Veco Corp. & Subsidiaries v. Commissioner of Internal Revenue, 141 T. C. 440 (U. S. Tax Ct. 2013)

In Veco Corp. & Subsidiaries v. Commissioner, the U. S. Tax Court ruled that an accrual method taxpayer could not accelerate deductions for expenses related to services and property to be provided in future periods. The court clarified that under the all events test, a liability is not fixed until the required performance occurs or payment is due, and that the recurring item exception to the economic performance rule does not apply if the liability is material for tax purposes. This decision underscores the importance of matching income and expenses for tax purposes and impacts how businesses account for deductions over multiple tax years.

Parties

Veco Corp. and its subsidiaries (collectively, Veco or petitioner) were the petitioners in this case. Veco sought to change its accounting method to accelerate deductions for expenses. The Commissioner of Internal Revenue (respondent) was the respondent, who disallowed the accelerated deductions and issued a notice of deficiency.

Facts

Veco Corp. , a Delaware corporation with its principal office in Alaska, was the parent company of an affiliated group of corporations involved in various businesses, including oil and gas field services, newspaper publishing, and real estate leasing. For the taxable year ending March 31, 2005 (TYE 2005), Veco, an accrual method taxpayer, filed a Form 1120 and attached a Form 3115 to implement a proposed change in its accounting method. This change aimed to accelerate deductions for parts of certain liabilities attributable to periods after March 31, 2005. Veco entered into several contracts, including software license agreements, service contracts, insurance agreements, and real estate and equipment leases, which were the basis for the accelerated deductions. These deductions were treated inconsistently for financial statement and tax purposes, with Veco accruing the liabilities over more than one taxable year for financial reporting but claiming them as deductions in TYE 2005 for tax purposes.

Procedural History

Veco filed a Form 1120 for TYE 2005, requesting a change in accounting method via Form 3115. The Commissioner issued a notice of deficiency on August 17, 2010, disallowing the accelerated deductions and determining a tax deficiency of $1,919,359. Veco petitioned the U. S. Tax Court for a redetermination of the deficiency. The case was submitted fully stipulated under Tax Court Rule 122. The Tax Court’s standard of review was de novo for the application of the all events test and the recurring item exception.

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Issue(s)

Whether Veco properly accelerated and deducted certain expenses attributable to periods ending after TYE 2005 under the all events test of I. R. C. § 461?

Whether Veco could use the recurring item exception under I. R. C. § 461(h)(3) to accelerate deductions for expenses attributable to future periods?

Rule(s) of Law

Under I. R. C. § 461(a), a deduction must be taken for the taxable year under the taxpayer's method of accounting. For accrual method taxpayers, a liability is incurred under the all events test when "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. " (Treas. Reg. § 1. 461-1(a)(2)(i)). The recurring item exception under I. R. C. § 461(h)(3) allows a taxpayer to treat an item as incurred during a taxable year if certain conditions are met, including that the item is not material or that accruing it in the current year results in a more proper match against income.

Holding

The Tax Court held that Veco did not satisfy the first requirement of the all events test for the majority of the accelerated deductions because neither the required performances nor the payment due dates occurred before the close of TYE 2005. For the remaining accelerated deductions, Veco failed to satisfy the recurring item exception because the liabilities were material for tax purposes and were treated inconsistently for financial and tax reporting.

Reasoning

The court analyzed the all events test and the recurring item exception. Regarding the all events test, the court determined that the fact of the liability is established upon the earlier of the required performance or the payment due date. For service contracts, the liability is not fixed until the services are performed. For rental agreements, the liability is fixed when the rent payment becomes due. Veco failed to show that the required performances or payment due dates occurred before the close of TYE 2005 for the majority of the accelerated deductions.

Concerning the recurring item exception, the court found that Veco did not meet the materiality requirement of I. R. C. § 461(h)(3)(A)(iv)(I). The court noted that the liabilities were material for tax purposes because they were prorated over more than one taxable year for financial statement purposes but were treated inconsistently for tax purposes. Veco also failed to prove that the liabilities were not material under Treas. Reg. § 1. 461-5(b)(4). The court considered the abnormal circumstances of the case, including the change in accounting method and the inconsistent treatment of the liabilities for financial and tax purposes, in determining materiality.

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Disposition

The Tax Court entered a decision for the respondent, disallowing Veco’s accelerated deductions for the taxable year ending March 31, 2005.

Significance/Impact

This case clarifies the application of the all events test and the recurring item exception in determining the timing of deductions for accrual method taxpayers. It emphasizes that the fact of a liability must be firmly established by the close of the taxable year, and economic performance is required for a deduction to be taken unless the recurring item exception applies. The decision also underscores the importance of consistent treatment of liabilities for financial and tax reporting purposes in determining materiality under the recurring item exception. This ruling impacts how businesses plan their tax strategies and account for expenses over multiple tax years.

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