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Dear :

This responds to your request for advice dated May 13, 2004.

ISSUE

Whether an adjustment (positive or negative) to the cost of wholesale purchased electricity delivered to Taxpayer during the year will be deemed to be determinable with reasonable accuracy by Taxpayer at year end under the second prong of the all events tests of I.R.C. §§ 461 and 451 when the amount is unknown until a complex calculation is completed by the supplier approximately 75 days after year end.

CONCLUSION

The adjustment will be deemed to be determinable with reasonable accuracy by Taxpayer at year end as the actual amount is determinable from data available at year end.

FACTS

Taxpayer is a rural electric generation cooperative that supplies electricity to member electric distribution cooperatives within its state. Taxpayer recently entered into a new multi-year contract with its main supplier. Under this new contract, the supplier provides periodic invoices for approximate amounts to Taxpayer for wholesale power delivered to Taxpayer during the year. The supplier then performs a complicated reconciliation after year-end to settle the account for the year of delivery, resulting in a final purchase cost adjustment for Taxpayer. This final purchase cost adjustment is completed approximately 75 days after year end. This adjustment can be positive or negative, and can be significant in amount.

The final purchase cost adjustment is for amounts that are fixed and determinable at year end. However, due to the lack of personnel and computing

resources, it simply takes the supplier some time to compute the final purchase cost adjustment.

For tax purposes, the supplier adjusts its income for the year of delivery by the amount of the final adjustment as computed after year-end. For financial reporting purposes, Taxpayer similarly adjusts its purchase cost for the year of delivery by the amount of the final adjustment as computed after year-end. Taxpayer wishes to adopt this financial method of accounting for tax purposes as well.

LAW AND ANALYSIS

Initially, we note that the adjustment determined after year end may increase or decrease the purchase cost of the electricity. If the adjustment increases the purchase cost of the electricity, and if the all events test is met, the rules of I.R.C. § 461 and Treas. Reg. § 1.461-1(a)(2)(i) will apply. On the other hand, if the adjustment decreases the purchase cost of the electricity, and if the all events test is met, the rules of I.R.C. § 451 and Treas. Reg. § 1.451-1(a) will apply. We will discuss the rules of I.R.C. § 461 first.

I.R.C. § 461(a) provides that the amount of a deduction shall be taken for the taxable year which is the proper taxable year under the taxpayer's method of accounting. For taxpayers using the accrual method, Treas. Reg. § 1.461-1(a)(2)(i) provides that 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. (Emphasis added). See also Treas. Reg. § 1.446-1(c)(1)(ii)(A); Rev. Rul. 81-173, 1981-1 C.B. 314 (the amount of expense must be determined with reasonable accuracy in the taxable year of accrual); Rev. Rul. 2003-90, 2003-33 I.R.B. 353. Treas. Reg. § 1.446-1(c)(1)(ii)(B) provides that the term "liability" includes any item allowable as a deduction, cost, or expense for federal income tax purposes.

The test of Treas. Reg. § 1.461-1(a)(2) discussed above will be referred to herein as the "section 461 all events test." This test governs when liabilities are incurred and taken into account for deduction or capitalization purposes.

A similar test, contained in Treas. Reg. § 1.451-1(a), is applicable for income and will be referred to herein as the "section 451 all events test." Under the section 451 all events test, income is included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.

To the extent that the two all events tests contain similar language, this language is interpreted similarly. For example, the question of whether an amount is

determinable with reasonable accuracy in the taxable year (i.e., the second prong of both tests) is similarly interpreted for both tests.

Under the section 461 all events test, in order to be deductible at year end, liabilities must be sufficiently: (1) fixed; (2) determinable; and (3) economic performance must have occurred. A liability will ordinarily become fixed when payment is due or when performance by the payee has occurred. Since performance by the payee has occurred in the instant case by year end (because the purchased power has been delivered to Taxpayer by the supplier), all events have occurred that establish the fact of any liability by year end. Thus, any liability is sufficiently "fixed" and the first prong of the all events test is satisfied.

For the same reason (i.e., because the purchased power has been delivered to Taxpayer by the supplier), the economic performance requirement is met and the third prong of the all events test is satisfied for any liability that may arise due to the adjustment at issue. See section 461(h)(2)(i) and Treas. Reg. § 1.461-4(d)(2)(i).

Therefore, the only issue (if the adjustment determined by the supplier after year end increases purchase cost), involves the second prong of the section 461 all events test, i.e., whether the amount of the liability of the taxpayer is sufficiently determinable at year end. Under the specific wording of the section 461 all events test, the issue is whether the amount of the liability can be determined with reasonable accuracy in the taxable year. Treas. Reg. § 1.461-1(a)(2)(i).

Similarly, the only issue (if the adjustment determined by the supplier after year end decreases purchase cost and, therefore, results in refund income) involves the second prong of the section 451 all events test, i.e., whether the amount of the income can be determined with reasonable accuracy in the taxable year. Treas. Reg. § 1.451-1(a).

If the adjustment determined by the supplier after year end increases purchase cost, another section of the regulations may be implicated. Treas. Reg. § 1.461-1(a)(2)(ii) provides that, if there is uncertainty as to the amount of a liability, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the liability which can be computed with reasonable accuracy within the taxable year.

In Rev. Rul. 81-176, the taxpayer ran a nursing home and was entitled to Medicaid payments from the state health department. The taxpayer was entitled to compensation equal to the "reasonable costs" incurred by the taxpayer in rendering nursing home services plus a 10 percent return on equity capital as a profit factor. Although the amount of this compensation could not finally be determined until the end of the year, the taxpayer billed and received an interim (tentative) rate per Medicaid patient day as a means of currently reimbursing the taxpayer for services rendered during the year. This interim rate was based upon the projected "reasonable cost" of

providing patient care during the upcoming year. Although the interim receipts were unrestricted as to use, the taxpayer was subject to an obligation to repay all amounts received during the year in excess of the actual "reasonable cost" incurred during the year to provide patient care as reflected in the taxpayer's "cost report." This cost report was to be certified by an officer of the taxpayer and was due 90 days after year end. Any refund due the health department, as reflected in the cost report, was due when the cost report was filed. If appropriate, any amount due to the taxpayer was made upon settlement of a desk audit performed by the health department.

For federal income tax purposes, the taxpayer accrued as income only the amounts due from the health department based on its interim billings during the tax year. When the actual amount due to the taxpayer for the tax year was determined by the taxpayer at the end of its taxable year to exceed the interim billings i.e., when there was an "underbilling"), the additional amount due was not included in income until the taxable year in which it was received. This year was held in the ruling not to constitute the proper year for income accrual under the all events test of Treas. Reg. § 1.451-1. Since the amount of the income accrual could be determined with reasonable accuracy as of the end of the taxable year in which the related services were performed, it was held that the year of performance was the proper year for the income accrual.

When the taxpayer determined at the end of its taxable year that it had overbilled the department, the taxpayer made an adjustment to decrease gross income based on the taxpayer's estimate of the probable amount that would have to be refunded to the department. The ruling stated that such an estimate was no more than an assumption, based on prior experience, that costs incurred in providing certain services during the tax year had remained the same as related costs incurred in prior years. The ruling held that the taxpayer's practice of deducting estimated refunds was not a proper basis for expense accrual under the all events test of Treas. Reg. § 1.461-1(a)(2). The ruling stated that all of the facts necessary for calculation of the taxpayer's actual "reasonable cost" were fixed as of the end of the year, as subsequently reflected in the certified cost report. Therefore, the ruling held that the exact amount of any amount due the health department (or any additional amount due the taxpayer) was determinable with reasonable accuracy at the end of the year. This was because the taxpayer at the end of its tax year had all the information necessary to readily calculate the exact amount of its compensation under the contract, and consequently the exact amount of any amount due the department or vice versa. The taxpayer had records that indicated both its actual costs, the interim payments accrued, and its equity capital.

Thus, the ruling held that the actual amount (as reflected on the cost report) that must be refunded to the department or paid to the taxpayer, whichever the case may be, is the proper amount that must be accrued by the taxpayer pursuant to Treas. Reg. §§ 1.461-1(a)(2) and 1.451-1(a), respectively.

Rev. Rul. 81-176 is helpful in answering Taxpayer's question for the following reasons. First, Rev. Rul. 81-176 is factually similar to Taxpayer's case in that: (a) Rev.

Rul. 81-176 required a complicated calculation (albeit by the taxpayer, subject to audit by the state health department) to arrive at the proper amount of an accrual affecting net income; (b) all facts and circumstances necessary to complete the calculation were fixed and unchangeable at year end; (c) the amount of the accrual was knowable, although unknown at year end; (d) the calculation was not reasonably subject to completion by the close of business on the last day of the taxpayer's tax year; (e) the calculation was not actually completed until after year end (the cost report was not due until 90 days after year end).

Based on these similarities, the holding in Rev. Rul. 81-176 supports the conclusion herein that the final purchase cost adjustment for power purchased by Taxpayer should be accrued for the year of delivery, as opposed to the subsequent year of calculation. In other words, the fact that the calculation is not made by Taxpayer's supplier until after year end should not be determinative under the second prong of the all events tests. Because the amount was knowable (although unknown) at year end, the fact that some period of time was required to calculate the figure after the end of the year should not cause Taxpayer to fail the second prong.

In Rev. Rul. 58-474, the taxpayer was a dealer in products of a certain manufacturer. For many years, the taxpayer contributed amounts to a fund for advertising and promoting the sale of the manufacturer's products. Each year, the calendar-year taxpayer deducted amounts accrued or contributed to the fund for that year. The advertising agencies which handled the fund maintained a separate account for each dealer, showing the amount of contributions to the fund, the charges, and the net balance. Each dealer received an annual statement showing the balance in its account.

In November of 1956, the taxpayer was notified by letter from the manufacturer that the fund would be discontinued at the end of the month. The letter announced that each dealer would receive a refund of the unspent portion of his account. Rev. Rul. 58-474 then states:

> The approximate amount of each dealer's unexpended balance on November 30, 1956, was known and the information was available to the dealers in January, 1957. Actual refunds were made beginning in February, 1957.

It is apparent that the taxpayer's balance was not known to the taxpayer as of the taxpayer's 1956 calendar year end because the ruling states that "the information was available to the dealers in January, 1957."

The relevant issue in Rev. Rul. 58-474 was whether the income related to the reimbursement had to be accrued by the taxpayer in 1956 (against the taxpayer's wishes) given that the taxpayer was not in possession of the necessary information to calculate the amount of income at the end of 1956. In other words, in order to calculate

this income, the taxpayer would have to have knowledge of the advertising expenditures made by the advertising agencies, the contributions of fellow dealers, and various other factors. This information was possessed only by others at December 31, 1956, the end of the taxpayer's tax year.

Nevertheless, Rev. Rul. 58-474 concludes that the income should be accrued for 1956. Therefore, Rev. Rul. 58-474 does not require the taxpayer to have sufficient information itself as of the end of its taxable year to accrue income for that year.

Based on Rev. Rul. 58-474, it is apparent that Taxpayer need not have information in its own possession at the end of the year of delivery in order to accrue the supplier's adjustment, as determined after year end.

If you have any questions, please contact Dan Cassano at (202) 622-7900.

Sincerely,

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Thomas D. Moffitt
Chief, Branch 2
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: