Accounting Methods Spotlight

A Washington National Tax Services (WNTS) Publication

November 21, 2011

This month's features:

- Key year-end planning opportunities for 2011
- Opportunities exist to correct depreciation through amended returns
- IRS addresses treatment of gift check sales
- New safe harbor method available for taxpayers using the nonaccrual-experience method
- IRS issues proposed regulations relating to the retail inventory method
- IRS addresses contributions of inventory
- Taxpayer permitted to claim additional first-year depreciation deduction for pipeline network
- IRS issues guidance regarding §199 deduction for telecom service providers
- Domestic production activities deduction doesn't create NOL
- Tax Court disregards express allocation of settlement proceeds

Did you know…?

Key year-end planning opportunities for 2011

Calendar-year companies, by taking certain actions before the end of the year, can take advantage of accounting method opportunities that could increase cash flow by deferring the recognition of income or accelerating the timing of a deduction. While certain of the opportunities described below involve filing an accounting method change request, in other cases positive results may be obtained through other actions taken by year end.

Insured reserves - Taxpayers that are fully or partially insured for future losses or other liabilities and separately record both a reserve for the liability and a corresponding insurance receivable as gross amounts may be overstating their taxable income by mistakenly calculating their book-tax adjustments by reversing the gross amount of the liability reserve and failing to reverse the related insurance receivable. In this case, a taxpayer could file a non-automatic method change request to properly calculate the book-tax differences for insured losses.

Defer recognition of unbilled receivables - Because the tax law requires revenue to be recognized at the earliest of when it is due, paid, or earned, an opportunity exists to take advantage of the differences in earnings events between book and tax with respect to unbilled receivables (i.e., revenue that has been recognized for books but is not due or paid). Taxpayers with unbilled receivables on their balance sheets may have an opportunity to file a non-automatic accounting method change request to defer the recognition of revenue for federal income tax purposes until such revenue is earned.

Disputed income - A taxpayer whose customers are disputing the payment of amounts due to the taxpayer may have an opportunity to exclude those disputed amounts from income for federal income tax purposes. Taxpayers may file a non-automatic method change request to exclude certain disputed amounts from taxable income.

Foreign pension plans - Many multinational companies that have foreign pension plans are not following the provisions of § 404A, and as a result, may be improperly claiming federal income tax deductions at a later point in time. Companies that primarily will benefit from a non-automatic method change to comply with § 404A are those with an unfunded reserve plan (e.g., a pension plan in Germany or Japan) that are taking pension deductions into account only when paid to the retirees for tax/E&P purposes (i.e., by reversing the pension plan liability).

Accrued bonuses - Over the last few years, many taxpayers have reviewed their bonus plans to determine whether such plans are "fixed" at year-end. Taxpayers that are not taking into account an accrued liability for bonuses because they have determined that the liability is not fixed at year-end may have an opportunity to change the terms of the bonus plan or take other action before year-end to fix the liability.

Taxpayers not within a window period may file with 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.

Opportunities exist to correct depreciation through amended returns

Taxpayers may choose whether to treat a change in computing depreciation for certain assets as an error corrected by filing amended returns or as method of accounting for which a taxpayer files a Form 3115. This opportunity is limited to assets placed in service in a year ending prior to December 30, 2003, for which depreciation or amortization is determined under §§ 167, 168, 197, 1400I, 1400L (b), or 1400L(c), or ACRS.

A taxpayer choosing to amend tax returns must amend any year affected by the change in computing depreciation beginning with earliest open year or the earliest year under examination, but in no event earlier than the placed-in-service year of the asset, and all subsequent affected taxable years. There is no published guidance addressing how to compute depreciation on amended tax returns where a portion of the asset's recovery period is earlier than the taxpayer's earliest open year. However, the IRS has informally advised and allowed taxpayers to effectuate this change by recovering the remaining basis of the asset over the remainder of the revised recovery period beginning with the earliest open year.

Taxpayers looking to change a method of computing depreciation for assets placed in service in a year ending prior to December 30, 2003, should consider whether it is more advantageous to file amended returns or file a request for change in method of accounting.

Other Guidance

IRS addresses treatment of gift check sales

The IRS, in a field attorney advice (FAA 20113802F), found that proceeds from an unincorporated association's sale of gift checks were gross income and not non-taxable member contributions.

The taxpayer is a corporation whose members include hundreds of franchisees. The taxpayer uses the cash method of accounting for financial reporting purposes and the accrual method of accounting for tax purposes. The taxpayer was formed solely for the "not-for-profit" purpose of conducting or promoting services that the franchisees could not afford. All amounts contributed to it by the franchisees were to be expended solely for such purposes in connection with its products. No part of any contribution is returned to a franchisee.

The taxpayer's primary sources of receipts come from contributions (paid by store owners as a percentage of food sales) and gift check sales. Gift checks are similar to actual checks in that they are pre-numbered, have separate checking account numbers based upon the face value of the gift check, and are processed through the Federal Reserve System. The gift checks are not dated and have no

expiration dates. The gift checks are ordered in batches and a new checking account is opened each time a new batch of gift checks is produced. On average, it takes about 3 years to sell an entire batch of gift checks. Lastly, if a gift check exceeds the value of the product purchases, the customer will receive cash back when redeeming the gift check. Therefore, there are some distinguishing characteristics between gift cards and gift checks. Gift check sales come in the form of sales to its franchisee stores, sales directly to scrip organizations at a 10% discount, and online sales. In general, the taxpayer will not deliver gift checks until it receives payment for the face amount of the gift checks for gift checks provided to the franchisee stores.

The taxpayer did not report any income from its gift check sales under the theory that it is a non-taxable intermediary that only handles the administration of the gift checks. The IRS agent asserted that the taxpayer's direct sales of gift checks to online purchasers and scrip organization are sales, and not deposits; therefore, the amounts received should be reported as income under §61 and §451.

LB&I counsel agreed with the agent and advised that proceeds received from direct sales of gift checks to the public or third parties are not deposits or funds held in trust; however, amounts received from certain franchisees may be viewed as a deposit or an amount held in trust for the benefit of those franchisees up to the time the franchisees sell the gift checks to customers.

New safe harbor method available for taxpayers using the nonaccrual-experience method

There is a new safe harbor method available under Rev. Proc. 2011-46 for taxpayers that utilize the nonaccrual-experience (NAE) method. The NAE book safe harbor is available to taxpayers that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, as well as to taxpayers that meet the $5 million or less "gross receipts test" under §448(c) and Reg. § 1.448-1T(f)(2) for all prior tax years. The NAE is not available in situations where the taxpayer charges interest or penalties on the failure to pay outstanding receivables.

To use the new book safe harbor method, a taxpayer would multiply the year-end allowance for doubtful accounts on the taxpayer's applicable financial statement that is attributable to the current-year NAE eligible accounts receivable (computed under Reg. §1.448-2(e),(f)) by 95%. This would be the amount of income that the taxpayer is not required to accrue for federal income tax purposes. A change to the new book safe harbor method is an automatic method change under Rev. Proc. 2011-14 that is implemented with a §481(a) adjustment.

Rev. Proc. 2011-46 also provides procedures for taxpayers to change their method of accounting within the book safe harbor method. For example, Rev. Proc. 2011-46 provides that a change in a taxpayer's method of accounting for determining its allowance for doubtful accounts for its

applicable financial statements is a change in method of accounting for purposes of §446. In addition, a change in the method of determining its NAE-eligible amount is considered a change in method of accounting for tax purposes. These two accounting method changes do not require the filing of a Form 3115. Instead, the taxpayer should provide the required information in a statement to be included in its federal income tax return. Both of these changes are implemented on a cut-off basis.

IRS issues proposed regulations relating to the retail inventory method

The IRS issued proposed regulations that clarify the computation of ending inventory values under the retail inventory method and provide a special rule for certain taxpayers that receive margin protection payments and similar vendor allowances. They also add rules addressing the treatment of sales-based vendor allowances and vendor markdown allowances and margin protection payments in the retail inventory method computation. Finally, the proposed regulations clarify the interaction of proposed Reg. §1.471-3(e) with the retail inventory method by excluding from the numerator of the cost complement formula the amount of a sales-based vendor allowance.

The retail inventory method determines an ending inventory value by maintaining proportionality between costs and selling prices. Under the retail lower of cost or market (LCM) method, a reduction in retail selling price reduces the value of ending inventory in the same ratio as the cost complement.

If a taxpayer earns an allowance, discount, or price rebate, the inventory cost in the numerator of the cost complement declines, resulting in a reduction of ending inventory value computed under the retail inventory method. If the allowance, discount, or price rebate is related to a permanent markdown of the retail selling price (as in the case of a markdown allowance or margin protection payment), ending inventory value is further reduced as a result of the decrease in ending retail selling prices (the multiplicand in the formula). This additional reduction of ending inventory value caused by reducing both the numerator of the cost complement and the multiplicand generally results in a lower ending inventory value for a retail LCM method taxpayer than for a similarly situated first-in, first-out (FIFO) taxpayer that values inventory at LCM, and, in the view of the IRS, does not clearly reflect income.

To address this perceived distortion, the proposed regulations provide that a retail LCM method taxpayer may not reduce the numerator of the cost complement for an allowance, discount, or price rebate that is related to or intended to compensate for a permanent markdown of retail selling prices. Thus, in the case of markdown allowances and margin protection payments, the value of ending inventory as computed under the retail LCM method is reduced solely as a result of the reduction in retail selling price, avoiding an unwarranted additional reduction in inventory value for a single markdown allowance and more reasonably approximating LCM.

As an alternative to this proposed modification, the retail inventory method could achieve the same result by permitting taxpayers to reduce the numerator of the cost complement for all non-sales based allowances,

discounts, or price rebates, including markdown allowances, but requiring a reduction of the denominator of the cost complement for all permanent markdowns related to markdown allowances. The IRS is seeking comments on whether the final regulations should provide this or other alternative retail LCM methods.

The proposed regulations also clarify that under the retail inventory method taxpayers do not adjust the cost complement or ending retail selling prices for temporary markdowns and markups.

Comments on the proposed regulations and requests for a public hearing must be submitted to the IRS by January 5, 2012. The proposed regulations would apply for tax years beginning after the date they are published as final regulations.

IRS addresses contributions of inventory

In FAA 20113801F, LB&I counsel determined that a taxpayer was precluded from claiming a charitable contribution deduction for inventory donations because the taxpayer failed to attach Form 8283 to its return.

The taxpayer is a manufacturer of food products that normally sells to wholesalers. Although there is no federal standard or state law that requires a "Best By" date to be used, the taxpayer includes a "Best By" date on its products to identify the date the products could be perceived to fall below the taxpayer's standards for quality. However, the date does not represent a safety date, and the products can be used for years beyond the Best By date. As a policy, the taxpayer does not sell products that are within 110 days of their Best By date. Instead, inventory within 110 days of the "Best By" date is donated to food banks and other organizations that deliver food to the ill, needy and infants.

Form 8283 is required to be attached to a taxpayer's federal income tax return for contributions of property other than money if the total claimed deduction for all property contributed was more than $5,000. A failure to attach the Form 8283 normally does not disallow a deduction if the failure to attach the appraisal summary was a good faith omission and the form is provided within 90 days of a request by the Service. In this case, the agent found that the taxpayer would have qualified for the enhanced deduction under §170(e)(3), but the taxpayer failed to attached the required Form 8283 to its tax return. Further, the taxpayer did not provide the Form 8283 within the 90 day period.

The Service also noted that even if a deduction were allowed, the taxpayer improperly calculated the contribution amount because the taxpayer did not reduce the fair market value of the inventory by its normal discounts and vendor allowances provided to customers. In the Service's view, because the taxpayer does not normally sell inventory within 110 days of the Best By date, the taxpayer could not reasonably have expected to realize its usual selling price at the date of contribution.

Taxpayer permitted to claim additional first-year depreciation deduction for pipeline network

In PLR 201140002, the taxpayer requested a ruling as to whether a pipeline network qualified for bonus depreciation. The taxpayer is a

disregarded limited partnership that is included in a consolidated return. The parent of the group is involved in the industrial gas business, and the taxpayer provides gas and energy solutions to customers. The taxpayer entered into a written agreement to supply hydrogen gas and consented to construct and operate a pipeline and meter station (the Property) for the manufacture, transportation and delivery of hydrogen. The Property was connected to other property previously placed in service and used by the taxpayer.

The IRS ruled that the depreciation deduction provided by §167(a) for the year the Property was placed in service includes an allowance of 50 percent of the adjusted basis of the Property because: (1) the Property is property to which §168 applies with a recovery period of 20 years or less; (2) the original use of the Property commenced on the relevant date, notwithstanding the fact that the Property was attached to property previously placed in service and used by the taxpayer in its business; and (3) the Property satisfied the acquisition requirements of §168(k)(2)(A)(iii) because the taxpayer constructed the Property, for the taxpayer 's own use, after December 31, 2007, but before January 1, 2013.

The IRS also ruled that the Property is included in asset class 46.0 of Rev. Proc. 87-56 and is 15-year property. The taxpayer constructed and used the Property to transport and deliver hydrogen from its facilities. As such, the IRS stated that the Property has a class life of 22 years, with a recovery period of 15 years under §168(c). The IRS then ruled that the Property satisfied the original use requirement in §168(k)(2)(A)(ii) because the taxpayer was the first and only user of the Property and such use began after December 31, 2007.

Finally, the IRS found that the Property satisfied the acquisition requirement provided in §168(k)(2)(A)(iii). According to the IRS, the taxpayer constructed the Property, for its own use, after December 31, 2007, but before January 1, 2013. The IRS also noted that the agreement was not a contract for the purchase or construction of the Property because the agreement did not provide any specifications about the construction. Therefore, the IRS ruled that the taxpayer met the requirements of §168(k)(2)(E)(i), and treated the Property as meeting the acquisition requirement of §168(k)(2)(A)(iii).

IRS issues guidance regarding §199 deduction for telecom service providers

The IRS released Rev. Rul. 2011-24, which determines in three scenarios whether a taxpayer providing telecommunications services is deriving gross receipts from services, leasing or renting property, or some combination thereof for purposes of the domestic production activities deduction under §199.

The revenue ruling addresses several variations of a transaction in which a corporation is in the business of providing telecommunication services, including the transmission of voice, data, and video communications. Relying on a variety of authorities concerning characterization of transactions, the IRS addressed whether each variation constitutes a service contract or a lease in part or in whole.

The IRS ruled that when and to the extent the transaction constitutes the provision of telecommunication services, the associated receipts do not

constitute domestic production gross receipts (DPGR) for purposes of §199. In one of the scenarios where the telecommunication services provider is deemed to be leasing customer premises equipment, the IRS ruled that the associated receipts may constitute DPGR to the extent they otherwise meet the requirements of §199 (i.e., manufacture of qualifying production property in whole or in significant part in the United States).

Domestic production activities deduction doesn't create NOL

In ECC 201139006, the IRS ruled that a taxpayer could not take a §199 deduction because the net operating loss carryback from a subsequent year must first offset the election year's §172(b)(2) taxable income, and that §172(d)(7) bars the use of §199 deductions to create net operating losses (NOL).

The taxpayer is a corporation with non-deductible controlled foreign corporation (CFC) dividends in Year 1, a year for which the taxpayer elected the benefits under §965. In year 2, the taxpayer had an NOL that was available to carry back to Year 1. Based on §172(d)(7), the taxpayer tried to use its §199 deduction to create an NOL in Year 1.

The IRS, however, stated that because the taxpayer's deductions did not exceed its gross income for Year 1, the taxpayer did not have an NOL for that year. The IRS noted that a deduction under §199 is based on the lesser of qualified production activities income or taxable income. Under Reg. §1.199-1(b)(1), for purposes of determining the deduction under §199, taxable income is defined under §63 except it is determined without regard to §199, but with regard to any NOL deductions allowed under §172.

The IRS concluded that before the allowable deduction under §199 is computed, the NOL carryback from Year 2 will operate to offset the other taxable income from Year 1. In addition, the IRS stated that §965(e)(2)(A) provides that the taxable income of any U.S. shareholder for any taxable year shall in no event be less than the amount of nondeductible CFC dividends received during the taxable year.

Notwithstanding the restriction under §965(e)(2)(A), the IRS found that §199 would permit the taxpayer to calculate a §199 deduction based on the lesser of taxable income or qualified production activities income. However, the IRS stated that a deduction under §199 cannot create, or increase, the amount of a net operating loss deduction. Because §172(d)(7) prohibits the use of §199 deductions in computing an NOL and the taxpayer did not have other deductions in Year 1 that exceeded the taxpayer 's Year 1 gross income, the IRS ruled that the taxpayer did not have an NOL for Year 1.

Recent Cases

Tax Court disregards express allocation of settlement proceeds

In *Healthpoint, Ltd., et al. v. Commissioner*, T.C. Memo. 2011-241 (2011), the Tax Court concluded that the characterization of proceeds from a settlement agreement as ordinary income or capital gain should reflect the allocation of the proceeds by the jury that considered the case, rather than the express allocation set forth in the settlement agreement.

Under the origin of the claim doctrine, the tax treatment of settlement proceeds or judgments depends on the

nature of the claim and the actual basis of the recovery. Where damages are received pursuant to a settlement agreement, the treatment of the proceeds depends on the nature of the claim. (*U.S. v. Burke*, (1992, Sup Ct) 69 AFTR 2d 92-1293). Where there is an express allocation in the settlement agreement, it will generally be followed in determining allocation for tax purposes if the settlement agreement is entered into in an adversarial context at arm's length and in good faith. However, an express allocation is not necessarily determinative if other facts indicate a different purpose.

Healthpoint, a pharmaceutical company, owns a prescription ointment called Accuzyme, as well as the exclusive rights to the trademark and associated goodwill. Ethex Corporation (Ethex) introduced a product, Ethezyme, which it marketed as a generic of Accuzyme. Ethezyme contained an additional chemical and different proportions of certain enzymes that caused negative results in some patients. As a result, many consumers stopped using both Ethezyme and Accuzyme.

In 2000, Healthpoint filed a District Court suit against Ethex (Ethex I). The parties attempted, but failed to reach a settlement. Healthpoint filed a second suit (Ethex II) in July 2001, while Ethex I was still ongoing. In September 2001, the jury in Ethex I ruled in favor of Healthpoint; however, the jury did not find that Ethex had knowingly or intentionally diluted Healthpoint's trademark or disparaged Healthpoint's business. The jury awarded over $16 million in damages, and Ethex appealed.

The parties ultimately agreed in August 2004 to settle Ethex I for $12 million and Ethex II for $4.5 million. However, the discussion surrounding the nondisparagement and confidentiality provisions remained contentious. In the end, the parties allocated $10,450,000 and $4,050,000 (for Ethex I and II, respectively) to damage to goodwill and reputation, and $1,350,000 and $450,000, respectively, to lost profits and disgorgement of profits. The settlement agreement also stated that "no part of the sums paid pursuant to this Agreement are for willful misconduct" or punitive damages.

Healthpoint did not keep any business documentation relating to goodwill or make any calculations during the settlement negotiations to justify the allocations. Healthpoint reported the settlement proceeds on its 2004 tax return as $14.5 million in long-term capital gain and $1.8 million in ordinary income. The IRS issued a final adjustment designating all proceeds of the settlement as ordinary income and imposed a penalty under §6662(a). The primary issue was whether the allocations in the settlement agreement should be respected, or whether the allocations made by the jury in Ethex I should control.

The Tax Court found that the allocations from the jury verdict in Ethex I, and not the allocations agreed to by the parties in the settlement agreement, should control. The Court determined that although the parties had numerous disagreements and a generally adverse relationship, the ultimate allocation of the funds didn't reflect their true intentions. The Tax Court found that Ethex's refusal to pay the punitive damages specified in Healthpoint's first draft of the settlement agreement merely indicated that it objected to the label of such damages as punitive and was indifferent as to the allocation so long as no wrongdoing was implied. The Court also found it significant that Healthpoint would have been taxed on

punitive damages at ordinary income rates.

The Court also noted that the allegations in Ethex II were very similar to those in Ethex I, and decided that the proceeds from that case should therefore be allocated in the same proportions and using the same classifications as those in Ethex I. The Tax Court also upheld the accuracy-related penalty under §6662(a), noting that Healthpoint's position was neither based on substantial authority nor adequately disclosed on its return. Healthpoint also failed to show that it relied on tax counsel as to the propriety of the ultimately agreed-to allocations. However, the amount of the penalty was reduced to reflect Service's concession to treat as capital gain the enhanced damages for loss of goodwill.

For more information, please do not hesitate to contact:

James Connor	*(202) 414-1771*	*james.e.connor@us.pwc.com*
Adam Handler	*(213) 356-6499*	*adam.handler@us.pwc.com*
Jennifer Kennedy	*(202) 414-1543*	*jennifer.kennedy@us.pwc.com*
George Manousos	*(202) 414-4317*	*george.manousos@us.pwc.com*
Annette Smith	*(202) 414-1048*	*annette.smith@us.pwc.com*
Christine Turgeon	*(646) 471-1660*	*christine.turgeon@us.pwc.com*
David Crawford	*(202) 414-1039*	*david.l.crawford@us.pwc.com*
James Martin	*(202) 414-1511*	*james.e.martin@us.pwc.com*
Dennis Tingey	*(602) 364-8107*	*dennis.tingey@us.pwc.com*