

# *Accounting Methods Spotlight*

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## *Did you know...?*

### Top Automatic Accounting Method Changes for 2011

Taxpayers today face sometimes competing objectives when considering tax planning opportunities involving accounting methods. For example, some taxpayers may be interested in increasing cash flow and decreasing their current cash tax liability and may therefore benefit from accounting method changes that accelerate deductions or defer revenue. At the same time, because of the increased focus on uncertain tax positions, taxpayers may also be interested in filing accounting method changes to correct improper methods of accounting and obtaining audit protection. An accounting method change from an improper to a proper method of accounting may result in an increase to taxable income.

Over the years, the number of changes that can be made without the prior consent of the IRS has increased dramatically. One of the greatest advantages to being able to file a change automatically is the due date. Specifically, a taxpayer that is not currently under IRS examination may file an automatic Form 3115, Application for Change in Accounting Method, at any time on or before the due date of the taxpayer's timely filed federal income tax return (including extensions).

Below is a list of common accounting method changes that can be requested automatically, assuming the prerequisites for making the particular accounting method change

are met. Currently, there are approximately 180 different automatic accounting method changes. As a result, taxpayers that are in the process of preparing their federal income tax returns for 2011 still have the ability to consider whether one or more of these automatic accounting method changes can help them to achieve their tax planning objectives.

#### **Accounting method changes to decrease taxable income**

The following list provides changes in methods of accounting that may provide taxpayers with opportunities to accelerate deductions or defer revenue recognition.

- Self-insured medical accruals/IBNR
- Software development costs
- Uniform capitalization
- Depreciation
- Advance payments
- Inventory valuation
- Bad debts
- Prepaid payment liabilities
- Cash to accrual method for a specific item

#### **Changes from improper to proper methods**

The following changes in method of accounting may benefit taxpayers that are currently using an improper method of accounting for the item by providing audit protection. In many cases, these changes will result in an increase to taxable income.

- Uniform capitalization
- Accrued bonuses

- Section 467 rental agreements
- Losses, expenses, and interest between related parties

## Medical IBNR/retiree prescription drug subsidy deduction sunsets in 2013

The Health Care and Education Reconciliation Act of 2010 (HCERA), which was signed into law by President Obama on March 30, 2010, includes a provision eliminating the tax deductibility of retiree health costs to the extent of federal subsidies received by plan sponsors that provide retiree prescription drug benefits equivalent to Medicare Part D coverage. This aspect of HCERA will be effective for tax years beginning after December 31, 2012. As a result of this legislation, taxpayers should consider filing an accounting method change to deduct the self-insured medical IBNR portion of their retiree medical liability at the time medical services are rendered to retirees, rather than when the medical claims are paid by the taxpayer.

To illustrate the impact of the legislation, assume that a taxpayer deducts the self-insured medical (retiree prescription drug benefits) IBNR portion of retiree medical expenses when medical claims are paid by the taxpayer. If prescription drug benefits are provided to a retiree during the tax year ended December 31, 2012, but the drug benefit claims are not paid by the taxpayer until after December 31, 2012, the taxpayer will lose the permanent tax benefit of the retiree drug subsidy because taxpayers are not eligible to deduct the retiree drug subsidy under Section 139A in

tax years beginning after December 31, 2012. Accordingly, taxpayers should consider the impact of HCERA when evaluating their accounting methods for the self-insured medical IBNR portion of retiree medical expenses.

## *Other Other Guidance*

### IRS rules on applicability of third-party comparable exception to online software

CCA 201226025 addresses how a taxpayer may demonstrate that it has satisfied the requirements of a rule that treats the provision of online software as a qualifying disposition of computer software that is eligible for the § 199 domestic production activities deduction.

The CCA involves a taxpayer that provides its customers access to its online software. The taxpayer identified other unrelated third parties that had computer software products that the taxpayer represented were similar to the taxpayer's online software and were offered to customers affixed to a tangible medium. The taxpayer represented that, in the aggregate, the third-party computer software products were equivalent to the taxpayer's online software. The CCA states that the greatest number of the taxpayer's online software features that were contained within a single third-party's computer software program was Y, a number less than X, where X represented the total features within the taxpayer's online software.

The first issue addressed was whether the taxpayer could aggregate the collective third-party offline computer software programs to permit the taxpayer's online software to satisfy the third-party comparable exception. The IRS concluded that the "plain language of [the third-party comparable exception] does not contemplate aggregating multiple third-party software programs...because integration in software can provide a different customer experience than a disjointed accumulation of software programs." According to the CCA, the functionality, features, and purpose of the taxpayer's online software must be replicated by a single competitor's offline software in order to be considered "substantially identical software." Accordingly, the IRS concluded that the taxpayer's online software did not meet the third-party comparable exception because the functionality, features, and purpose of the taxpayer's online software were not replicated by a single competitor's offline software.

The second issue addressed was whether the taxpayer could apply the shrink-back rule to qualify for § 199 any eligible components of the taxpayer's online software that individually satisfied the third-party comparable exception. The CCA concluded that gross receipts attributable to a component of the online software should qualify as domestic production gross receipts to the extent that the taxpayer can show that an individual component of its online software has a substantially identical offline counterpart (assuming all other § 199 requirements are met).

This CCA offers valuable insight to taxpayers that manufacture or

produce online software in the United States. Specifically, taxpayers that manufacture or produce online software in the United States should evaluate whether such online software, or any component thereof, satisfies the third-party comparable exception (or, alternatively, the "self-comparable" exception under which the taxpayer itself offers via tangible medium to its customers' computer software that has minor or immaterial differences when compared to the taxpayer's online software).

### Charitable contribution carryover may reduce AMT NOL absorbed in a carryover year

In ILM 201226021, the taxpayer had alternative minimum tax net operating loss (AMT NOL) carryovers from multiple years that were sufficient to eliminate the taxpayer's alternative minimum taxable income (AMTI) were it not for the 90% limitation. The taxpayer also had charitable contributions available to use.

Section 56(d)(1)(A) limits the AMT NOL to the lesser of the AMT NOL or 90 % of AMTI. Section 170(b)(2) limits charitable contribution deductions to 10 % of taxable income. If carryover contributions are less than the 10 % limit, carryover contributions are taken into account in the order in which they arose, and expire after five taxable years. The statutory language that imposes the 90 % limit on the AMT NOL deduction does not exclude the charitable contribution deduction from the measure of income on which the limitation is computed. Additionally, however, the statutory

language that imposes the 10 % limit on the charitable contribution deduction does not exclude any AMT NOL deduction attributable to an AMT NOL carryover from the measure of income on which that limitation is computed. Thus, the order in which these limitations should be applied is unclear.

Given the lack of an ordering rule, the ILM considers whether the charitable contributions should or should not be deducted from regular taxable income before the NOL (in calculating the 90% AMT NOL limitation). The exam team noted in its request for advice that in *Shell Oil Company* the court permitted the use of simultaneous equations in the absence of a statutory ordering rule that specifies which deduction takes priority. The IRS National Office agreed that because there was no ordering rule, it was appropriate for a taxpayer to use simultaneous linear equations to determine the amount of AMT NOL and charitable contributions that could be taken into account in determining AMTI.

### Floating gaming facility is classified as nonresidential real property

In a recent legal memorandum, the IRS held that the taxpayer's floating gaming facility should be classified as nonresidential real property under § 168(e) with a recovery period of 39 years for purposes of § 168(a) and a recovery period of 40 years for purposes of § 168(g). The IRS determined that the facility was not a vessel, barge, tug or similar watercraft, which is depreciable over 10 years.

ILM 201225012 involves a gaming facility which is permanently moored to a dock. Despite being moored to the land, the facility is capable of being moved. In 2009, the U.S. Coast Guard, which had been regulating the floating casino, published a notice of policy stating that it will no longer inspect permanently moored crafts. The Coast Guard indicated that such riverboats are designed not for transportation but for lawful gaming, and have taken on the attributes of buildings to such a degree that the Coast Guard should no longer be the primary guarantor of their fitness for public use.

The IRS found that the floating gaming facility is not a vessel for purposes of depreciation and that the facility is an inherently permanent structure that meets the appearance and function tests of § 1.48-1(e)(1). As a result, the IRS concluded that the floating gaming facility is a building classified as nonresidential real property under § 168(e) with a recovery period of 39 years.

### Multiple buildings on rehabilitation site constitute single project

The IRS concluded in PLR 201228015 that the rehabilitation of three separate buildings (separated by public streets) constructed within a reasonable time of each other and interconnected through skywalks would constitute a single project for purposes of determining eligibility for the Federal historic tax credit.

The taxpayers are three separate multi-member State LLCs, taxed as partnerships. Each LLC acquired a building for the purpose of rehabilitating, constructing,

developing, leasing and selling the building in a manner where the expenditures would qualify for the Federal historic tax credit. The buildings have been determined by the National Park Service to be "contributing buildings" and therefore "certified historic structures." The taxpayers recognize that the buildings may not meet the requirements for the Federal historic tax credit individually but would qualify if the three buildings are deemed a single project.

For purposes of the rehabilitation tax credit under § 47(c)(2)(B)(v)(I), as amended by § 3025(a) of the Housing Assistance Act of 2008, the term qualified rehabilitation expenditure does not include any expenditure (in connection with the rehabilitation of a building) which is allocable to the portion of the property which is tax-exempt use property. Tax-exempt use property is defined under §168(h) as property leased to a tax-exempt entity in a disqualified lease. For purposes of determining the taxpayer's eligibility for the rehabilitation credit, a property will be considered tax-exempt use property if the portion of the property leased to tax-exempt entities in disqualified leases is more than 50 percent of the net rentable floor space of the property.

Because one of the buildings will be leased primarily to tax-exempt entities in a disqualified lease, the taxpayers requested a ruling that the 50 percent determination should be made by reference to the total net rentable floor space in the buildings combined because the buildings are part of the same project. In this case, there is a common plan for the construction/rehabilitation of the buildings. The design of the buildings was executed by a single architect and the construction of the buildings

utilized a single contractor. In addition, the construction and renovation of the buildings will all be completed within a reasonable time of each other and will all be connected by skywalks. As mentioned above, parking lots will be shared among the tenants of the buildings and tenants will share several retail amenities and services. Based on these facts, the IRS agreed that the three buildings will work in an integrated manner and therefore would constitute a single project for purposes of § 1.168(j)-1T, Q&A-6 of the temporary regulations. Therefore, for purposes of the rehabilitation tax credit, the net rentable floor space of all buildings should be included.

### Leasing of aircraft is a change in use for depreciation purposes

In ILM 201228036, the taxpayer purchased an airplane for business travel and began to depreciate the airplane under § 168(a) as 5-year property. In order to offset the cost of maintaining the airplane, the taxpayer entered into a dry lease agreement with a charter company (a third party certified air carrier). The lease provided that the taxpayer would lease the airplane when the airplane was not in use by the taxpayer. The taxpayer would then collect a monthly fee for the plane to be listed on a charter certificate and would receive an additional dollar amount based upon the number of flight hours used by the charter company. During the lease agreement, the airplane was used by both the taxpayer for business purposes (and minimal personal use) and by the charter company under the lease agreement. For the length of the lease agreement, the airplane was used (based on flight hours) primarily



by the charter company for the commercial carrying of passengers.

In this case, the airplane had previously been used only for business purposes and as such was originally classified and depreciated as 5-year property. However, the airplane was later used in two business activities. Courts have concluded that the actual purpose and function of an asset determines its asset class rather than the terminology used to describe an asset by its owners. Based on the use of the airplane (per flight hours) during the term of the lease agreement, the IRS determined that the airplane was used primarily by the charter company. As such, the IRS determined that there had been a change in the use of the aircraft for purposes of § 168(i)(5).

## Cases

### Court holds adjusted basis of aircraft should not reflect impermissible depreciation deductions

The US Federal Court of Federal Claims recently ruled in *CBS Corp. et al. v. United States*, 109 A.F.T.R.2d 2012-2105, that impermissible depreciation deductions under the Foreign Sales Corporation (FSC) regime do not constitute allowed or allowable deductions and as such should not lower the basis of the related asset.

The taxpayer is a corporation with its principal place of business in New York and is the common parent of an affiliated group of corporations. The taxpayer wholly-owns two Bermuda corporations (collectively "FSCs"),

both of which qualify as FSCs. In 1990, the FSCs each purchased a Boeing 747-467 aircraft. Both aircraft were leased to Cathay Pacific Airways until 2005, when Catha purchased the aircraft. From 1990 to 2005, the taxpayer depreciated the aircraft in accordance with § 167(a). However, the taxpayer only took 70% of the depreciation deduction since the depreciation deduction related to the exempt foreign trade income (30%) was disallowed under § 921(b). When the taxpayer sold the aircraft in 2005, the taxpayer reported a higher gain because it incorrectly reduced the basis of the aircraft by the disallowed depreciation expense. Upon discovery of this error, the taxpayer amended its 2005 U.S. Federal Income Tax Return and sought to increase the aircraft's basis by the amount of the depreciation previously allocated to the exempt foreign trade income, thus decreasing its gain. The taxpayer argued that the depreciation was neither an allowed nor allowable deduction and should not have reduced the basis of the airplanes. The IRS disallowed the claim and the taxpayer filed suit.

The court held that the taxpayer had properly excluded the depreciation expenses in its originally filed returns. Because the aircraft were used solely for business purposes, the court agreed that 30% of the depreciation expense should have been disallowed. However, the court agreed with the taxpayer that the basis in the assets should not have been reduced to the extent of the disallowed depreciation and therefore ruled that the taxpayer was entitled to a refund.

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