Accounting Methods Spotlight

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Did you know...?

Government officials provide updates at ABA, AICPA fall meetings

This fall, government officials spoke at ABA and AICPA meetings regarding various tax accounting issues, including updates with respect to the items listed on the priority guidance plan. A summary of the more significant items that were discussed is included below:

- The IRS and Treasury are expecting that regulations under § 263(a) addressing the treatment of amounts paid to acquire, produce, or improve tangible property will be forthcoming by the end of the year. It is expected that two accounting method change procedures will accompany the publication of the regulations.

- Government officials discussed Rev. Proc. 2011-42, which provides guidance with respect to the use and evaluation of statistical sampling procedures. From the government's perspective, if statistical sampling is specifically permitted, taxpayers can rely on the procedures described in Rev. Proc. 2011-42. According to government panelists, the revenue procedure was not intended to provide any guidance as to when statistical sampling might be appropriate; rather, it was intended only to provide guidance as to how the sampling should be performed. Taxpayers should look to other guidance to determine whether statistical sampling is appropriate.

- Government officials discussed various issues with respect to accounting method changes related to the earnings and profits (E&P) of foreign corporations. Although there seemed to have been some question as to how the "item" should be defined for purposes of applying the method change procedures (e.g., was the item E&P or the specific item subject to the request), government officials clarified that the "item" being changed with respect to the E&P of a foreign corporation was the specific item subject to the request (e.g., depreciation). Accordingly, if a taxpayer is considering a change in method of accounting for a foreign corporation, the automatic method change procedures should be available to the extent that the item being changed is within the scope of Rev. Proc. 2011-14.

Other Guidance...

IRS issues guidance regarding bonus deductions

In Rev. Rul. 2011-29, the IRS ruled that an accrual method employer can take a deduction in the current year for a fixed amount of bonuses payable to a group of employees even though the employer does not know which of the employees will receive a bonus or the amount of any particular bonus until after the end of the tax year.

In this ruling, a company pays bonuses to a group of employees under a program that defines the terms and conditions under which the bonuses are paid. The company communicates the general terms of the program to employees when they become eligible and whenever the program is changed. Under the program, bonuses are paid to employees for services performed during the tax year. The minimum total amount of bonuses payable under the program to employees as a group is determinable either:

1) through a formula that is fixed before the end of the tax year, taking into account financial data reflecting results as of the end of that tax year; or

2) through other corporate action, such as a resolution of the board of directors or compensation committee, made before the end of the tax year, that fixes the bonuses payable to the employees as a group.

To be eligible for a bonus, an employee must perform services during the tax year and be employed on the date that bonuses are paid. Bonuses are paid after the end of the tax year in which the employee performed the related services but before the 15th day of the 3rd calendar month after the close of that tax year. Any bonus amount allocable to an employee who is not employed on the date on which bonuses are paid is reallocated among other eligible employees.

Under these facts, the IRS said that an employer can satisfy the all events test under § 461 for bonuses payable to a group of employees even though the employer does not know the identity of any particular bonus recipient and the amount payable to that recipient until after the end of the tax year.

This ruling conforms the IRS' published position to long-standing court cases that held that the first prong of the all events test is met where the commitment to pay a bonus is to a pool of employees rather than to specific employees. Since the issuance of CCA 200949040, which concluded that a taxpayer's liability is not fixed as of the end of the year if an employee must be employed on the date the bonuses are paid, the approach described in Rev. Rul. 2011-29 has been widely used by taxpayers to fix the liability for bonuses.

Any change in a taxpayer's treatment of bonuses to conform with the holdings in Rev. Rul. 2011-29 can be made automatically under Rev. Proc. 2011-14.

LB&I directive provides relief for certain automatic accounting method changes

The Large Business and International division (LB&I) recently issued field guidance on the examination of any taxpayer-initiated change in accounting method filed pursuant to § 15.11 of the Appendix of Rev. Proc. 2011-14, which provides automatic consent for taxpayers applying Rev. Proc. 2004-34 to change their method of accounting to conform to a change in the way advance payments are recognized in their applicable financial statement (AFS).

Section 15.11(4)(c)(i) provides that a taxpayer that changes its book method of accounting must secure the Commissioner's consent before applying its new book method of accounting for tax purposes. Therefore, a taxpayer that previously adopted the deferral method for advance payments under Rev. Proc. 2004-34 must request permission to change its method of accounting for tax purposes if the taxpayer subsequently changes its book method for the advance payments and wants to use its new book method in determining the extent to which advance payments are included in gross income under Rev. Proc. 2004-34.

The accounting method change described in § 15.11 of the Appendix of Rev. Proc. 2011-14 did not waive the scope limitations of § 4.02. However, because taxpayers are required to file a statement in lieu of a Form 3115, some taxpayers under IRS examination may have filed the accounting method change outside of a window period and without director consent.

As a result of the ambiguity in the description of the accounting method change in § 15.11, the LB&I directive provides that during the examination of a taxpayer's federal tax return filed for its first or second tax year ending after April 29, 2010, an examiner will not assert that the taxpayer's present method of accounting for advance payments is not a proper deferral method solely on the grounds that the taxpayer failed to obtain direct consent for the change in method of accounting if the taxpayer:

1) received advance payments, as defined in Rev. Proc. 2004-34;

2) used the deferral method described in § 5.02(3)(a) of Rev. Proc. 2004-34 for including those advance payments in gross income in accordance with its AFS;

3) changed the manner in which advance payments are recognized in revenues in its AFS;

4) changed its method of accounting for deferring advance payments in accordance with the requirements of § 15.11 of the APPENDIX except that it did not obtain the Consent of Director as required under § 6.03(4) of Rev. Proc. 2011-14; and,

5) used its new AFS method with respect to a timely filed original federal income tax return in determining the amount of advance payments included in gross income under the deferral method of Rev. Proc. 2004-34.

IRS withdraws, reissues proposed regulations on tax accounting elections for foreign corporations

The IRS recently issued proposed regulations under § 964 ("2011 proposed regulations") that, if finalized, would clarify required book-to tax adjustments for a foreign corporation, including those in respect of depreciation and amortization, as well as provide rules regarding IRS-initiated accounting method changes.

The IRS had previously issued regulations in 1992, but those regulations were withdrawn in connection with the publication of the 2011 proposed regulations.

In general, the 2011 proposed regulations do not provide for substantively different rules than the prior proposed regulations. Rather, the IRS has added some additional examples and removed examples referencing deadwood provisions.

The 2011 proposed rules would apply in computing the earnings and profits of foreign corporations in tax years of foreign corporations beginning on or after their adoption as final regulations, and tax years of shareholders with or within which such tax years of the foreign corporations end.

Comments on the proposed regulations and requests for a public hearing must be submitted to the IRS by February 2, 2012.

PLR concludes that state grant payment is a non-shareholder contribution to capital

In PLR 201144006, the IRS ruled that a taxpayer's receipt of a state economic development grant as reimbursement for building construction costs, pursuant to a contract entered into between the parties, is a non-shareholder contribution to capital under § 118(a), which is excludible from the taxpayer's gross income under § 61.

The taxpayer is the parent corporation of an affiliated group that filed a consolidated federal income tax return and is the single-member owner of LLC 1 (a disregarded entity for federal income tax purposes). LLC 1 is the single-member owner of LLC 2 (a disregarded entity for federal income tax purposes). State established the Grant Program, run by Department. Department and LLC 2 entered into a contract governing the terms and conditions of a grant under the Grant Program on Date 1. The terms and conditions required LLC 2 to use the grant for construction and renovation costs, engineering/architecture costs (subject to limitations) and for the purchase of office furniture, fixtures, machinery and equipment as part of LLC 2's plan to centralize and expand its business. LLC 2 could not use the grant for any other activities without first obtaining consent from Department. On Date 2, LLC 2 submitted a payment request to Department requesting reimbursement of costs incurred in the construction of Building at an approved address. On Date 3, Department made the grant payment to LLC 2. The taxpayer requested a ruling that the grant payment received from State was a non-shareholder contribution to capital under § 118(a), which was excludible from the taxpayer's gross income under § 61.

In reaching the conclusion that payment was a non-shareholder contribution to capital under § 118(a), the IRS relied heavily on the factors set forth by the Supreme Court in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973). The ruling did not address the application of the basis reduction rules under § 362(c).

Recent Cases....

Fifth Circuit affirms disallowance of deductions is a change in method of accounting

In *Bosamia v. Commissioner*, 661 F.3d 250 (5th Cir. 2011), the Fifth Circuit upheld a 2010 Tax Court decision that the disallowance of deductions claimed by the sole shareholders of two S Corporations constituted a change in the taxpayers' method of accounting.

The taxpayers had two S Corporations, India Music, Inc (India Music) and Houston-Rakhee Imports (HMI), both wholly owned by the taxpayers (husband and wife). India Music uses the accrual method of accounting, and HMI uses the cash method of accounting.

India Music purchased most of its inventory from HMI on credit and didn't make payment for seven years, from 1998 and through the year at issue (2004). In 2008, when examining India Music's 2004 tax return, the IRS concluded that India Music improperly claimed deductions as a result of not having applied § 267(a)(2). In the notice of deficiency, the IRS not only disallowed these deductions for the open years, but they also included a § 481(a) adjustment to recapture the improper deductions taken in prior years. The taxpayer challenged the IRS notice of deficiency and the Tax Court held in favor of the IRS. The taxpayer appealed to the Fifth Circuit.

There was no dispute between the parties as to whether § 267(a)(2) applies. Rather, the only question before the court was whether the Service's disallowance of the deductions under § 267(a)(2) is a method of accounting for purposes of §481.

Although the taxpayer made a number of arguments as to why this should not be treated as a change in method of accounting, the Fifth Circuit upheld the Tax Court decision that a disallowance of a deduction as a result of § 267(a)(2) constitutes a change in a taxpayer's method of accounting for purposes of § 481.

Fourth Circuit affirms decision in *Capital One*

The Fourth Circuit in *Capital One Financial Corp. & Sub. v. Commissioner* upheld an earlier decision by the Tax Court that Capital One could not retroactively change its method of accounting for credit card late fees even though it was on an improper method. The Court also upheld the Tax Court's decision that Capital One's credit card rewards program did not qualify as a premium coupon under Treas. Reg. § 1.451-4.

Notwithstanding the various arguments put forth by Capital One, the Fourth Circuit upheld the Tax Court's decision, affirming that the prerequisite of prior consent under § 446(e) prevents taxpayers from unilaterally amending their tax returns simply because they have discovered that a different method of accounting yields a lower tax liability than the method they originally chose. As a result, Capital One was precluded from changing its method of accounting for late fees.

The Fourth Circuit also affirmed the Tax Court's decision with respect to the application of Treas. Reg. § 1.451-4 to Capital One's credit card rewards program. In reaching its conclusion, the Court said that the regulation applies only to coupons issued "with sales," and that there was no sale with respect to Capital One's rewards program. The Court also pointed out that Treas. Reg. § 1.451-4 provides that estimated costs be deducted from "gross receipts with respect to sales with which ... coupons are issued," and that Capital One's coupons were not issued in conjunction with the revenue it earns from lending services. As a result, the Court concluded that Treas. Reg. § 1.451-4 did not apply.

Tax Court finds that individual is entitled to travel and home office deductions

In *Roberts v. Commissioner*, T.C. Summ. Op. 2011-127, the Tax Court held that an individual was entitled to deduct expenses for travel and a home office, finding that his home office was his principal place of business and was used exclusively for business purposes.

The sole issue in this case is whether the taxpayer was entitled to deduct transportation expenses under § 162(a), incurred in connection with travel between his home office in Roanoke, Alabama, and his testing facility in Metairie, Louisiana.

The taxpayer was a resident of the State of Alabama. In 1997, the taxpayer started a sole proprietorship involved in vocational rehabilitation and evaluation services. During 2004, 2005, and 2006, the taxpayer worked from a space in his residence that he converted to a home office. All work, including the composition of a final expert report, was performed from the taxpayer's home office in Roanoke.

The taxpayer began receiving referrals from the Louisiana area requesting his services. During the tax years at issue, the taxpayer travelled to Louisiana if a case required testing or if a deposition or court appearance was scheduled. In 2004, the taxpayer made 47 trips between Birmingham, Alabama, and New Orleans, Louisiana. In 2005, the taxpayer made 33 trips between Alabama and Louisiana. After Hurricane Katrina devastated New Orleans in August 2005, the taxpayer began using his vehicle to travel to Louisiana. Consequently, in 2005, the taxpayer made 14 round trips with his vehicle. In 2006, the taxpayer made 50 trips in his vehicle from his home office to Louisiana. The taxpayer deducted his transportation expenses for those years.

Generally, expenditures for transportation between a taxpayer's home and place of business are considered personal expenses and are not deductible. Transportation expenses, however, may be deducted under § 162(a)(2) if they are (1) ordinary and necessary; (2) incurred while "away from home"; and (3) incurred in pursuit of a trade or business.

The Tax Court stated that, as a general rule, the location of a taxpayer's principal place of business is his tax home, not the location of the taxpayer's personal residence. However, when a home office qualifies as the taxpayer's principal place of business, the taxpayer's personal residence is considered his tax home and expenses paid or incurred travelling between that residence and another workplace may be deductible.

After careful consideration, the Tax Court found that the taxpayer's home office was his principal place of business during the years at issue. Consequently, the court held that the taxpayer was entitled to deduct the ordinary and necessary transportation expenses paid or incurred for travel away from Alabama in pursuit of his business.

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