Accounting Methods Spotlight

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This month's features:

- Treasury and IRS publish 2011-2012 Priority Guidance Plan
- AICPA provides comments on ways to make Schedule M-3 less burdensome
- IRS drops schedule M-3 supporting attachment requirement for required R&D costs
- IRS publishes audit technique guide for attorneys and law firms
- Final regulations on post-reorganization accounting method changes modify rules
- IRS issues guidance regarding income from telephone excise tax refunds
- First Circuit affirms that a covenant not to compete is an amortizable intangible

Did you know...?

Treasury and IRS publish 2011-2012 Priority Guidance Plan

On September 2, 2011, the IRS released its 2011-2012 Priority Guidance Plan, which includes 22 tax accounting projects, three of which have already been published. The list of 22 items is down from the 25 projects listed in the 2010-2011 Priority Guidance Plan.

Some of the more significant guidance plan projects include:

- Final regulations under § 263(a) regarding the deduction and capitalization of expenditures for tangible assets;
- Revenue ruling under § 461 regarding the recurring item exception to the all events test;
- Regulations on the carryover of last-in, first-out (LIFO) layers following a § 351 or § 721 transaction;
- Regulations under § 174 regarding procedures for adopting and changing methods of accounting for research and experimental expenditures; and
- Regulations under § 964 on accounting method elections.

The guidance plan also includes a few projects unique to specific industries. These projects are primarily the result of the Industry Issue Resolution Program and include revenue procedures under § 263(a) regarding:

- Capitalization of electric generation property;
- Capitalization of natural gas transmission and distribution property; and
- Cable network property.

AICPA provides comments on ways to make Schedule M-3 less burdensome

In response to an IRS request for comments on Schedule M-3, the AICPA issued a preliminary comment letter on April 25, 2011, and submitted additional comments on August 1, 2011. The most significant recommendation was for the IRS and Treasury to establish a working group to understand how Schedule M-3 is currently being used and how it could potentially be revised or eliminated. One of the general themes of the recommendations was to eliminate duplicate reporting. For example, Schedule M-3 includes a specific line for Items Relating to Reportable Transactions, but taxpayers are already required to separately disclose reportable transactions elsewhere in the tax return.

The AICPA comment letter also recommended:

- Eliminating the required mapping of book income and expense accounts;
- Keeping the reconciliation of financial statement income;
- Replacing Schedule M-3 with an expanded Schedule M-1;

- Eliminating or revising Form 8916-A, which is a book-tax reconciliation for cost of goods sold;
- Expanding the use of Schedule B and Schedule C, which are information reporting forms, for risk assessment in lieu of adding new lines to Schedule M-3; and
- Allowing taxpayers to have more than one year to implement potential changes.

IRS drops schedule M-3 supporting attachment requirement for required R&D costs

On August 4, 2011, the IRS announced that taxpayers will no longer be required to submit supporting detail for research and development (R&D) expenditures on Schedule M-3. This change is effective for 2010 and 2011. In 2010, the IRS added a line to Schedule M-3 that required taxpayers to report R&D expenditures. In addition to reporting total R&D expenditures on Schedule M-3, taxpayers were also required to attach a statement that would provide details for the R&D expenses on that line. These additional requirements created confusion and were expected to create a fairly substantial compliance burden. Although the elimination of the supporting attachment is welcome news, many practitioners believe that taxpayers will continue to struggle with reporting the amount of R&D expenses on Schedule M-3 because there are numerous definitions for R&D. As a result, practitioners have requested that the IRS provide further instruction on the specific R&D expenses that should be disclosed on Schedule M-3.

IRS publishes audit technique guide for attorneys and law firms

On July 19, 2011, the IRS released an Attorneys Audit Technique Guide (the "ATG") to assist examiners in the audit of an attorney's tax return. The ATG provides guidance to direct the IRS field agents on areas to review and examine, including how an attorney's area of expertise may influence fee arrangements and income recognition.

The ATG highlights client litigation costs paid by attorneys during the trial and how those costs should be treated by cash basis taxpayers. The ATG reaffirms that the cost reimbursement doctrine should be applied to client expenses for which an attorney expects to be reimbursed. Under the cost reimbursement doctrine, expenses paid on behalf of the client are considered advances and should be treated in the nature of a loan for tax purposes. Therefore, the cost of client litigation expenses paid by the attorney should not be deducted, nor should income be recognized upon reimbursement by the client. The ATG notes that some attorneys paid on a contingent fee basis may argue that there is no guarantee they will ever be reimbursed for the client costs and as a result, they should be entitled to a current deduction. The ATG suggests that exam agents should consider the attorney's success rate in recovering advance litigation costs to determine if a current deduction should be allowed, or if the cost reimbursement doctrine should apply.

Other items of note in the ATG include the treatment of texts and periodicals. The ATG provides that texts and periodicals should be currently deductible if the useful life is one year or less, but permanent volumes should be depreciated. The ATG also highlights the need to determine whether a law firm is a personal service corporation (PSC) or a qualified personal service corporation (QPSC) for purposes of properly applying the passive loss rules.

Other Guidance…

Final regulations on post-reorganization accounting method changes modify rules

The IRS recently finalized regulations under § 381 that significantly modify the rules that determine the method of accounting that must be used by the acquiring entity in certain corporate reorganizations or tax-free liquidations described in § 381. These final regulations affect taxpayers that are party to a transaction described in § 381 that occurs on or after August 31, 2011.

The final regulations provide under both § 381(c)(4) and § 381(c)(5) that the accounting method to be used after a § 381(a) transaction by the acquiring corporation will depend on whether (1) the businesses of the parties to the § 381(a) transaction are combined after the transaction by the acquiring corporation; and (2) the method is permissible.

If the trades or businesses of the parties to the § 381(a) transaction are operated as separate trades or businesses after that transaction, then an accounting method used by the parties prior to that transaction carries over and is used by the acquiring corporation, provided the method is permissible (the "carryover method"). If the trades or businesses of the parties to the § 381(a) transaction are not operated as separate trades or businesses after that transaction, then the acquiring corporation must determine and use the "principal method," provided the method is permissible. If either the carryover method or the principal method is impermissible, the acquiring entity must change the method of accounting in accordance with § 1.446-1(e) and the applicable administrative procedures (i.e., Rev. Proc. 97-27 and Rev. Proc. 2011-14).

The final regulations provide a general rule that the principal method generally is the accounting method used by the acquiring corporation prior to the § 381(a) transaction. However, there are two exceptions:

- If the acquiring corporation does not have an accounting method for a particular item or type of goods, the principal method is the accounting method for the item or type of goods used by the distributor or transferor corporation prior to the § 381(a) transaction.

- If the distributor or transferor corporation is larger than the acquiring corporation, the principal methods for the overall accounting method and for the accounting method for a particular item or type of goods are the methods used by the distributor or transferor corporation prior to the § 381(a) transaction.

Under the final regulations, the determination of whether the distributor or transferor corporation is larger than the acquiring corporation is made by comparing certain attributes --

under § 381(c)(4), the adjusted bases of assets and gross receipts, and under § 381(c)(5), the fair market value of the inventory -- of only the trades or businesses that will be integrated after the date of distribution or transfer.

The final regulations provide that the rules governing accounting method changes under § 446(e) apply to determine (1) whether the § 381(a) accounting method change is implemented with a § 481(a) adjustment or on a cut-off basis; (2) the computation of the § 481(a) adjustment; and (3) the appropriate number of tax years over which the adjustment is included in taxable income.

In addition, the final regulations clarify that if a taxpayer is required to change the method of accounting (e.g., because either the principal method or carryover method is impermissible), the acquiring entity must request an accounting method change on Form 3115 and not by filing a request for a private letter ruling. Such a request must be filed by the later of (1) the last day of the tax year in which the combination occurred; or (2) the earlier of: (a) 180 days after the date of distribution or transfer or (b) the day on which the acquiring corporation files its federal income tax return for the tax year in which the distribution or transfer occurred.

The final regulations do not provide audit protection when an acquiring corporation uses a principal method after the date of distribution or transfer. However, audit protection ordinarily is provided for any voluntary change in method of accounting for which a party to a § 381(a) transaction obtains consent under § 446(e) and the generally applicable administrative procedures set forth in Rev. Procs. 97-27 and 2011-14.

IRS issues guidance regarding income from telephone excise tax refunds

The IRS National Office recently addressed the proper timing for the accrual of income from a telephone excise tax refund. In responding to a request for assistance from LB&I (PMTA 2011-018), the National Office referenced Notice 2006-50, in which the IRS announced that it would stop assessing and collecting the federal telephone service excise tax under § 4251. The IRS provided guidance in that notice for telecommunications and other companies to request credit or refund of excise taxes paid. According to the IRS, § 5(f) of Notice 2006-50 states that, "although the credit or refund allowed to a taxpayer ... will be requested on the taxpayer's income tax return, it is not a credit against tax for purposes of §§ 6654 and 6655. Accordingly, the taxpayer may not take the credit or refund into account in determining the amount of the required installments of estimated tax for 2006. In determining the amount of the required installments of estimated tax for 2007, the income attributable to the credit or refund is taken into account on the date the income is paid or credited in the case of a cash method taxpayer and on the date the return making the request is filed in the case of an accrual method taxpayer."

Based on the language in the notice and the general rules under § 451(a), the IRS concluded that a business entity that uses an accrual method of accounting should report income from a telephone excise tax refund on the date the return making the request is filed.

Recent Cases…

First Circuit affirms that a covenant not to compete is an amortizable intangible

In Recovery Group Inc. et al. v. Commissioner, 108 A.F.T.R.2d 2011-5437, the taxpayer redeemed the shares of one of its shareholders and paid him approximately $400,000 for a one-year covenant not to compete. The buyout represented approximately 23% of the outstanding stock of the taxpayer. The taxpayer relied on advice provided by its tax accountant and amortized the covenant not to compete over the one-year life of the agreement. The taxpayer took the position that the covenant not to compete did not qualify as a § 197 intangible because it did not satisfy the requirements of § 197(d)(1)(E) and Treas. Reg. 1.197-2(b)(9), which states that a covenant not to compete will qualify as a § 197 intangible "if it is entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof." The taxpayer's position was that an acquisition of a 23% interest did not qualify as "substantial." The IRS disagreed and argued that the covenant qualified as a § 197 intangible and was required to be amortized over a 15 year period.

In 2010, the Tax Court found in favor of the IRS, holding that in a direct or indirect acquisition of an interest in a trade or business, any portion of the purchase price allocable to a covenant not to compete should be amortized over 15 years, regardless of the size of the interest being acquired. The taxpayer appealed the decision, but the First Circuit found the taxpayer's arguments unpersuasive and affirmed the holding of the Tax Court that a covenant not to compete is a 15-year amortizable asset under § 197 and that "an interest in a trade or business" as used in § 197(d)(1)(E) means an acquisition of any portion of an interest in a trade or business.

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