B.

Corp B, a State Y corporation, was a first-tier subsidiary of Corp A. It employed all of the drivers responsible for performing the freight driver services for Parent. Corp B's sole asset was its workforce. Parent compensated Corp B for its driver services through an intercompany service fee. Neither Parent, nor any affiliate of Parent, ever compensated Corp B through an advance payment for driver services expected to be rendered in the future. As a result, Corp B never received an advance payment for driver services prior to the restructuring.

As part of the Month 1, Year 1 restructuring, Corp B was converted to a two-member LLC, LLC B, pursuant to the State Act. Under the State Act, LLC B's existence was deemed to have commenced on the date Corp B commenced its existence and LLC B was deemed to be the same entity as Corp B for all purposes of the laws of the State Y. Thus, the operations, assets, and liabilities of Corp B remained vested in LLC B after the conversion. In addition, pursuant to advice from its tax advisor, LLC B retained Corp B's federal taxpayer identification number for payroll reporting purposes.

LLC B is treated as a partnership for federal income tax purposes and the membership interests of LLC B are owned 99% by LLC A and 1% by Corp C. LLC B operates on a calendar year basis and uses an overall accrual method of accounting.

On December 28, Year 1, Parent and LLC B entered into a receivables management agreement. This agreement provided that Parent may pay LLC B for services rendered with certain accounts receivable and that LLC B agreed to accept these receivables without recourse to Parent. Under the agreement, Corp D[1] is the designated agent responsible for collecting these receivables for a fee of 0.25 percent of the net trade receivables.

On December 29, Year 1, Parent and LLC B entered into a services agreement ("Services Contract"). The Services Contract, effective on December 29, Year 1, had a one-year term that was automatically renewable unless expressly terminated within 30 days of the end of the preceding one-year period. Pursuant to the Services Contract, LLC B agreed to provide to Parent, upon reasonable request and in sufficient numbers to meet the needs of Parent, over-the-road truck drivers holding valid commercial drivers' licenses and meeting applicable state Department of Transportation requirements. Pursuant to the Services Contract, LLC B agreed to provide transportation services in exchange for a payment on a per-mile basis for the cost of insurance, driver pay, and driver benefits. The Services Contract specified that the payment per mile is calculated based on: (1) the costs incurred by LLC B to provide the transportation services to Parent plus a five percent mark-up; and (2) dividing the sum computed in step 1 by the total miles driven. LLC B compensated its drivers based on

[1] Corp D is a State X corporation also formed during the Month 1, Year 1 restructuring. It is a first-tier, wholly owned subsidiary of Parent. Corp D employs a significant number of administrative personnel who are responsible for providing most of the support services to Parent and its affiliates.

the number of miles driven on a weekly basis and it provided its drivers with a competitive benefits package.

Payment generally was due under the Services Contract within fifteen days following the receipt of an invoice from LLC B; however, the Services Contract provided Parent the option to prepay up to three and one-half months (the Prepayment Period) worth of driver services that were reasonably expected to be rendered by LLC B within the Prepayment Period. The prepayment could be made in cash or cash equivalents such as trade receivables (accounts receivable). In addition, the Services Contract provided Parent with a prepayment discount equal to 130% of the short-term applicable federal rate in effect for the month in which the prepayment was made times the average period covered by the prepayment. Further, it specified the manner in which to determine the face amount of receivables needed to satisfy a prepayment. This amount was to equal the prepayment amount, less the prepayment discount, plus the product of the discounted prepayment amount times 100% of the short-term applicable federal rate in effect for the month in which the prepayment was made times the average period of time that the receivables remain outstanding. The Services Contract did not contain any refund provisions with regard to the prepayment.

On December 29, Year 1, Parent exercised its prepayment option in the amount of $p according to the terms and conditions of the Services Contract. After applying the prepayment discount in accordance with the Services Contract, Parent transferred $q of accounts receivable to LLC B on December 31, Year 1 (the Advance Payment) as a prepayment for the driver services that it expected LLC B to render during the period January 1, Year 2 through March 31, Year 2.[2] The expenses represented by the Advance Payment amount consisted of estimated expenses that Parent anticipated would be incurred by LLC B during the first three months of Year 2 for driver salaries and wages, payroll taxes, interest, advertising for driver positions, pension/profit sharing plans, employee benefits programs, driver travel/lodging, driver physicals, and other deductions. According to Parent, it relied on historical data, existing customer orders, existing long term contracts, and forecasts of future demand to determine that it could expect LLC B to render approximately $p of driver services for the three month period from January 1, Year 2 to March 31, Year 2. In Year 1, for book purposes, Parent recorded the Advance Payment as an asset. For tax purposes, Parent deducted the Advance Payment as an expense.

LAW AND ANALYSIS:

ISSUE (1)

[2] Although the Services Contract authorized a prepayment up to 3 ½ months' worth of driver services that were reasonably expected to be rendered by LLC B within the Prepayment Period, the $p prepayment here actually represented driver services that were reasonably expected to be rendered during a 3 month period, not a 3 ½ month period.

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. For a taxpayer using an accrual method of accounting, § 461 and the regulations thereunder provide rules for determining when a liability is incurred. Specifically, § 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"). It is fundamental to the all events test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. *United States v. General Dynamics Corp.*, 481 U.S. 239, 243-4 (1987). A taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. *Brown v. Helvering*, 291 U.S. 193, 201 (1934). Each of the three prongs of the all events test (fact of liability, amount determinable with reasonable accuracy, and economic performance) must be met before the liability is incurred. This issue addresses whether all the events have occurred that establish the fact of the liability.

Generally, under § 1.461-1(a)(2), all the events have occurred that establish 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. Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, *amplified by* Rev. Rul. 2003-90, 2003-2 C.B. 353. Thus, with regard to services, the event fixing the liability generally is the performance of services, unless payment is due prior to the services being performed. The term "liability" is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred. Section 1.446-1(c)(ii)(B).

The terms of a contract are relevant in determining the events that fix a taxpayer's obligation to pay. *See*, *e.g.*, *Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), *acq.*, 1967-2 C.B. 2. In the instant case, the Services Contract generally provides that LLC B will provide driver services upon Parent's request and will bill Parent on a per mile basis after the services have been provided. It further provides that Parent will pay the charges for services within fifteen days following receipt of LLC B's bill. Because payment under the Services Contract is not due until after the services are performed, the first event that occurs to fix Parent's liability is LLC B's performance of services. Thus, the fact of the liability for driver services was established in Year 2.[3]

[3] We note that § 267 does not apply to this transaction because both Parent and LLC B use an accrual method of accounting. *See* § 267(a)(2)(A).

Parent argues that its liability for driver services was fixed in Year 1. In that year, the Services Contract was executed and Parent made the Advance Payment under the prepayment option of the Services Contract.[4] We do not believe either one of these events fixed Parent's liability for the driver services. First, it is well established that an accrual basis obligor is not permitted to deduct an expense stemming from a bilateral contractual arrangement, that is, mutual promises, prior to the performance of the contracted for services by the obligee. Rev. Rul. 80-182, 1980-2 C.B. 167, citing *Levin v. Commissioner*, 21 T.C. 996 (1954), *aff'd*, 219 F.2d 588 (3d Cir. 1955) (an agreement for services to be performed in the next year did not fix the liability but was simply an agreement under which a liability would be incurred in the future) and *Amalgamated Housing Corp. v. Commissioner*, 37 B.T.A. 817 (1938), *aff'd per curium*, 108 F.2d 1010 (2d Cir. 1940).

In *Amalgamated Housing*, the taxpayers owned apartment buildings and were required to renovate the apartments after a period of months. In holding the taxpayers did not have a fixed liability until the renovation occurred, the court stated:

> They [the taxpayers] did not have to wait until they had actually paid for the renovating before they could accrue their liabilities to pay for that renovating, but, on the other hand, they could not property accrue as an expense the estimated cost of the renovating prior to the end of the period of months, and prior to the time that the painter rendered some services. . . . Although petitioners were obligated to renovate, they had no liability to pay anyone anything until someone had performed some services. The accrual is for services in renovating, not of the duty to renovate. The accrual method does not permit the anticipation of future expenses prior to the rendition of the services for which the payment is due.

Id. at 829 (citations omitted). In *National Bread Wrapping Machine Co. v. Commissioner*, 30 T.C. 550 (1958), the taxpayer was denied a deduction for guaranteed installation services for machines sold but uninstalled. The court stated:

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[4] The prepayment of services raises the issue of whether the Advance Payment should be capitalized under § 263(a). As of December 31, 2003, however, § 1.263(a)-4(f) provides that a taxpayer is not required to capitalize amounts paid to create any right or benefit for the taxpayer that does not extend beyond the earlier of – (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. Although this "12-month rule" was not effective during the taxable year at issue, LMSB did not raise capitalization as an issue because, after the Advance Notice of Proposed Rulemaking proposed a 12-month rule, the Commissioner of LMSB advised examiners not to pursue this issue if they had not already prepared a Form 5701 as of February 26, 2002.

> There can be no doubt that under its sales contracts the petitioner was obligated to render some services in connection with the installation of its machines and the estimate of cost made by the petitioner was not substantially different from the amounts subsequently expended. However, until those services were rendered there was no definite liability on the part of the petitioner to pay any amount to any person. The liability was contingent until there was performance.

Id. at 556. *See also Capital Warehouse Co., Inc. v. Commissioner*, 171 F.2d 395 (8th Cir. 1948) (taxpayer's contractual obligation to pay moving costs in a future year became final when the contract was executed but was not fixed until the moving services were performed); *Spencer, White & Prentis, Inc. v. Commissioner*, 144 F.2d 45, 47 (2d Cir. 1944) ("It is well settled that deductions may only be taken for the year in which the taxpayer's liability to pay becomes definite and certain, even though the transactions (such as the contract in the present case) which occasioned the liability, may have taken place in an earlier year") (citations omitted); *Yost Auto Co. v. Commissioner*, 26 B.T.A. 685 (1932) (contractual obligation to purchase tires in a future year did not create a fixed liability); *Hallack & Howard Lumber Co. v. Commissioner*, 18 B.T.A. 954 (1930) (a contract for future railroad track removal services did not fix the taxpayer's liability but was simply an agreement under which a liability would be incurred in the future); *William J. Ostheimer*, 1 B.T.A. 18 (1924) (lessee's obligation under lease to restore or replace certain property at the end of the lease term was not fixed until the property was restored or replaced).

The fixed liability determinations in the cases cited above are not affected by the enactment of the economic performance rules in the 1984 Tax Act. Section 461(h) added the economic performance requirement to the all events test, but did not change the requirement that a liability must be fixed and determinable with reasonable accuracy. Although the statute is clear that the economic performance rules did not change the first two prongs of the all events test, it has been argued that the legislative history to § 461(h) provides that, after 1984, the mere existence of a contract is enough to fix a taxpayer's liability. In addressing the record-keeping required for taxpayers to prove compliance with the economic performance requirement, the House Report provides:

> In the absence of unusual circumstances, the existence of a valid contract requiring another person to provide property or services to the taxpayer prior to the end of the taxable year (or 8 ½ months thereafter in the case of recurring items) would be sufficient to establish compliance with the economic performance standard with respect to the taxpayer's liability for an expense reflected in such contract.

H. Rep. No. 98-861, page 876. This language was intended to illustrate what proof a taxpayer might use to show compliance with the economic performance requirements, and was not intended to illustrate when a liability is fixed. The legislative history does not provide any support for the proposition that a liability is fixed merely upon the existence of a valid contract.

Further, the preamble to the final regulations implementing § 461(h) clearly indicates that the IRS and Treasury Department believed that the mere execution of a contract does not satisfy the fixed liability prong of the all events test. The preamble explains why former Example 9 in the proposed regulations was removed:

> Commentators also said Example 9 of § 1.461-4(d)(6) of the proposed regulations, which illustrates the 3 ½ month rule, suggests that an executory contract satisfies the all events test. The examples in the proposed and final regulations are intended to illustrate the principles of economic performance; they are not intended to illustrate all aspects of the all events test. Nevertheless, this example and Example 8 of § 1.461-4(d)(6) of the proposed regulations are removed from the final regulations ***to avoid any implication that an executory contract satisfies the all events test***. (Emphasis added).

Preamble to T.D. 8408, 57 Fed. Reg. 12411 (Apr. 10, 1992) [1992-1 C.B. 155, 156]. Thus, neither § 461(h) nor the regulations there under change the result of the cases discussed above, nor do they affect our analysis in the instant case.

Finally, Parent's facts are not analogous to the line of cases holding that a liability may be fixed by a statutory or regulatory obligation to perform certain activities. *See Ohio Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981); *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959), *acq.*, 1958-2 C.B. 5; *Harrold v. Commissioner*, 192 F.2d 1002 (4^{th} Cir. 1951). In each of these cases, the taxpayer engaged in strip mining and was required by law to file a reclamation plan accompanied by a bond equal to the total estimated reclamation costs. The court in each case held that the taxpayer had a fixed liability for reclamation costs in the year in which the mining ceased rather than in the year in which the reclamation activities occurred. These cases are often cited for the proposition that a statutory or regulatory obligation can fix a taxpayer's liability. *See also United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) (casino had fixed liability for guaranteed payment amounts on progressive slot machines that were not yet won because the liability was fixed by state gaming regulations after the last play of the slot machine); *Gold Coast Hotel & Casino v. United States*, 158 F.3d 484 (9^{th} Cir. 1997) (casino could deduct value of slot club points won by slot club member but not yet redeemed because the liability was fixed by state gaming regulations once a member accumulated a certain number of points).

The Services Contract in this case does not impose the same level of regulatory oversight that was common to the reclamation and casino cases. Thus, those cases do not require a conclusion that a fixed liability exists upon the mere execution of the Services Contract in this case. In fact, Parent has no liability under the Services Contract in this case unless and until LLC B provides driver services to Parent.

Further, in the reclamation and casino cases cited above, the existence of the statute or regulation was not the event that fixed the liability. Instead, the courts in those cases considered what event under the statute or regulation triggered the liability. For example, in the reclamation cases, the court held that it was the strip mining itself, and not the statute alone, that created the reclamation liability. Similarly, in *Hughes* and *Gold Coast*, the courts determined that the event creating the liability was not the state gaming regulation, but instead the last play of the slot machine before the end of the tax year, and accumulation by a club member of the minimum number of points needed to redeem a prize, respectively. Therefore, even if the Services Contract created the equivalent of a statutory or regulatory obligation, that obligation was not triggered by the mere execution of the Services Contract. *See also Chrysler Corp. v. Commissioner*, T.C. Memo 2000-283 (warranty liability not fixed by mere existence of warranty), *Exxon Mobil Corp. v. Commissioner*, 114 T.C. 293 (2000) (oil company's "expectation" and "prediction" that it would be required to perform restoration to certain oil field equipment and facilities did not fix the restoration liability); *World Airways v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977) (statutory requirement to overhaul aircraft after specified number of flight hours did not fix overhaul liability).

In the instant case, the Services Contract between Parent and LLC B merely obligated Parent to pay for driver services in the event that Parent ever requested those services and LLC B provided the services. Parent had no liability to pay under the Services Contract unless and until any driver services were performed. Thus, performance of services by LLC B was a condition precedent to the establishment of Parent's liability for driver services. The execution of the Services Contract in Year 1 did nothing more than establish a contractual duty to pay in the future if contingent services were provided. There is no indication in the facts of this case that any services were performed by LLC B under the Services Contract in Year 1. Thus, the execution of the Services Contract in Year 1 did not fix Parent's liability to LLC B for the driver services.

Neither did the Advance Payment fix Parent's liability for the driver services under the Services Contract. Parent argues that the Advance Payment somehow changes the result of the cases discussed above and provides an earlier date for the liability being fixed. As noted above, it is clear that a liability is fixed if payment is due under the terms of a contract. However, the Advance Payment in this case was not due under the Services Contract in Year 1. The Services Contract merely provided that Parent could, at its option, prepay an estimated amount to cover services to be provided in the next 3 ½ months. Therefore, Parent's liability for the driver services was not fixed in Year 1.[5] *See* § 1.446-1(c)(ii)(B) (amounts prepaid for goods or services and amounts

[5] As noted earlier in the discussion of this issue, the second prong of the all events test provides that a liability is not incurred unless the amount of the liability can be determined with reasonable accuracy. Thus, even if Parent's liability for driver services were fixed in Year 1, Parent would also have to show

paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred). Parent has not cited any authority holding that an optional prepayment by an accrual method taxpayer can accelerate the establishment of a liability that is otherwise not fixed until a later year.[6] The particular facts of this case raise other questions as well.[7]

ISSUE (2)

As discussed in Issue (1), Parent did not have a fixed liability for driver services in Year 1. Thus, no deduction in Year 1 is permitted. However, even assuming that Parent had a fixed liability in Year 1 (and could determine the amount with reasonable accuracy, an issue not addressed in this technical advice memorandum), it also would have to meet the economic performance prong of the all events test. See § 461(h)(1) and § 1.461-4(a)(1). 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 with respect to the driver services as the services are provided by LLC B to Parent, even though the Advance Payment is made prior to the services being performed.

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that the amount could be determined with reasonable accuracy. We understand that Parent has not yet provided substantiation to the field regarding how it determined the amount of its liability.

[6] The only authority cited by Parent in support of its position that the Advance Payment fixed the liability for driver services is *Stradlings Building Materials Inc. v. Commissioner*, 76 T.C. 84 (1981), *acq.*, 1981-2 C.B. 2, in which the court allowed a deduction for an accrual method taxpayer's prepayment of intangible drilling and development costs (IDC) two days before the end of its taxable year to an unrelated drilling contractor pursuant to a contract to drill six wells. However, the Government did not raise the issue as to whether the taxpayer's liability for the drilling expenses met the all events test in the year of the deduction until filing its reply brief with the court. Thus, the court refused to consider the Government's arguments, stating that these issues were effectively abandoned during the early stages of this proceeding. Therefore, without considering the issue of whether the contract represented a fixed obligation in the year of the deduction under the all events test, the court assumed that the liability was fixed and ruled in favor of the taxpayer. *See also Cheroff v. Commissioner* T.C. Memo 1980-125 (Commissioner conceded both elements of the all events test for IDC costs). Thus, these cases are not relevant to determining whether Parent's Advance Payment fixed its liability for driver services. *See Heitzman v. Commissioner*, 859 F.2d 783, 788 (9th Cir. 1988) (holding that IDC liability was not fixed on execution of the contract and distinguishing *Stradlings* and *Cheroff* on the basis that those cases did not consider the application of the all events test).

[7] For example, the Advance Payment was made by a transfer of trade receivables between related parties and the sole basis for determining the amount of the Advance Payment was to take advantage of the 3 ½ month rule in § 1.461-4(d)(6)(ii). These particular facts call into question whether even a mandatory prepayment under the Services Contract would have fixed the liability in this case. *See Darco Realty Corp. v. Commissioner*, 301 F.2d 190 (2d Cir. 1962) (determining the proper tax treatment of transactions involving related parties requires close scrutiny).

However, an exception to the economic performance rule for services 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.[8] Thus, Parent in this case argues that it can treat the Advance Payment as meeting economic performance so long as Parent can reasonably expect the services to be provided within 3 ½ months after the Advance Payment. The question is whether this rule contemplates that ***all*** of the services under the Services Contract must be provided within 3 ½ months, or whether this rule permits Parent to accelerate into Year 1 a deduction for 3 ½ months' worth of services to be provided in Year 2.

The particular liability in this case is for driver services to be provided both during and after the 3 ½ month period following the Advance Payment. In general, a 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). The Services Contract in this case provides for driver services to be performed and billed on a per-mile basis; it does not provide for different or divisible services. In the absence of a divisible contract, there is no authority in the § 461 regulations allowing Parent use the 3 ½ month rule for some portion of the liability for driver services under the Services Contract, even if Parent 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. For example, 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)-

[8] "Payment" for this purpose has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Section 1.461-4(g)(1)(ii)(A). Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include an amount transferred as a loan, refundable deposit, or contingent payment. In this case, Parent has not shown that the receivables transferred as the Advance Payment, which were transferred to LLC B without recourse, are cash equivalents. In addition, Parent has not demonstrated that the Advance Payment was not a loan, refundable deposit, or contingent payment. Although the Services Contract is silent as to whether Parent could receive a refund of the Advance Payment, we think a voluntary prepayment in a transaction between unrelated parties generally would be refundable. Therefore, even assuming the Advance Payment is a cash equivalent, it may not constitute "payment" for § 461(h) purposes (or even a deductible expense under § 162) if the Advance Payment is a loan, refundable deposit, or contingent payment. Parent has the burden of clearly showing its entitlement to a deduction for the Advance Payment. *See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). Parent has not yet done that.

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 (or a properly divisible portion of a liability). Therefore, the 3 ½ month rule does not apply to allow a deduction for the Advance Payment made in Year 1 for services to be performed in the first 3 ½ months of Year 2 because the term of the Services Contract extends beyond the 3 ½ month period. *See also* 1994 FSA LEXIS 463 (November 14, 1994), Issue (4) (concluding that the taxpayer may not deduct a prorated amount of services under § 1.461-4(d)(6)(ii) if not all services will be provided within 3 ½ months).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Parent. Section 6110(k)(3) provides that it may not be used or cited as precedent.