Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201442048**
Release Date: 10/17/2014

CC:ITA:B02:HFRogers
POSTF-100642-14

UILC: 461.00-00

date:
July 14, 2014

to:
Associate Area Counsel
(Large Business & International)

from: Kari Fisher
Assistant to the Branch Chief, Branch 2
(Income Tax & Accounting)

---

subject: Recurring Item Exception Eligibility under § 1.461-5

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
A	=
B	=
C	=
D	=
1	=
2	=
T	=

ISSUE

Whether the recurring item exception under § 1.461-5 of the Income Tax Regulations can be used for a liability to pay for damaged goods.

CONCLUSION

The recurring item exception under § 1.461-5 cannot be used for the liability to pay for damaged goods.

FACTS

Taxpayer is a professional moving company. When a customer engages Taxpayer to provide moving services, Taxpayer and the customer execute a bill of lading, or contract, providing the level of Taxpayer's liability. The contract states T and provides two options for placing a value on the customer's shipment. Under the first option, Taxpayer's liability is capped at an amount equal to the greater of A or B. The customer also has the option to request a C for the shipment. The second option limits Taxpayer's liability to D per article lost or stolen. Taxpayer's liability for damaged or lost goods is limited to the maximum liability stated in the contract.

A customer may seek reimbursement or replacement of any lost or damaged goods only by submitting a claim in writing to Taxpayer within 1 of delivery. The customer may then only file suit against Taxpayer within 2 from the date of claim disallowance.

Taxpayer uses the accrual method of accounting and deducts its liability for claims received and paid in the taxable year and also pending at year-end that are paid within the first five months of the subsequent taxable year. Taxpayer uses the recurring item exception under § 1.461-5 to deduct the liability for claims paid subsequent to the taxable year-end.

LAW AND ANALYSIS

Section 461(a) provides that the amount of any deduction must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred and generally taken into account 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.

Section 1.461-4(g) identifies 6 types of liabilities, in addition to liabilities arising out of workers' compensation or out of any tort, for which payment constitutes economic performance: 1) liabilities arising out of a breach of contract; 2) liabilities arising from a violation of law; 3) rebates and refunds; 4) awards, prizes and jackpots; 5) amounts paid for insurance, warranty and service contracts; and 6) taxes other than creditable foreign taxes.

Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which specific economic performance rules are not provided elsewhere in the section or in any other 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.

Section 1.461-4(g)(5) provides that if a liability arises out of the provision to a 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. Section 1.461-4(g)(5)(i) states that 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. Section 1.461-4(g)(5)(ii) states the term insurance has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under § 162.

Sections 461(h)(3) and 1.461-5 provide a recurring item exception to the normal economic performance requirement for accrual method taxpayers. Section 1.461-5(c) provides in part that the recurring item exception does not apply to any liability of a taxpayer described in paragraph (g)(7) (other liabilities) of §1.461-4.

As an initial matter, Taxpayer's payment for damaged goods constitutes a liability under §1.461-4(g), and economic performance occurs as payments are made. However, the payment for damaged goods is not specifically enumerated in the list of liabilities under § 1.461-4(g). Consequently, if it is a payment liability, it must fall under § 1.461-4(g)(5) (insurance, or warranty or service contracts) or (7) (other liabilities).

Section 1.461-4(g)(5) covers provision <u>to</u> a taxpayer of insurance, or a warranty or service contract. *See also* §1.461-4(g)(8) Examples 5-7. Taxpayer is not purchasing or making payments for insurance, or a warranty or service contract in the liability arrangement it enters into with its customers. Further, it is not insurance, or a warranty or service contract provided by another party <u>to</u> Taxpayer but rather is a liability-limiting contract offered by Taxpayer to its customers.

Neither the Internal Revenue Code nor the Income Tax Regulations defines the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck & Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). Of significance here, however, recent case law provides relevant instruction through a thorough analysis of the nature of a similar clause between a carrier of goods and its customer, concluding the provision at issue was to limit liability and not an insurance arrangement. *Thermal Technologies, Inc. v. United Parcel Service, Inc.*, 2008 U.S. Dist. LEXIS 90243 (N.D. Ok. Nov. 5, 2008).

Consistent with statutory and common law, the court in *Thermal Technologies* determined that the tariff language in the common carrier's contract solely imposed a limitation on the carrier's liability for goods damaged in shipment and did not constitute insurance. In this case, Taxpayer's own contract explicitly states that the provision is not insurance but a tariff; clearly, this clause only serves to limit Taxpayer's liability for any damage sustained to customer goods during shipment. Thus, the payment liability for damaged goods is not for insurance under § 1.461-4(g)(5)(ii).

In addition, Taxpayer's contract covers property owned by customers, not property bought or leased by Taxpayer, and Taxpayer is obligated to pay damages if the other party to the contract, Taxpayer's customer, has property lost, damaged, or destroyed. Therefore, the liability to pay for damaged goods also does not qualify as a warranty or service contract in § 1.461-4(g)(5)(i) .

Accordingly, because the payment liability for damaged goods is not described in § 1-461-4(g)(5), by default it is a liability under § 1.461-4(g)(7). As such, Taxpayer cannot use the recurring item exception for its liability to pay for damaged goods. *See s*ection 1.461-5(c).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-7011 if you have any further questions.