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This thought leadership paper dwells on understanding the safe harbor for ratable service contracts.

Shishir Lagu
Partner, Taxation

On July 30, 2015, the IRS issued Rev. Proc. 2015-39, which provides a safe harbor for accrual-basis taxpayers that would like to treat economic performance as occurring ratably over the term of certain types of service contracts *(ratable service contracts).* Many practitioners likely first familiarized themselves with the term "ratable service contract" upon reading this guidance. Some may still be questioning what the revenue procedure provides to taxpayers that was not previously available. The answer to that question is the focus of this discussion.

A ratable service contract must meet three requirements to qualify for the safe harbor: *(1)* The contract must provide for similar services to be provided on a regular basis *(daily, weekly, or monthly)*; *(2)* each occurrence of the service must provide independent value, meaning that the benefits from each occurrence must not depend on the receipt of prior or subsequent services; and *(3)* the contract must not exceed 12 months. A contract containing both qualifying and nonqualifying services must contain separate pricing for a taxpayer to apply the safe harbor to those services that qualify.

The revenue procedure provides several examples of services that could qualify under the safe harbor, including janitorial services, landscape maintenance services, and information technology support and maintenance services. Additional services that could qualify include human resources, bookkeeping, payroll, marketing, advertising, and similar types of services.

Pursuant to Sec. 461 and the regulations thereunder, an accrual-basis taxpayer is generally allowed to treat a liability as incurred in the tax year in which all the events have occurred that establish the fact of the liability *(fixing the liability)*, the amount of the liability can be determined with reasonable accuracy *(these first two qualifying factors are collectively referred to as the all-events test)*, and economic performance has occurred with respect to the liability. Rev. Proc. 2015-39 deals exclusively with certain types of liabilities that arise from the provision of services to taxpayers *(service liabilities)*.

Economic performance is generally deemed to occur with respect to a service liability as the service is provided to the taxpayer *[Regs. Sec. 1.461-4(d)(2)(i)].* However, two exceptions allow a taxpayer to treat a service liability as incurred in the tax year prior to the tax year in which the services are provided: the 3½-month rule and the recurring-item exception. Under the 3½-month rule, a taxpayer may treat economic performance as occurring with respect to a service liability when payment is made, as long as the taxpayer reasonably expects the person providing the services to provide them within 3½ months after the taxpayer makes the payment. It should be noted that this rule requires service performance within 3½ months after payment, not 3½ months after year end.

Under the recurring-item exception, a taxpayer may treat a liability as incurred for a tax year if at the end of the year the all-events test has been met and economic performance occurs on or before the earlier of the due date of the tax return *(including extensions)* or 8½ months after the end of the tax year. The liability must be recurring in nature and either *(1)* the amount of the liability is immaterial, or *(2)* the accrual of the liability results in a better matching with income than would otherwise occur.

The revenue procedure reduces uncertainty for taxpayers. A comprehensive example from Rev. Proc. 2015-39 should help illustrate this advantage:

On December 31, 2015, Taxpayer enters into a one-year service contract with X. Under the contract, X will provide landscape maintenance services to Taxpayer from January through December 2016 on a monthly basis. Under the contract Taxpayer pays X $4,000 a month to maintain Taxpayer's grounds. The contract requires Taxpayer to prepay for the twelve months of services with the full payment of $48,000 due on December 31, 2015. On December 31, 2015, Taxpayer makes the $48,000 payment to X for services to be provided from January 1, 2016, through December 31, 2016. As of December 31, 2015, all events have occurred to establish the fact of Taxpayer's $48,000 contractually-required payment and the amount of the liability is determinable with reasonable accuracy.

The contract meets the requirements of a Ratable Service Contract because the maintenance services are to be provided on a regular basis *(monthly)*; each occurrence of the maintenance service provides independent value, such that the benefits from each occurrence of the service are not dependent on the receipt of prior or subsequent maintenance services; and the contract term does not exceed 12 months.

Under the provisions of *[Rev. Proc. 2015-39]*, Taxpayer may treat economic performance as occurring ratably under the contract. Assuming that Taxpayer satisfies the requirements of the recurring item exception and files its return on September 15, 2016, Taxpayer is allowed to incur a liability in 2015 of $34,000 *([8.5 months ÷ 12 months] × $48,000)* for the services provided from January 1 through September 15, 2016. For the services provided from September 16 through December 31, 2016, the period outside of the recurring item exception, economic performance occurs ratably as the services are provided to Taxpayer during that time and a liability for these services of $14,000 *([3.5 months ÷ 12 months] × $48,000)* is incurred in 2016.

Prior to this revenue procedure, the IRS had often taken the position that the recurring-item exception or the 3½-month rule would not apply to only a portion of a contract for services. In other words, the taxpayer in the example above may not have been allowed to deduct the $34,000 in 2015 under the recurring-item exception because the contract would not be completed within 8½ months after year end. Thus, prior to the issuance of Rev. Proc. 2015-39, the taxpayer in this example would have lacked clear guidance for determining when it satisfied the economic performance requirement for landscape maintenance services that spanned two tax years.

Should the taxpayer have treated the services as provided ratably over the term of the contract or provided only after all of the services had been rendered? The IRS may have challenged the position if the taxpayer had treated the services as occurring ratably. In addition, many taxpayers may have considered this type of arrangement a prepayment for services, deducted the prepayments monthly, and not applied the recurring-item exception.

In navigating Rev. Proc. 2015-39, an accrual-basis taxpayer should remember the first prong of the all-events test: A taxpayer is generally allowed to treat a liability as incurred no earlier than the tax year in which all of the events have occurred that establish the fact of the liability. Generally, all of the events have occurred that establish the fact of the liability for services provided to a taxpayer when the event fixing the liability occurs *(in this case, required performance occurs)* or payment is due, whichever happens earlier.

The execution of a contract between a taxpayer and a service provider in an earlier year does not by itself establish the fact of the liability *(see Rev. Rul. 2007-3)*. Whether prepayment is required by the contract is relevant in determining whether a taxpayer incurs the associated liability in the year of payment. The example above specifically indicates that 'all events have occurred to establish the fact of Taxpayer's $48,000 contractually-required payment'. Without this fact, the discussion ends.

Why not use the 12-month prepaid rule? The 12-month prepaid rule is an exception to the requirement to capitalize any prepayments as an intangible, but it does not affect the determination of whether economic performance has occurred with respect to a liability. Since economic performance is deemed to occur with respect to a service liability as the service is provided to the taxpayer, an accrual-basis taxpayer may never use the 12-month prepaid rule for service liabilities incurred in the following year.

Rev. Proc. 2015-39 clarifies that economic performance for service contracts qualifying under the safe harbor accrues ratably over the contract instead of at the conclusion of the contract. The safe harbor now permits a taxpayer to use the 3½-month rule or the recurring-item exception on a portion of a ratable service contract. Moreover, the revenue procedure does not alter the other requirements under either exception. For example, the recurring-item exception is available only if the amount of the liability is immaterial or the accrual of the liability results in better matching. Because the landscape maintenance example would not seem to result in better matching since all services are provided to the taxpayer in the following year, the liability would therefore need to be immaterial.

In determining whether a liability is material, consideration should be given to the amount of the liability in absolute terms and in relation to the amount of other items of income and expense attributable to the same activity *[Regs. Sec. 1.461-5(b)(4)]*. However, a liability is material if it is material for financial statement purposes under GAAP. To the extent an item is immaterial for financial statement purposes, it would presumably result in a likewise immaterial tax benefit. Therefore, the 3½-month rule may provide the most opportunity, since it does not require an amount to be considered immaterial for financial statement purposes.