Accounting Methods Spotlight

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Did you know…?

Potential opportunity to accelerate deductions for sales-based royalties

Taxpayers currently allocating sales-based royalties to ending inventory under §263A may want to file an accounting method change to begin treating sales-based royalties as indirect costs subject to capitalization under §263A, but allocable entirely to cost of goods sold, consistent with the proposed regulations (REG-149335-08) issued in December 2010. Note that this favorable treatment does not apply to non-sales based royalties, such as manufacturing-based royalties (e.g., royalties paid based on each item manufactured) or minimum royalties (i.e., royalty payments of a specified amount regardless of the number of trademarked items manufactured or sold), or to the amortization of upfront and milestone payments, as these payments must continue to be capitalized in part to ending inventory.

Taxpayers using a facts and circumstances method to allocate indirect costs, including sales-based royalties, under §263A may want to file an accounting method change to begin using the simplified production method or the simplified resale method in order to reduce the administrative burden related to the calculations under the facts and circumstances method while continuing to allocate sales-based royalties entirely to cost of goods sold.

Other Guidance

IRS issues proposed regulations on reimbursed entertainment expenses

The IRS issued proposed regulations explaining the exception to the deduction limitations on certain expenditures paid or incurred under reimbursement or other expense allowance arrangements. The proposed regulations clarify the rules for applying the exceptions to §§274(a) and (n) and amend Reg. §1.274-2(f)(2)(iv)(a) to provide a definition of a reimbursement or other expense allowance arrangement under §274(e)(3).

A reimbursement or other expense allowance arrangement involving employees is defined as an arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (which could be the employer, its agent, or a third party) for an expense that the employee incurs in performing services in that capacity (an employee). On the other hand, a reimbursement or other expense allowance arrangement involving non-employees is an arrangement under which an independent contractor receives an allowance, advance, or reimbursement from a client or customer for expenses incurred by the independent contractor if either: (1) a written agreement between the parties that states that the client will reimburse the independent contractor for expenses subject to limitation; or (2) a written agreement between the parties identifies the party that is subject to limitations. Multiple party reimbursement arrangements are

separately analyzed as a series of two-party reimbursement arrangements.

The proposed regulations would apply to expenses paid or incurred in tax years beginning on or after the date final regulations are published. However, taxpayers may apply the regulations for tax years beginning before the date the regulations are published as final for which the period of limitations has not expired.

IRS issues final regulations on deductions for personal use of corporate jets

The IRS recently issued final regulations addressing certain personal use of employer-provided aircraft. The regulations limit the costs that a taxpayer may deduct when a specified individual uses employer-provided aircraft for personal entertainment travel, including use for bona fide security purposes.

Reg. §1.274-2(b)(1) provides that expenses for the entertainment use of an employer-provided aircraft are disallowed to the employer except to the extent of the amount treated as compensation to the specified individual or the extent that a specified individual reimburses the taxpayer for that flight. In calculating the amount that is disallowed, the regulations provide that the taxpayer must take into account all the expenses of operating the aircraft, including all fixed and operating costs.

The final regulations provide two methods of allocating expenses to personal entertainment flights: (1) the occupied-seat method and (2) the flight by flight method. The occupied seat method allocates expenses using either occupied seat hours or occupied seat miles flown by the aircraft. Under the flight by flight method, the taxpayer aggregates all expenses for the tax year and divides the amount of total expenses by the number of flight hours or miles for the taxable year to determine the cost per hour or mile. Under this method, the taxpayer would then allocate expenses to each flight in determining the disallowed expense.

Assignment of rights in lawsuit will not produce taxable income

In PLR 201232024, the taxpayer held beneficial interests in a trust with a college. At the time that the trust's principal and undistributed income was bequeathed to the taxpayer and the college, the trust was subject to a lawsuit against the trustee, and the taxpayer and the college were substituted as parties in the lawsuit. The taxpayer executed a contingent assignment to the college of all its rights, title and interest in the trust. The college agreed to pay all attorney fees and costs attributable to a recovery from a lawsuit, and after the effective date of the assignment, the taxpayer will cease to be responsible for attorney fees or costs. Because the taxpayer assigned its right to the college before the time of the expiration of appeals, the IRS determined that any proceeds from the lawsuit would not be includible in the taxpayer's income.

IRS addresses reporting of excise tax refund income

In ILM 201231011, the IRS concluded that a taxpayer should report income related to a telephone excise tax refund when all the events have occurred that fix the right to receive such income and the amount can be reasonably determined.

In Notice 2006-50, a telephonic communication for which there was a toll charge that varied with elapsed transmission time was not a taxable toll telephone service as defined under §4252. The notice informed taxpayers that they could request a refund for tax paid on non-taxable service between 2003 through August 1, 2006.

The ILM concludes that a taxpayer should report income resulting from the excise tax refund on the date the taxpayer makes a request for a refund by means of filing a return if the request is properly substantiated and was for the actual amount of telephone excise tax paid. Otherwise, a taxpayer generally should report income from the refund on the earlier of (1) the date of payment for the tax refund is received or (2) the date the request for refund is approved.

IRS audit adjustments constitute changes in accounting method

In ILM 201231004, the IRS concluded that a change in the time for deducting an expenditure, as well as a change from deducting to capitalizing an expenditure are both changes in accounting method under §446.

The taxpayer was involved in a lawsuit that resulted in a settlement agreement. As part of the settlement, the taxpayer received a cash amount as well as a line of credit, which were used as part of a development plan to pay existing loan balances, for immediate repairs and upgrades to existing facilities, and for renovations and redevelopment of the taxpayer's facilities.

The taxpayer reported the settlement proceeds as income, but also claimed a deduction for the amount of the settlement proceeds, despite documents indicating that the expenditures under the development plan were capital in nature. In addition, the taxpayer did not prove that any of the expenditures were for deductible repairs.

As part of an audit, the IRS proposed an adjustment by changing the taxpayer's method of accounting to capitalize expenditures and to deduct expenditures only when economic performance has occurred.

The IRS concluded that the change in the time when the deduction was claimed constituted a change in method of accounting because the adjustments involved changes in the proper time for the taking of the deductions. Similarly, the IRS found that the change from expensing to capitalizing the item also constituted a change in method of accounting because these changes affect only timing and have no permanent impact on the cumulative amount of taxable income.

IRS will not challenge some partial worthlessness deductions for insurers

The IRS Large Business & International (LB&I) division issued a directive providing that LB&I examiners should not challenge an insurance company's partial worthlessness deduction under §166(a)(2) for the amount of the Statement of Statutory Accounting Principle (SSAP) 43R credit-related impairment charge-offs of eligible securities as reported on its Annual Statement. According to the IRS, independently determining partial worthlessness amounts under §166 imposes a significant burden on both insurance companies and LB&I.

For companies under examination, the examiners and company will decide whether to change the amount of the worthlessness deduction in year(s) under examination or whether the taxpayer will be required to file amended returns to reflect the change.

If a company is not under examination, the company may choose to implement the directive by either filing amended returns or by first applying this directive for the company's taxable year. The insurance company must attach a statement to its return explaining that it is implementing the directive beginning in that Adjustment Year. Taxpayers that file consolidated returns may make separate decisions for each company as to whether and when to adopt the provisions of the LB&I directive.

If an insurance company claims a §166(a)(2) partial worthlessness deduction for eligible securities, but does not meet the requirements of the directive, regular audit procedures will apply.

Cooperative's dividends paid are not deductible until taken into account by patrons

In ILM 201228035, the IRS applied §267(a)(2) and (3) to conclude that patronage dividends paid by a cooperative to related patrons were not deductible until the cooperative's patrons included the amounts in gross income.

The cooperative's patrons were members of a consolidated group and related controlled foreign corporations. For years, the cooperative deducted patronage dividends; however, those amounts were not paid to or included in the income of the patrons until a later taxable year in accordance with their method of accounting.

The IRS stated that the treatment of the patronage dividends as provided by §§1382(a) and 1385(a) were methods of accounting, despite the fact that the cooperative and its patrons each used an overall accrual method of accounting. The IRS concluded that the cooperative's deductions would be deferred to the date the dividends are included in the gross income of the related patrons under §267(a)(2).

The IRS also considered the deferral rules under §267(f) and determined that the patronage dividends were "intercompany sales" for purposes of Reg. §1.267(f)-1(b)(i), resulting in the deferral of the cooperative's deduction under the matching principles of Reg.

§1.1503-13 until the patrons took the dividend income into account. Also, the IRS raised the potential applicability of §267(a)(3), but stated that the facts were insufficient to determine if any of the exceptions applied.

Cases

Accrual method taxpayer may not deduct state taxes when incurred

A Federal District Court held in *Wells Fargo v. U.S.* that an accrual basis taxpayer cannot deduct the California business privilege tax it paid in year 1 for the privilege of doing business in year 2. The District Court agreed with the taxpayer that the all-events test would have been met but for §461(d), which governs the year in which a taxpayer can take a deduction for accrued taxes. Section 461(d) prohibits post-1960 law changes from affecting the timing of the deduction. This means that if a state changes its law after 1960 to require the taxpayer to accelerate tax payments that would in turn result in an accelerated deduction, the change is ignored for federal tax purposes.

Prior to 1972, California law allowed a full refund of the taxes paid in year 1 if the taxpayer ceased conducting business in California in year 2. California subsequently changed its law to disallow any refunds regardless of whether or not the taxpayer conducted business in year 2. Since this change occurred after 1960, the change in state law is ignored for federal income tax purposes in accordance with §461(d). Therefore, the court concluded that the liability was not fixed at the end of year 1 under federal tax law, and as such, disallowed the deduction in year 1.

Relator's share taxable as ordinary income

In *Alderson v. U.S*, the Ninth Circuit affirmed a district court decision holding that a relator's share of a settlement in a qui tam action was ordinary income and not capital gain.

The taxpayer was the CFO for the North Valley Hospital. Later that year, Quorum, an Affiliate of the Hospital Corporation of America, started to manage the hospital. Quorum asked the taxpayer to prepare two sets of books. One set would be for the hospital's financial auditors. They asked for a second set to serve as the basis for the hospital's Medicare cost reports. The taxpayer refused to prepare two sets of books and was subsequently terminated.

The taxpayer then filed a wrongful termination suit. Information such as sample Medicare cost reports were obtained during discovery of the taxpayer's wrongful termination suit. He used this information to file a pro se qui tam suit against Quorum, HCA and affiliated companies under the False Claims Act. The taxpayer expended significant personal efforts in pursuing the suit and trying to persuade the United States to intervene in the suit. There were two suits filed. The taxpayer received relator's awards for each suit. The taxpayer initially reported the relator's awards as ordinary income. He later amended his return to report this as capital gain.

The Court concluded that the relator's fee was ordinary income. The court

analyzed §1222 to determine whether the taxpayer had capital gain. In analyzing §1222, the court focused on the "sale or exchange" and "capital asset" requirements. The court concluded that the taxpayer did not sell or exchange his information, but rather that his right to the relator's share was conferred to him under the Fair Claims Act. The court also concluded that the information was not a capital asset nor was it property.

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