Accounting Methods Spotlight

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Did you know…?

There is still time to file automatic accounting method changes for calendar year 2010

Calendar year taxpayers that have not yet filed their Federal income tax return and want to reduce taxable income for the 2010 tax year through a favorable automatic method change have until September 15, 2011 to file Form 3115, Application for Change in Accounting Method. Under Rev. Proc. 2011-14, taxpayers have until the due date, including extensions, of their original timely filed federal income tax returns to apply for an automatic change in method of accounting.

Taxpayers that are under examination must meet certain other requirements to file a qualifying change in method of accounting as automatic. Taxpayers that are under exam generally may file an automatic change in method of accounting if filed:

- within the first 90 days of the tax year of change
- within 120 days after an exam has ended, regardless of whether an exam has begun for another year, or
- with consent of the director

The 90-day window period has passed for calendar year taxpayers, but taxpayers under exam may file an automatic method change under the guidance of the other two procedures, as applicable.

Taxpayers within the 120-day window period may file an automatic method change so long as the item being changed is not an issue under consideration or placed in suspense by the examining agent. If the 120-day window will come to an end prior to the filing of the Federal income tax return and there is not time to compute the § 481(a) adjustment, the automatic method change can be filed before the tax return with the § 481(a) adjustment stated as "to be determined." Taxpayers that file the method change with the § 481(a) adjustment as "to be determined" will need to calculate and provide the adjustment amount to the IRS by the time the income tax return is filed, so as to properly include that amount as an adjustment to taxable income.

Taxpayers not within a window period may file under consent of the director. Director consent will generally be granted if the applicable change would not ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under exam. In the event director consent is not received in time for the filing of the tax return, but consent is expected to be granted due to the change being taxpayer favorable, it is generally acceptable to file the Form 3115 with a statement that consent has been requested, and will be retained once received should it be requested by the IRS at a later date.

Taxpayers that have already filed their 2010 Federal income tax returns still have an opportunity to file an automatic method change by September 15, 2011. Rev. Proc. 2011-14 provides guidance indicating that such taxpayers can do so by filing an amended return with the original Form 3115 for change in method of accounting attached. A copy of the

application must be filed with the National Office. Also, Form 3115 must include a statement stating the application is being filed pursuant to § 301.9100-3(c)(2) and Rev. Proc. 2011-1. Taxpayers that filed their Federal income tax returns under an extension may be able to file a superseding return to the originally filed return, rather than file an amended return.

For a listing of common automatic method changes, see WNTS Insight: Top 10 automatic accounting method changes.

Automatic accounting method changes from one permissible depreciation method to another permissible method are made on a cut-off basis

Taxpayers requesting a change in method accounting from a permissible method of deprecation to another permissible method are required to use the cut-off method in lieu of a § 481(a) adjustment. (See § 6.02 of the Appendix of Rev. Proc. 2011-14) This is contrary to the rules applicable to a change in method of accounting from an impermissible method of accounting for depreciation to a permissible method (§ 6.01 of the Appendix of Rev. Proc. 20 11-14), which requires the use of a § 481(a) adjustment.

A § 481(a) adjustment is used to prevent the omission or duplication of amounts when a taxpayer uses a different method of accounting than it used in a preceding tax year. The § 481(a) adjustment is the cumulative difference between (a) the cumulative depreciation as of the beginning of the year of change, computed as if the proposed method of accounting had always been used and (b) the cumulative depreciation as of the beginning of the year of change under the taxpayer's present method of accounting (§ 2.05 of Rev. Proc. 2011-14). This difference, if negative (i.e., more depreciation was allowable under the proposed method than under the present method), is recognized immediately in the year of change. However, if the adjustment is positive (i.e., too much depreciation was taken in years prior to the year of change), the taxpayer will generally recognize the adjustment over 4 tax years, beginning with the year of change and the three subsequent tax years.

However, in certain cases the IRS prescribes that a change is only applied prospectively and therefore does not require a § 481(a) adjustment to prevent omission or duplication of amounts. For purposes of a method change from a permissible method to another permissible method of depreciation, the IRS requires a taxpayer to begin its new depreciation method with the adjusted basis of the property at the end of the preceding tax year as calculated using the previous depreciation method. Because the adjusted basis of the underlying asset does not change there is no omission or duplication of amounts. For this reason the § 481(a) adjustment is not necessary and a cut-off method is utilized to implement changes under § 6.02 of the Appendix of Rev. Proc. 2011-14.

IRS issues final regulations under §§ 195, 248 and 709

On August 16, 2011, the IRS issued final regulations (TD 9542) relating to elections to deduct start-up expenditures under § 195, organizational expenditures of corporations under § 248 and organizational expenses of partnerships under § 709.

The final regulations were made to apply retroactively, averting the July 6, 2011 expiration of the temporary regulations issued in 2008. The regulations are effective on their publication in the Federal Register and apply to expenditures paid or incurred after that date. Taxpayers may also apply them to expenditures paid or incurred after October 22, 2004, to the extent not barred by the limitation period for assessment of tax.

As with the temporary regulations, for start-up or organizational expenses as defined in §§ 195(c)(1), 248(b) and §1.248-1(b), and 709(b)(3) and §1.709-2(a), which were paid or incurred after September 8, 2008, the taxpayer is deemed to make an election to deduct start-up or organizational expenses for the taxable year in which the taxpayer begins business. Therefore, a taxpayer is not required to attach a separate election statement to the return or specifically identify the deductions as start-up or organizational expense for the election to be effective. The taxpayer may choose to forgo the deemed election by "affirmatively electing" to capitalize its start-up expenses on a timely filed federal income tax return (including extensions) for the tax year in which the active trade or business begins (for start-up expenditures) or it begins business (for organizational expenditures). The election is irrevocable and applies to all start-up/organizational expenditures.

Taxpayers should note that in general, a change in the characterization of an item as a start-up or organizational expense, or a change in the determination of the taxable year in which the taxpayer begins business, will be treated as a change in method of accounting with a § 481(a) adjustment.

Other Guidance…

FFA 201112701F: Bank enterprise award payments

In FFA 201112701F, a bank received a Bank Enterprise Award payment and was denied § 118 treatment of the income. The IRS stated that the payment program was meant to increase service in distressed communities and that the purpose of the program was to supplement the revenue of the recipient. The field advice also cited the fact that the funds were able to be used for general business expenses and were calculated based on a prior year's investment, lending, and deposit activities. Therefore the payments are considered payments for services and do not qualify for non-recognition under § 118.

Overview of a Change in Method of Accounting for Sale, Lease, or Financing Transactions

Rev. Proc. 2011-14 provides procedures for a taxpayer to request automatic consent to change its method of accounting from improperly treating property as either sold, leased, or financed by a taxpayer to properly treating such property as either sold, leased, or financed by a taxpayer. However, certain taxpayers are excluded from making this change (e.g., rent-to-own dealers and taxpayers that hold assets for sale or lease).

This automatic change in method of accounting is applied on a cut-off basis, which means that only transactions arising on or after the beginning of the year of change are accounted for under the new method of accounting. A § 481(a) adjustment is not necessary because no amounts are duplicated or omitted. Also, taxpayers do not receive audit protection for such transactions occurring prior to the year of change.

If a taxpayer would like to change its method of accounting for an existing sale, lease, or financing transaction, then it must file a non-automatic method change under the provisions of Rev. Proc. 97-27. Such a change would receive audit protection and require a § 481(a) adjustment. However, unless the taxpayer's proposed method of accounting is consistent with the method used by the counterparty(ies) in the transaction, the IRS will not consider the request. To substantiate this consistency requirement, taxpayers must submit with Form 3115 a statement describing the method of accounting used by the counterparty(ies). Such statement must also be signed under penalties of perjury by the counterparty(ies). If such statement is not provided, a non-automatic method change will only be considered in unusual and compelling circumstances.

Treasury and IRS 2010-2011 Priority Guidance Plan: Year in review

On December 7, 2010, the IRS released the long-awaited 2010-2011 Priority Guidance Plan, which contains 310 projects to be completed during the year running from July 2010 to July 2011. This plan included 25 tax accounting projects, of which one had been addressed by the publication date. The list of 25 was down from the 44 listed in the 2009-2010 Priority Guidance Plan. The discussion below focuses on the guidance issued since the release of the plan, the guidance expected to be issued, and other important guidance.

Since the release of the guidance plan, there has been guidance released on nine projects. Some of the significant completed guidance projects include: guidance (Rev. Proc. 2011-26) under § 168(k) (bonus depreciation); guidance (Rev. Proc, 2011-29) regarding the supporting documentation required under § 1.263(a)-5(f) to allocate success-based fees; regulations under § 263A regarding the treatment of sales-based costs; final regulations under §§ 381(c)(4) and (5) (carryover of accounting methods and inventory in certain corporate acquisitions);

guidance (Rev. Proc. 2011-14) amplifying, clarifying and modifying Rev. Proc. 2008-52 (guidance relating to automatic accounting method changes); and guidance (Rev. Proc. 2011-17 and Rev. Proc. 2011-18) under §§ 451 and 461 regarding the sale and use of gift cards.

Some of the guidance issued addresses areas of significant controversy between taxpayers and the IRS, such as the documentation of success-based fees, the treatment of sales-based costs, and the sale and use of gift cards. Recently, the Large Business and International ("LB&I") division of the IRS issued a memorandum directing examiners that they should not challenge a taxpayer's treatment of success-based fees if they are in accordance with the recent guidance, even if the fees at issue were incurred prior to the effective date of the Revenue Procedure. This is another move by IRS LB&I Commissioner Heather Malloy to allocate LB&I resources to areas where they are needed most.

Although the regulations under § 263A regarding the treatment of sales-based costs also address the treatment of sales-based vendor allowances, the Treasury Department is still planning to issue regulations under § 1.471-8 regarding the treatment of vendor allowances under the retail inventory method.

Other guidance projects issued relate to newly enacted legislation, such as guidance regarding 100-percent bonus depreciation. When enacted, there was uncertainty surrounding this newly created provision. The guidance answered many of the questions raised by taxpayers, including questions raised by the Joint Committee on Taxation.

The IRS has also recently issued final regulations relating to the election to deduct start-up and organizational expenditures under §§ 195, 248 and 709. *See* page 4 for more on these regulations.

There is one significant tax accounting item on the guidance plan that has not yet been issued- final regulations under § 263(a) regarding the deduction and capitalization of expenditures for tangible assets, more commonly referred to as the repairs regulations. As discussed in previous Accounting Methods Spotlights, Treasury Department officials have expressed their intention of issuing these regulations in proposed, temporary, and final form before the October 2011 ABA meeting.

Government agencies are currently being asked to do more with less. Therefore, we will have to wait and see whether the IRS and Treasury issue their 2011-2012 Priority Guidance Plan in a more timely manner and how much progress is made on that plan.

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