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Challenged Accounting Method Upheld: *Continuing Life Communities v. Commissioner*

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In general, taxable income is required to be computed under the method of accounting used by a taxpayer in maintaining its books, except as otherwise required by the Internal Revenue Code ("IRC" or "Code") or Treasury regulations (IRC § 446(a)). Consequently, a taxpayer that consistently applies generally accepted accounting principles (GAAP) in computing its income from a business for purposes of its financial statements ordinarily will use that same method in computing its taxable income. If, however, that method "does not clearly reflect income," the computation of taxable income must be made under such method as, in the opinion of the Commissioner, does clearly reflect income (IRC § 446(b)).

Continuing Life Communities Thousand Oaks, LLC v. Commissioner (TC Memo 2022-31) considers the scope of the power of the Commissioner to impose a different accounting method with respect to upfront fees not included in income at the time of payment. In this case it was undisputed that the petitioner ("Continuing Life," a limited liability company classified as a partnership for tax purposes) used a method permitted by GAAP, but the IRS believed that the method did not clearly reflect income.

In the context of deciding cross-motions for summary judgment, the Tax Court concluded that Continuing Life's accounting method under GAAP clearly reflected its income, and declined to uphold adjustments set forth in the Commissioner's notice of final partnership administrative adjustment that would have resulted in substantial additional taxes for the years at issue (2008 through 2010) premised on the Commissioner's opinion that the accounting method used did not clearly reflect income.

Facts in Continuing Life

Continuing Life was in the business of providing housing and care to senior citizens through the use of facilities located in California.

When someone was admitted as a resident of the facilities, that person may have needed only housing and food, but Continuing Life agreed at the time of admission to provide for the resident's lifetime needs including skilled nursing care. Continuing Life's facilities operated under a certificate of authority issued by the California Department of Social Services, its operations were subject to standards imposed by the Department, and California law required that owners of such facilities follow GAAP and provide financial statements based on GAAP to the residents.

Each incoming resident was required to sign a Residence Agreement with Continuing Life under which the resident agreed to pay monthly fees and made a large upfront payment. The computation of the upfront payment was based solely on the space to be occupied by the resident, rather than on the age, health, or life expectancy of the resident. As required by state law, the upfront payment made by each resident (referred to as the "Contribution Amount") was paid to the trustee of a trust which was in turn authorized to lend trust funds to Continuing Life, without interest, to provide financing and fund improvements to the facilities.

Each resident was also required to pay as an additional fee (the "Deferred Fee") a percentage of the Contribution Amount that increased over the duration of the residency pursuant to a schedule: 5% of the Contribution Amount if residency was not more than 1 year (subject to a right to cancel within the first 90 days and thereby avoid any fee), increasing by five percentage points per year to 25% of the Contribution Amount if the termination of residency occurred more than four years after the Residency Agreement was signed. The Deferred Fee was paid following the termination of residency and leasing of the space to a new resident, through withholding against the Contribution Amount -- which amount was otherwise refundable upon such termination.

If termination of residency was by reason of the voluntary departure or death, the Deferred Fee and any unpaid monthly fees or optional charges were deducted from the Contribution Amount and paid by the trustee to Continuing Life, with the balance of the Contribution Amount being returned to the former resident or the resident's estate. If the termination was by reason of expulsion of the resident by Continuing Life (a rare event which happened once during the years at issue), no Deferred Fee was payable.

The controversy before the Tax Court related to the accounting for Deferred Fees. Under a method authorized by GAAP, no Deferred Fee was taken into income by Continuing Life when a Contribution Amount was paid by a resident to the trustee. Over the succeeding years, however, the Deferred Fee with respect to that resident was taken into account ratably using a straight-line method over the actuarially determined estimated life of the resident, as recomputed annually. When the resident left the facilities or died, and the former resident's space was occupied by a new resident, the Deferred Fee for the former resident was paid by the trust to Continuing Life, and any part of such resident's Deferred Fee not already included in the income of Continuing Life was recognized as income at that time.

Although the method sought to be imposed by the IRS following an audit was not discussed at length in the opinion, it appears that the Commissioner was asserting to the court that the Deferred Fees should be taken into account with respect to each resident over the first several years of residency, as the percentage of that resident's Contributed Amount that the Continuing Life was eligible to receive under the Residence Agreement increased from zero to 25%.

Analysis

The Tax Court memorandum decision discusses at length *Thor Power Tool Co. v. Commissioner* (439 U.S. 522 (1979)), referenced in the decision as the "most important case in the field" in respect of the powers of the Commissioner to impose another method of accounting where the taxpayer is (allegedly) following GAAP. It was undisputed that Continuing Life had consistently followed a GAAP method, and it appeared that the method was consistent with common industry practice and not in conflict with any specific accounting guidance of the Commissioner. Therefore, the general rule, that a GAAP accounting method consistently applied by the taxpayer should also be used in computing the taxpayer's taxable income, appeared applicable.

The GAAP method would not be controlling, however, if it did not clearly reflect income. One of the factors relevant to concluding whether a method clearly reflects income is whether the method appropriately matches income and expense. The court concluded that the GAAP method used by Continuing Life matched income and expense better than the method favored by the Commissioner, because (i) the promise of continued care made by Continuing Life to each new resident related to the entire remaining lifespan of the resident, not just the resident's first four years of occupancy, and (ii) Continuing Life therefore became entitled to the Deferred Fee only through its continued provision of services until the time the resident voluntarily departed from the facilities or died.

Accordingly, the court took issue with the Commissioner's argument that the schedule computing the Deferred Fee by reference to an increasing percentage of the Contributed Amount, a percentage that reached its maximum after just four years, was the key determinant of when Continuing Life earned the fees. The court found that, under the terms of the Residence Agreement, Continuing Life's right to the fee was earned only at the time of termination of residency.

The court further declined to accept the Commissioner's argument that the requirement of continued services should be viewed as a "condition subsequent," delay in the determination of which should not affect when the Deferred Fee was earned. The court acknowledged that the likelihood of non-fulfillment of the obligation to provide services to the date of termination of residency was low, and that this circumstance might favor characterization of this requirement as a condition subsequent, but nonetheless appeared to conclude that this condition was at the core of the Residence Agreement and could not be ignored in determining when the income was earned.

It was undisputed that Continuing Life received the Deferred Fee only after the trustee closed the account of a former resident after the resident's death or departure, and, further, that any funds borrowed from the trust funded with Contribution Amounts were required to be used by Continuing Life to improve its capital plant. This requirement appears to have helped the court distinguish other cases cited in the decision in which taxpayers in analogous circumstances had unfettered discretion to use deposited funds and were taxed at an earlier time. So far as appears from the decision, the Commissioner did not argue that receipt of the funds by the trustee, coupled with the interest-free loans of those funds by the trust to Continuing Life, was tantamount to receipt by Continuing Life of the funds deposited in trust.

The opinion also acknowledged the observation in *Thor* that the different objectives of financial and tax accounting preclude a general rule that tax accounting should always track financial accounting. The Tax Court concluded, however, that, in the circumstances before it, there was no reason to believe that Continuing Life's spreading of the Deferred Fee income over the estimated lifetimes of its residents contradicted the objectives of tax accounting in determining the appropriate timing of income for purposes of computing tax obligations.

The *Continuing Life* opinion also discussed what the court characterized as the remarkable sentence in the regulations under section 446 which states: "However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income" (Reg. § 1.446-1(a)(2)). The court indicated that it viewed the sentence as being in conflict with the text of Code section 446(b), which provides in substance that, *if the method used does not clearly reflect income*, then taxable income shall be computed under such method as is determined, in the opinion of the Commissioner, to clearly reflect income. The court apparently concluded that, at least in the circumstances before it, its finding that the method used by Continuing Life to account for the Deferred Fees clearly reflected income precluded the imposition of a different method of accounting by the Commissioner, notwithstanding its otherwise broad powers under section 446 and otherwise to change a taxpayer's method of accounting.

Observations

Particular circumstances in *Continuing Life*, including the undisputed circumstance that the petitioner had followed GAAP, and, further, that its business was in a highly regulated industry such that many of its financial and contractual arrangements were effectively required by state law and regulation, should make practitioners proceed with great caution in attempting to extend the holding of the case to different situations. Nonetheless, *Continuing Life* appears helpful in confirming that the Code does not generally provide the Commissioner with discretion to change an accounting method consistently followed by a taxpayer where the method is consistent with GAAP or other widely accepted financial accounting principles and clearly reflects income.

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