199904036 SEP 30 1998

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index Numbers: 461.00-00
461.06-00

Control Number: TAM-105292-98

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Tax Years Ended:
Date of Conference:

LEGEND:

Taxpayer =

State X =

Date 1 =

Date 2 =

a =

ISSUES:

(1) When is the liability for payment of deferred sales tax associated with the acquisition of an asset incurred by the Taxpayer for purposes of § 461 of the Internal Revenue Code?

(2) If the deferred sales tax is not incurred by the Taxpayer under § 461 of the Code until the year(s) of payment, and thus, not includible in the basis of the asset until

the year(s) of payment, then how is the deferred sales tax taken into account for purposes of depreciation under § 168?

CONCLUSIONS:

(1) The liability for payment of deferred sales tax associated with the acquisition of an asset is incurred by the Taxpayer under § 461 of the Code in the year(s) in which payment is made, and not in the year in which the asset is purchased.

(2) The Taxpayer must redetermine its depreciable basis in an asset in each taxable year in which a deferred sales tax payment is made with respect to that asset.

FACTS:

The Taxpayer is a company that manufactures electronic components in State X and uses an accrual method of accounting. In the early 1990's, Taxpayer constructed a manufacturing and research facility, and pursuant to State X's sales and use tax deferral program for certain manufacturing or research and development investment projects, Taxpayer was able to defer payment of sales taxes related to the acquisition of qualifying buildings and equipment. Specifically, the Taxpayer applied for and received several deferral certificates by State X, which enabled the Taxpayer to defer "state and local retail sales tax and use tax due on the construction of buildings as well as the acquisition of qualified machinery and equipment to be used therein as an integral and necessary part of the manufacturing or research and development operation." The Taxpayer's payment of the deferred sales taxes is due in five installments. The first payment (10% of the total tax deferred) was due on December 31 of the third year after the construction project was operationally complete, and four subsequent annual payments (15%, 20%, 25%, and 30%, respectively) are due on December 31 of the following four years. Thus, the Taxpayer's first installment payment was due on Date 1.

At the time the Taxpayer purchased an asset eligible under State X's deferral program, the Taxpayer included the deferred sales tax in the determination of the asset's basis and began depreciating the asset at the time it was placed in service. The Taxpayer's first installment payment of the deferred sales taxes was made on or before Date 1. Thus, the Taxpayer's net amount of deferred sales taxes due was $a for the taxable period ending on Date 2.

The agent has questioned whether the economic performance rules under § 461 preclude the Taxpayer from taking the deferred sales tax into account in determining the basis of an asset until the time when payment is made. The Taxpayer argues that the deferred sales taxes at issue were properly added to the basis of depreciable assets to which they relate as of the date of acquisition and that the economic performance rules should not apply to acquisition costs of depreciable assets. Moreover, if the deferred sales taxes are not properly added to basis until payment is made, the Taxpayer questions the correct method for computing depreciation deductions under §168.

LAW AND ANALYSIS:

Section 461(a) of the Code provides generally that the amount of any deduction or credit shall be accounted for in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.263(a)-1(b) of the Income Tax Regulations provides that the amount of any cost required to be capitalized under section 263 may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

Section 461(h)(1) of the Code generally 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.

Section 461(h)(4) of the Code provides that the all events test is met if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.461-1(a)(1) of the regulations provides that under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as deductions for depreciation, depletion, and losses under sections 167, 611 and 165, respectively.

Section 1.461-1(a)(2)(i) of the regulations provides, in part, that under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) 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. Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability is generally taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 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 (within the meaning of 1.263A-1T(a)(5)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Code sections and guidance published by the Secretary.

Section 1.446-1(c)(1)(ii)(B) of the regulations provides, in part, that the term "liability" includes any item allowable as a deduction, cost or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property.

Section 461(h)(2)(D) of the Code provides that in the case of a liability not described in §§ 461(h)(2)(A), (B), or (C), economic performance occurs at the time determined under regulations prescribed by the Secretary.

Section 1.461-4(g) of the regulations provides that in the case of liabilities described in paragraphs (g)(2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed.

Section 1.461-4(g)(6) of the regulations provides, in part, that if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax.

Section 1.461-4(g)(1)(ii)(A) of the regulations provides that the term "payment" 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. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a governmental agency).

Section 167(a) of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, and wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or held for the production of income. For tangible depreciable assets placed in service after 1986, § 168 provides that the depreciation deduction provided by § 167(a) shall be determined by using the applicable depreciation method, recovery period, and convention.

Generally, a taxpayer using an accrual method of accounting may not take an amount into account in computing its basis in acquired property until that amount is incurred. §§ 1.263(a)-1(b) and 1.446-1(c)(1)(ii)(B). The regulations under § 461 provide a three prong test to determine when an item is incurred and can be taken into account by taxpayers using an accrual method. Specifically, § 1.461-1(a)(2)(i) of the regulations provides that a liability is incurred and taken into account in the taxable year in which (i) all events have occurred to establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the liability. The agent has not questioned whether the first two prongs have been met, but has questioned whether economic performance occurs in the year in which the asset is purchased or in the year(s) in which the deferred sales tax is paid. Neither the agent nor the Taxpayer dispute the fact that the deferred sales tax liability is a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year within the meaning of § 263(a) and thus, is taken into account in the taxable year incurred through capitalization.

We believe § 1.461-4(g)(6) of the regulations clearly provides that taxes are among the liabilities requiring payment to another person in order for economic performance to occur. Moreover, the deferred sales taxes at issue are clearly the type of taxes covered by the regulations. Thus, economic performance does not occur for the deferred sales taxes until the taxes are actually paid by the Taxpayer to State X, and thus, the Taxpayer may not take the deferred sales tax into account in computing its basis in the depreciable assets until payment is made.

The Taxpayer argues that notwithstanding the literal language of the Code and regulations underlying § 461, the deferred sales taxes at issue should be included in the determination of its basis in acquired assets as of the date of acquisition for several reasons. First, the Taxpayer argues that the economic performance rules effectively place accrual method taxpayers on a cash method, and since cash method taxpayers can add acquisition costs to the basis of assets even if the asset was purchased on credit or with a debt instrument (i.e., even if payment for the asset was not made), accrual method taxpayers such as the Taxpayer should be allowed similar treatment. For support, the Taxpayer cites § 1.461-1(a)(1) of the regulations, which states that under the cash method of accounting, amounts representing allowable deductions as a general rule shall be taken into account for the taxable year in which paid, and a taxpayer using the cash method may also be entitled to certain deductions which do not involve cash disbursements during the taxable year, such as deductions for depreciation, depletion, and losses under sections 167, 611 and 165, respectively. Further, the Taxpayer cites Crane v. Commissioner, 331 U.S. 1 (1974), as authority for its assertion that property acquired by purchase has a basis equal to its cost, and cost includes money paid plus liabilities assumed. Thus, the Taxpayer argues that "depreciation is an exception to the general rule that a cash-basis taxpayer cannot deduct amounts not actually paid." Accordingly, the Taxpayer argues that since "the payment rule effectively places an accrual method taxpayer on par with a taxpayer on the cash method of accounting, it is reasonable to allow an accrual method taxpayer to capitalize all costs associated with the acquisition of an asset regardless of when payment for the asset is made."

We do not agree with the Taxpayer's basic premise that the economic performance rules effectively place accrual method taxpayers on a cash method. Under § 1.461-1(a)(1), expenditures are to be deducted under the cash method for the taxable year in which paid. Thus, taxpayers using the cash method must simply make payment in order to deduct an expense. In contrast, however, a liability is only incurred and is taken into account for Federal income tax purposes by a taxpayer using an accrual method in the taxable year in which (i) all the events have occurred that establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the liability. §§ 1.446-1(c)(1)(ii)(A) and 1.461-1(a)(2)(i). We believe the standards applicable to cash method and accrual method taxpayers are different standards, and there is no indication in § 461 that Congress intended to provide uniform rules and results for all taxpayers using cash and accrual methods of accounting. Moreover, we do not believe the Taxpayer's characterization of the tax treatment of depreciation deductions by cash method taxpayers is correct. The Taxpayer argues that depreciation is an exception to the general rule that a cash-basis taxpayer cannot deduct amounts not actually paid. Although a taxpayer using the cash method who finances the purchase of an asset is entitled to depreciate the full purchase price of the asset, that taxpayer is only entitled to do so because the taxpayer has incurred a current obligation and so payment has been made within the meaning of § 1.461-1(a)(1), and thus, that taxpayer is entitled to include the full purchase price of the asset in its depreciable basis. In contrast, a taxpayer who has not yet paid deferred sales taxes associated with the acquisition of an asset has not incurred the obligation and is not in the same position as a taxpayer who has paid for an asset, but has paid with borrowed funds. Under the cash method, actual payment is required before an expense can be deducted, and payment through a financing transaction meets the payment requirement. Thus, we do not agree that depreciation deductions are an exception to the general rule that a cash method taxpayer cannot deduct amounts not actually paid, rather depreciation deductions are allowed because in the case of a financed acquisition, there was a disbursement of borrowed cash. Moreover, although § 1.461-4(g)(1)(ii)(A) of the regulations provides that the term "payment" 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, the regulations specifically provide that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a governmental agency). Thus, even if the Taxpayer were correct in its characterization of the tax treatment of cash method taxpayers, these regulations clearly require actual payment by accrual method taxpayers without borrowed funds.

Second, the Taxpayer argues that if the Taxpayer is not allowed to take the deferred sales taxes into account in determining basis until payment is made, depreciation deductions in taxable years before payment of deferred taxes will not match the time period in which an asset is used to generate revenue, nor will the deductions match the cost of the asset with the time period in which the asset is used to generate revenue. The Taxpayer argues that in Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), the Supreme Court expressed two matching principles regarding depreciation . First, depreciation represents the exhaustion of an asset as it is actually consumed in a business, and second, depreciation deductions should correspond with the time period in which an asset is used to generate income. Thus, the Taxpayer argues that if depreciation deductions are not allowed until actual payment has been made, then the matching principle could be completely eliminated, especially in situations, for example, where an asset may have a useful life of three years, but payment is deferred for four years. We do not dispute the purpose of depreciation deductions as stated by the Supreme Court, however, we do not believe these matching principles are relevant to the issue at hand. Regulations under §§ 461 and 446 specifically provide that a liability is not incurred and cannot be taken into account in the determination of the basis of an asset until payment is made. These authorities do not provide any different or special rules for depreciable assets. Moreover, it is not uncommon for the depreciable basis of an asset to be redetermined for a variety of reasons after the year of acquisition. Where there is a subsequent adjustment to the purchase price of an asset that changes the amount of depreciation that should have been taken, we do not require a taxpayer to readjust its purchase price and depreciation deductions as of the date of acquisition, but instead, allow the taxpayer to account for the adjustment in the year the adjustment occurs.

Accordingly, despite the Taxpayer's arguments, we believe the literal language of both the Code and regulations under § 461 supports the conclusion that economic performance for the liability for payment of the deferred sales tax occurs as payments are made in satisfaction of the liability. Accordingly, the Taxpayer may not take into account the deferred sales taxes in determining its basis of acquired assets until such payments are made.

Because we conclude that the Taxpayer may not include the deferred sales tax in the basis of related assets until the year(s) in which payment is actually made to State X, the Taxpayer questions what is the appropriate method for computing depreciation deductions for the assets in questions. The Taxpayer must treat the payment(s) of the deferred sales taxes as a redetermination of the sales price. Thus, for each of the taxable years in which the adjusted basis of an asset is redetermined because of a payment of the deferred sales taxes, the recovery allowance is the amount determined by multiplying the redetermined adjusted basis by the redetermined applicable percentage. For this purpose, the redetermined adjusted basis is the unadjusted basis reduced by the recovery allowance previously allowed or allowable to the taxpayer with respect to the property and adjusted to reflect the redetermination. The redetermined applicable percentage is the percentage determined by dividing the applicable percentage computed under either the method set out in Section 6 of Rev. Proc. 87-57, 1987-2 C.B. 687, 692, or by use of the optional tables set out in Section 7 of that revenue procedure, by an amount equal to the unrecovered percentage (i.e., 100% minus the applicable percentage for recovery years prior to the year in which the basis is redetermined). Thus, the increase or decrease in basis shall be accounted for over the remaining recovery years beginning with the recovery year in which the basis is redetermined.

CAVEAT:

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

- END -