

§ 1.461-3

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trust, an escrow account, or a court to provide for the satisfaction of an asserted workers compensation, tort, or other liability designated under § 1.461-4(g) that the taxpayer is contesting unless the trust, escrow account, or court is the person to which the liability is owed or the taxpayer's payment to the trust, escrow account, or court discharges the taxpayer's liability to the claimant. Rather, economic performance occurs in the taxable year the taxpayer transfers money or other property to the person that is asserting the workers compensation, tort, or other liability designated under § 1.461-4(g) that the taxpayer is contesting or in the taxable year that payment is made from a trust, an escrow account, or a court registry funded by the taxpayer to the person to which the liability is owed.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example 1. A, an individual, makes a gift of certain property to B, an individual. A pays the entire amount of gift tax assessed against him but contests his liability for the tax. Section 275(a)(3) provides that gift taxes are not deductible. A does not satisfy the requirement of paragraph (a)(1)(iv) of this section because a deduction would not be allowed for the taxable year of the transfer even if A did not contest his liability to the tax.

Example 2. Corporation X is a defendant in a class action suit for tort liabilities. In 2002, X establishes a trust for the purpose of satisfying the asserted liability and transfers \$10,000,000 to the trust. The trust does not satisfy the requirements of section 468B or the regulations thereunder. In 2004, the trustee pays \$10,000,000 to the plaintiffs in settlement of the litigation. Under paragraph (e)(2) of this section, economic performance with respect to X's liability to the plaintiffs occurs in 2004. X may deduct the \$10,000,000 payment to the plaintiffs in 2004.

(f) *Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto.* [Reserved]

(g) *Effective dates.* (1) Except as otherwise provided, this section applies to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(2) Paragraph (c)(1)(iii)(E) of this section applies to transfers of any stock of

the taxpayer or any stock or indebtedness of a person related to the taxpayer on or after November 19, 2003.

(3) Paragraph (e)(2)(i) of this section applies to transfers of money or other property after July 18, 1984.

(4) Paragraph (e)(2)(ii) and paragraph (e)(3) *Example 2* of this section apply to—

(i) Transfers after July 18, 1984, of money or other property to provide for the satisfaction of an asserted workers compensation or tort liability; and

(ii) Transfers in taxable years beginning after December 31, 1991, of money or other property to provide for the satisfaction of asserted liabilities designated in § 1.461-4(g) (other than liabilities for workers compensation or tort).

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§ 1.461-3 Prepaid interest. [Reserved]

§ 1.461-4 Economic performance.

(a) *Introduction—(1) In general.* For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in § 1.446-1(c)(1)(ii)(B)) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

(2) *Overview.* Paragraph (b) of this section lists exceptions to the economic performance requirement. Paragraph (c) of this section provides cross-references to the definitions of certain terms for purposes of section 461 (h) and the regulations thereunder. Paragraphs (d) through (m) of this section and § 1.461-6 provide rules for determining when economic performance occurs. Section 1.461-5 provides rules relating to an exception under which certain recurring items may be incurred for the taxable year before the year during which economic performance occurs.

(b) *Exceptions to the economic performance requirement.* Paragraph (a)(2)(iii)(B) of § 1.461-1 provides examples of liabilities that are taken into

account under rules that operate without regard to the all events test (including economic performance).

(c) *Definitions.* The following cross-references identify certain terms defined for purposes of section 461(h) and the regulations thereunder:

(1) *Liability.* See paragraph (c)(1)(ii)(B)d of § 1.446-1 for the definition of “liability.”

(2) *Payment.* See paragraph (g)(1)(ii) of this section for the definition of “payment.”

(d) *Liabilities arising out of the provision of services, property, or the use of property—(1) In general.* The principles of this paragraph (d) determine when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. This paragraph (d) does not apply to liabilities described in paragraph (e) (relating to interest expense) or paragraph (g) (relating to breach of contract, workers compensation, tort, etc.) of this section. In addition, except as otherwise provided in Internal Revenue regulations, revenue procedures, or revenue rulings this paragraph (d) does not apply to amounts paid pursuant to a notional principal contract. The Commissioner may provide additional rules in regulations, revenue procedures, or revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (d).

(2) *Services or property provided to the Taxpayer—(i) In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

(ii) *Long-term contracts.* In the case of any liability of a taxpayer described in paragraph (d)(2)(i) of this section that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs—

(A) As the services or property is provided; or, if earlier,

(B) As the taxpayer makes payment (as defined in paragraph (g)(1)(ii) of

this section) in satisfaction of the liability to the person providing the services or property. See paragraph (k)(2) of this section for the effective date of this paragraph (d)(2)(ii).

(iii) *Employee benefits—(A) In general.* Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), and section 419 (welfare benefit funds). See § 1.461-1(a)(2)(iii)(D).

(B) *Property transferred in connection with performance of services.* [Reserved]

(iv) *Cross-references.* See *Examples 4* through *6* of paragraph (d)(7) of this section. See paragraph (d)(6) of this section for rules relating to when a taxpayer may treat services or property as provided to the taxpayer.

(3) *Use of property provided to the taxpayer—(i) In general.* Except as otherwise provided in this paragraph (d)(3)d and paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property (taking into account any reasonably expected renewal periods when necessary to carry out the purposes of section 461(h)). See *Examples 6* through *9* of paragraph (d)(7) of this section.

(ii) *Exceptions—(A) Volume, frequency of use, or income.* If the liability of a taxpayer arises out of the use of property by the taxpayer and all or a portion of the liability is determined by reference to the frequency or volume of use of the property or the income from the property, economic performance occurs for the portion of the liability determined by reference to the frequency or volume of use of the property or the income from the property as the taxpayer uses the property or includes income from the property. See *Examples 8* and *9* of paragraph (d)(7) of this section. This paragraph (d)(3)(ii) shall not apply if the District Director determines, that based on the substance of the transaction, the liability of the taxpayer for use of the property

is more appropriately measured ratably over the period of time the taxpayer is entitled to the use of the property.

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, economic performance occurs as provided in § 1.461-1(a)(2)(iii)(E).

(4) *Services or property provided by the taxpayer*—(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with the satisfaction of the liability. See *Examples 1* through *3* of paragraph (d)(7) of this section.

(ii) *Barter transactions.* If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of—

(A) The cumulative extent to which the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with its liability to provide the services or property; or

(B) The cumulative extent to which the services or property is provided to the taxpayer.

(5) *Liabilities that are assumed in connection with the sale of a trade or business*—(i) *In general.* If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See § 1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

(ii) *Trade or business.* For purposes of this paragraph (d)(5), a trade or business is a specific group of activities carried on by the taxpayer for the purpose of earning income or profit if every operation that is necessary to the process of earning income or profit is included in the group. Thus, for example, the group of activities generally must include the collection of income and the payment of expenses.

(iii) *Tax avoidance.* This paragraph (d)(5) does not apply if the District Director determines that tax avoidance is one of the taxpayer's principal purposes for the sale or exchange.

(6) *Rules relating to the provision of services or property to a taxpayer.* The following rules apply for purposes of this paragraph (d):

(i) Services or property provided to a taxpayer include services or property provided to another person at the direction of the taxpayer.

(ii) A taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the services or property within 3½ months after the date of payment.

(iii) A taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of § 1.446-1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

(iv) If different services or items of property are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided. However, if a service or item of property to be provided to the taxpayer is incidental to other services or property to be provided under a contract or agreement, the taxpayer is not required to allocate

any portion of the total contract price to the incidental service or property. For purposes of this paragraph (d)(6)(iv), services or property is treated as incidental only if—

(A) The cost of the services or property is treated on the taxpayer's books and records as part of the cost of the other services or property provided under the contract; and

(B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met, and that the recurring item exception is not used. Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable. The examples are as follows:

Example 1. Services or property provided by the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease with Y. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of \$200,000.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services (see paragraph (d)(2) of this section). Consequently, X incurs \$200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z \$130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. Under paragraph (d)(2) of this section, X does not incur this cost until Z performs the services. Thus, economic performance with respect to the \$130,000 X pays Z occurs in 1998.

Example 2. Services or property provided by the taxpayer. (i) W corporation, a calendar year, accrual method taxpayer, sells tractors under a three-year warranty that obligates W to make any reasonable repairs to each tractor it sells. During 1990, W sells ten tractors. In 1992 W repairs, at a cost of \$5,000, two tractors sold during 1990.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to

W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 1992 as, for example, replacement parts are provided to W (see paragraph (d)(2) of this section). Consequently, \$5,000 is incurred by W for the 1992 taxable year.

Example 3. Services or property provided by the taxpayer; Long-term contracts. (i) W corporation, a calendar year, accrual method taxpayer, manufactures machine tool equipment. In November 1992, W contracts to provide X corporation with certain equipment. The contract is not a long-term contract under section 460 or § 1.451-3. In 1992, W pays Z corporation \$50,000 to lease from Z, for the one-year period beginning on January 1, 1993, testing equipment to perform quality control tests required by the agreement with X. In 1992, pursuant to the terms of a contract, W pays Y corporation \$100,000 for certain parts necessary to manufacture the equipment. The parts are provided to W in 1993. W's employees provide W with services necessary to manufacture the equipment during 1993, for which W pays \$150,000 in 1993.

(ii) Under paragraph (d)(4) of this section, economic performance with respect to W's liability to provide the equipment to X occurs as W incurs costs in connection with that liability. W incurs these costs during 1993, as services, property, and the use of property necessary to manufacture the equipment are provided to W (see paragraphs (d)(2) and (d)(3) of this section). Thus, \$300,000 is incurred by W for the 1993 taxable year. See section 263A and the regulations thereunder for rules relating to the capitalization and inclusion in inventory of these incurred costs.

(iii) Alternatively, assume that the agreement with X is a long-term contract as defined in section 460(f), and that W takes into account all items with respect to such contracts under the percentage of completion method as described in section 460(b)(1). Under paragraph (d)(2)(ii) of this section, the \$100,000 W pays in 1992 for parts is incurred for the 1992 taxable year, for purposes of determining the percentage of completion under section 460(b)(1)(A). W's other costs under the agreement are incurred for the 1993 taxable year for this purpose.

Example 4. Services or property provided to the taxpayers. (i) LP1, a calendar year, accrual method limited partnership, owns the working interest in a parcel of property containing oil and gas. During December 1990, LP1 enters into a turnkey contract with Z corporation pursuant to which LP1 pays Z \$200,000 and Z is required to provide a completed well by the close of 1992. In May 1992, Z commences drilling the well, and, in December 1992, the well is completed.

(ii) Under paragraph (d)(2) of this section, economic performance with respect to LP1's

liability for drilling and development services provided to LP1 by Z occurs as the services are provided. Consequently, \$200,000 is incurred by LP1 for the 1992 taxable year.

Example 5. Services or property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an automobile dealer. On January 15, 1990, X agrees to pay an additional \$10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X.

(ii) During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional \$10,000 as provided in the agreement. Y, in turn, uses this \$10,000 to provide advertising and promotional activities during 1992.

(iii) Under paragraph (d)(2) of this section, economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, \$10,000 is incurred by X for the 1992 taxable year.

Example 6. Use of property provided to the taxpayer; services or property provided to the taxpayer. (i) V corporation, a calendar year, accrual method taxpayer, charters aircrafts. On December 20, 1990, V leases a jet aircraft from L for the four-year period that begins on January 1, 1991. The lease obligates V to pay L a base rental of \$500,000 per year. In addition, the lease requires V to pay \$25 to an escrow account for each hour that the aircraft is flown. The escrow account funds are held by V and are to be used by L to make necessary repairs to the aircraft. Any amount remaining in the escrow account upon termination of the lease is payable to V. During 1991, the aircraft is flown 1,000 hours and V pays \$25,000 to the escrow account. The aircraft is repaired by L in 1993. In 1994, \$20,000 is released from the escrow account to pay L for the repairs.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to V's base rental liability occurs ratably over the period of time V is entitled to use the jet aircraft. Consequently, the \$500,000 rent is incurred by V for the 1991 taxable year and for each of the next three taxable years. Under paragraph (d)(2) of this section, economic performance with respect to the liability to place amounts in escrow occurs as the aircraft is repaired. Consequently, V incurs \$20,000 for the 1993 taxable year.

Example 7. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells electronic circuitry. On November 15, 1990, X enters into a contract with Y that entitles X to the exclusive use of a product owned by Y for the five-year period beginning on January 1, 1991. Pursuant to the contract, X pays Y \$100,000 on December 30, 1990.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to

X's liability for the use of property occurs ratably over the period of time X is entitled to use the product. Consequently, \$20,000 is incurred by X for 1991 and for each of the succeeding four taxable years.

Example 8. Use of property provided to the taxpayer. (i) Y corporation, a calendar year, accrual method taxpayer, enters into a five-year lease with Z for the use of a copy machine on July 1, 1991. Y also receives delivery of the copy machine on July 1, 1991. The lease obligates Y to pay Z a base rental payment of \$6,000 per year at the beginning of each lease year and an additional charge of 5 cents per copy 30 days after the end of each lease year. The machine is used to make 50,000 copies during the first lease year: 20,000 copies in 1991 and 30,000 copies from January 1, 1992, to July 1, 1992. Y pays the \$6,000 base rental payment to Z on July 1, 1991, and the \$2,500 variable use payment on July 30, 1992.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to Y's base rental liability occurs ratably over the period of time Y is entitled to use the copy machine. Consequently, \$3,000 rent is incurred by Y for the 1991 taxable year. Under paragraph (d)(3)(ii) of this section, economic performance with respect to Y's variable use portion of the liability occurs as Y uses the machine. Thus, the \$1,000 of the \$2,500 variable-use liability that relates to the 20,000 copies made in 1991 is incurred by Y for the 1991 taxable year.

Example 9. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, enters into a five-year product distribution agreement with Y, on January 1, 1992. The agreement provides for a payment of \$100,000 on January 1, 1992, plus 10 percent of the gross profits earned by X from distribution of the product. The variable income portion of X's liability is payable on April 1 of each subsequent year. On January 1, 1992, X pays Y \$100,000. On April 1, 1993, X pays Y \$3 million representing 10 percent of X's gross profits from January 1 through December 31, 1992.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's \$100,000 payment occurs ratably over the period of time X is entitled to use the product. Consequently, \$20,000 is incurred by X for each year of the agreement beginning with 1992. Under paragraph (d)(3)(ii) of this section, economic performance with respect to X's variable income portion of the liability occurs as the income is earned by X. Thus, the \$3 million variable-income liability is incurred by X for the 1992 taxable year.

(e) *Interest.* In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

(f) *Timing of deductions from notional principal contracts.* Economic performance on a notional principal contract occurs as provided under § 1.446-3.

(g) *Certain liabilities for which payment is economic performance—(1) In general—*

(i) *Person to which payment must be made.* 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. Thus, except as otherwise provided in paragraph (g)(1)(iv) of this section and § 1.461-6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund. For special rules relating to the taxation of amounts transferred to “qualified settlement funds,” see section 468B and the regulations thereunder. The Commissioner may provide additional rules in regulations, revenue procedures, and revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (g).

(ii) *Payment to person to which liability is owed.* Paragraph (d)(6) of this section provides that for purposes of paragraph (d) of this section (relating to the provision of services or property to the taxpayer) in certain cases a taxpayer may treat services or property as provided to the taxpayer as the taxpayer makes payments to the person providing the services or property. In addition, this paragraph (g) provides that in the case of certain liabilities of a taxpayer, economic performance occurs as the taxpayer makes payment to persons specified therein. For these and

all other purposes of section 461(h) and the regulations thereunder:

(A) *Payment.* 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 government agency). As a further example, payment does not include a promise of the taxpayer to provide services or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

(B) *Person to which payment is made.* Payment to a particular person is accomplished if paragraph (g)(1)(ii)(A) of this section is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of section 451 (without regard to section 104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person.

(C) *Liabilities that are assumed in connection with the sale of a trade or business.* Paragraph (d)(5) of this section provides rules that determine when economic performance occurs in the case of liabilities that are assumed in connection with the sale of a trade or business. The provisions of paragraph (d)(5) of this section also apply to any liability described in paragraph (g) (2) through (7) of this section that the purchaser expressly assumes in connection with the sale or exchange of a trade or business by a taxpayer, provided the

taxpayer (but for the economic performance requirement) would have been entitled to incur the liability as of the date of the sale.

(iii) *Person*. For purposes of this paragraph (g), “person” has the same meaning as in section 7701(a)(1), except that it also includes any foreign state, the United States, any State or political subdivision thereof, any possession of the United States, and any agency or instrumentality of any of the foregoing.

(iv) *Assignments*. If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g) (2) through (7) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

(2) *Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law*. If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers compensation act or out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed. See *Example 1* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(2)—

(i) A liability to make payments for services, property, or other consideration provided under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages; and

(ii) A liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law, respectively, is alleged.

(3) *Rebates and refunds*. If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the per-

son to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, “payment” is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. See *Example 2* of paragraph (g)(8) of this section. For purposes of determining whether the recurring item exception of § 1.461-5 applies, a liability that arises out of a tort, breach of contract, or violation of law is not considered a rebate or refund.

(4) *Awards, prizes, and jackpots*. If the liability of a taxpayer is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 3* and *4* of paragraph (g)(8) of this section.

(5) *Insurance, warranty, and service contracts*. If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 5* through *7* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(5)—

(i) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances.

(ii) The term “insurance” has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under section 162.

(6) *Taxes*—(i) *In general*. Except as otherwise provided in this paragraph (g)(6), 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.

For purposes of this paragraph (g)(6), payment includes payments of estimated income tax and payments of tax where the taxpayer subsequently files a claim for credit or refund. In addition, for purposes of this paragraph (g)(6), a tax does not include a charge collected by a governmental authority for specific extraordinary services or property provided to a taxpayer by the governmental authority. Examples of such a charge include the purchase price of a parcel of land sold to a taxpayer by a governmental authority and a charge for labor engaged in by government employees to improve that parcel. In certain cases, a liability to pay a tax is permitted to be taken into account in the taxable year before the taxable year during which economic performance occurs under the recurring item exception of § 1.461-5. See *Example 8* of paragraph (g)(8) of this section.

(ii) *Licensing fees.* If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.

(iii) *Exceptions—(A) Real property taxes.* If a taxpayer has made a valid election under section 461 (c), the taxpayer's accrual for real property taxes is determined under section 461 (c). Otherwise, economic performance with respect to a property tax liability occurs as the tax is paid, as specified in paragraph (g)(6)(i) of this section.

(B) *Certain foreign taxes.* If the liability of a taxpayer is to pay an income, war profits, or excess profits tax that is imposed by the authority of any foreign country or possession of the United States and is creditable under section 901 (including a creditable tax described in section 903 that is paid in lieu of such a tax), economic performance occurs when the requirements of the all events test (as described in § 1.446-1 (c)(1)(ii)) other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901 (a).

(7) *Other liabilities.* In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section or in any other

Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. This paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. If a liability may properly be characterized as, for example, a liability arising from the provision of services or property to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under paragraph (d) of this section and not under this paragraph (g)(7).

(8) *Examples.* The following examples illustrate the principles of this paragraph (g). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met and, except as otherwise provided, that the recurring item exception is not used.

Example 1. Liabilities arising out of a tort. (i) During the period 1970 through 1975, Z corporation, a calendar year, accrual method taxpayer, manufactured and distributed industrial products that contained carcinogenic substances. In 1992, a number of lawsuits are filed against Z alleging damages due to exposure to these products. In settlement of a lawsuit maintained by A, Z agrees to purchase an annuity contract that will provide annual payments to A of \$50,000 for a period of 25 years. On December 15, 1992, Z pays W, an unrelated life insurance company, \$491,129 for such an annuity contract. Z retains ownership of the annuity contract.

(ii) Under paragraph (g)(2) of this section, economic performance with respect to Z's liability to A occurs as each payment is made to A. Consequently, \$50,000 is incurred by Z for each taxable year that a payment is made to A under the annuity contract. (Z must also include in income a portion of amounts paid under the annuity, pursuant to section 72.) The result is the same if in 1992 Z secures its obligation with a standby letter of credit.

(iii) If Z later transfers ownership of the annuity contract to A, an amount equal to the fair market value of the annuity on the date of transfer is incurred by Z in the taxable year of the transfer (see paragraph (g)(1)(ii)(B) of this section). In addition, the transfer constitutes a transaction to which section 1001 applies.

Example 2. Rebates and refunds. (i) X corporation, a calendar year, accrual method

taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X during any calendar year. During the 1992 calendar year, X becomes liable to pay a \$2,000 rebate to distributor A. X pays A \$1,200 of the rebate on January 15, 1993, and the remaining \$800 on October 15, 1993. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred.

(ii) If X does not adopt the recurring item exception described in § 1.461-5 with respect to rebates and refunds, then under paragraph (g)(3) of this section, economic performance with respect to the \$2,000 rebate liability occurs in 1993. However, if X has made a proper election under § 1.461-5, and as of December 31, 1992, all events have occurred that determine the fact of the rebate liability, X incurs \$1,200 for the 1992 taxable year. Because economic performance (payment) with respect to the remaining \$800 does not occur until October 15, 1993 (more than 8½ months after the end of 1992), X cannot use the recurring item exception for this portion of the liability (see § 1.461-5). Thus, the \$800 is not incurred by X until the 1993 taxable year. If, instead of making the cash payments to A during 1993, X adjusts the price of hardware purchased by A that is delivered to A during 1993, X's "payment" occurs as X would otherwise be required to recognize income resulting from a disposition at an unreduced price.

Example 3. Awards, prizes, and jackpots. (i) W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to \$10,000 per year for a period of 20 years. On December 1, 1992, A is declared the winner of the contest and is paid \$10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays \$10,000 to A.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the \$200,000 contest liability occurs as each of the \$10,000 payments is made by W to A. Consequently, \$10,000 is incurred by W for the 1992 taxable year and for each of the succeeding nineteen taxable years.

Example 4. Awards, prizes, and jackpots. (i) Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1993, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of \$50,000. On October 1, 1994, the \$50,000 jackpot is paid to B.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the \$50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, \$50,000 is incurred by Y for the 1994 taxable year.

Example 5. Insurance, warranty, and service contracts. (i) V corporation, a calendar year, accrual method taxpayer, manufactures toys. V enters into a contract with W, an unrelated insurance company, on December 15, 1992. The contract obligates V to pay W a premium of \$500,000 before the end of 1995. The contract obligates W to satisfy any liability of V resulting from claims made during 1993 or 1994 against V by any third party for damages attributable to defects in toys manufactured by V. Pursuant to the contract, V pays W a premium of \$500,000 on October 1, 1995.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Thus, \$500,000 is incurred by V for the 1995 taxable year.

Example 6. Insurance, warranty, and service contracts. (i) Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1992, Y enters into a contract with Z, an unrelated insurance company, under which Z must satisfy any liability of Y that arises during the succeeding 5 years for damages under a workers compensation act or out of any tort, provided the event that causes the damages occurs during 1993 or 1994. Under the contract, Y pays \$360,000 to Z on December 31, 1993.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Consequently, \$360,000 is incurred by Y for the 1993 taxable year. The period for which the \$360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year.

Example 7. Insurance, warranty, and service contracts. Assume the same facts as in *Example 6*, except that Y is obligated to pay the first \$5,000 of any damages covered by the arrangement with Z. Y is, in effect, self-insured to the extent of this \$5,000 "deductible." Thus, under paragraph (g)(2) of this section, economic performance with respect to the \$5,000 liability does not occur until the amount is paid to the person to which the tort or workers compensation liability is owed.

Example 8. Taxes. (i) The laws of State A provide that every person owning personal property located in State A on the first day of January shall be liable for tax thereon and that a lien for the tax shall attach as of that date. In addition, the laws of State A provide that 60% of the tax is due on the first day of

December following the lien date and the remaining 40% is due on the first day of July of the succeeding year. On January 1, 1992, X corporation, a calendar year, accrual method taxpayer, owns personal property located in State A. State A imposes a \$10,000 tax on S with respect to that property on January 1, 1992. X pays State A \$6,000 of the tax on December 1, 1992, and the remaining \$4,000 on July 1, 1993.

(ii) Under paragraph (g)(6) of this section, economic performance with respect to \$6,000 of the tax liability occurs on December 1, 1992. Consequently, \$6,000 is incurred by X for the 1992 taxable year. Economic performance with respect to the remaining \$4,000 of the tax liability occurs on July 1, 1993. If X has adopted the recurring item exception described in § 1.461-5 as a method of accounting for taxes, and as of December 31, 1992, all events have occurred that determine the liability of X for the remaining \$4,000, X also incurs \$4,000 for the 1992 taxable year. If X does not adopt the recurring item exception method, the \$4,000 is not incurred by X until the 1993 taxable year.

(h) *Liabilities arising under the Nuclear Waste Policy Act of 1982.* Notwithstanding the principles of paragraph (d) of this section, economic performance with respect to the liability of an owner or generator of nuclear waste to make payments to the Department of Energy ("DOE") pursuant to a contract required by the Nuclear Waste Policy Act of 1982 (Pub. L. 97-425, 42 U.S.C. 10101-10226 (1982)) occurs as each payment under the contract is made to DOE and not when DOE satisfies its obligations under the contract. This rule applies to the continuing fee required by 42 U.S.C. 10222(a)(2) (1982), as well as the one-time fee required by 42 U.S.C. 10222 (a)(3) (1982). For rules relating to when economic performance occurs with respect to interest, see paragraph (e) of this section.

(i) [Reserved]

(j) *Contingent liabilities.* [Reserved]

(k) *Special effective dates—(1) In general.* Except as otherwise provided in this paragraph (k), section 461(h) and this section apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred after July 18, 1984. For example, the economic performance requirement applies to all liabilities arising under a workers compensation act or out of any tort that would, under the law in effect before the enactment of section

461(h), be incurred after July 18, 1984. For taxable years ending before April 7, 1995, see Q&A-2 of § 1.461-7T (as it appears in 26 CFR part 1 revised April 1, 1995), which provides an election to make this change in method of accounting applicable to either the portion of the first taxable year that occurs after July 18, 1984 (part-year change method), or the entire first taxable year ending after July 18, 1984 (full-year change method). With respect to the effective date rules for interest, section 461(h) applies to interest accruing under any obligation (whether or not evidenced by a debt instrument) if the obligation is incurred in any transaction occurring after June 8, 1984, and is not incurred under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred. Interest accruing under an obligation described in the preceding sentence is subject to section 461(h) even if the interest accrues before July 19, 1984. Similarly, interest accruing under any obligation incurred in a transaction occurring before June 9, 1984, (or under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred) is not subject to section 461(h) even to the extent the interest accrues after July 18, 1984.

(2) *Long-term contracts.* Except as otherwise provided in paragraph (M)(2) of this section, in the case of liabilities described in paragraph (d)(2)(ii) of this section (relating to long-term contracts), paragraph (d)(2)(ii) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(3) *Payment liabilities.* Except as otherwise provided in paragraph (m)(2) of this section, in the case of liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section), paragraph (g) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(l) [Reserved]

(m) *Change in method of accounting required by this section*—(1) *In general.* For the first taxable year ending after July 18, 1984, a taxpayer is granted the consent of the Commissioner to change its method of accounting for liabilities to comply with the provisions of this section pursuant to any of the following procedures:

(i) For taxable years ending before April 7, 1995, the part-year change in method election described in Q&A-2 through Q&A-6 and Q&A-8 through Q&A-10 of § 1.461-7T (as it appears in 26 CFR part 1 revised April 1, 1995);

(ii) For taxable years ending before April 7, 1995, the full-year change in method election described in Q&A-2 through Q&A-6 and Q&A-8 through Q&A-10 of § 1.461-7T (as it appears in 26 CFR part 1 revised April 1, 1995); or

(iii) For taxable years ending before April 7, 1995, if no election is made, the cut-off method described in Q&A-1 and Q&A-11 of § 1.461-7T (as it appears in 26 CFR part 1 revised April 1, 1995).

(2) *Change in method of accounting for long-term contracts and payment liabilities*—(i) *First taxable year beginning after December 31, 1991.* For the first taxable year beginning after December 31, 1991, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (D)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning December 31, 1991.

(ii) *Retroactive change in method of accounting for long-term contracts and payment liabilities.* For the first taxable year beginning after December 31, 1989, or the first taxable year beginning after December 31, 1990, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this

section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning after December 31, 1989, or the first day of the first taxable year beginning after December 31, 1990. For taxable years ending before April 7, 1995, the taxpayer may make the change in method of accounting, including a full-year change in method election under paragraph (m)(1)(ii) of this section and Q&A-5 of § 1.461-7T (as it appears in 26 CFR part 1 revised April 1, 1995), by filing an amended return for such year, provided the amended return is filed on or before October 7, 1992.

[T.D. 8408, 57 FR 12421, Apr. 10, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8593, 60 FR 18743, Apr. 13, 1995; T.D. 8820, 64 FR 26851, May 18, 1999; T.D. 8408, 69 FR 44597, July 27, 2004]

§ 1.461-5 Recurring item exception.

(a) *In general.* Except as otherwise provided in paragraph (c) of this section, a taxpayer using an accrual method of accounting may adopt the recurring item exception described in paragraph (b) of this section as method of accounting for one or more types of recurring items incurred by the taxpayer. In the case of the “other payment liabilities” described in § 1.461-4(g)(7), the Commissioner may provide for the application of the recurring item exception by regulation, revenue procedure or revenue ruling.

(b) *Requirements for use of the exception*—(1) *General rule.* 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—