Recent rulings from the IRS provide clarity on several tax accounting method issues

In this month's Accounting Methods Spotlight, taxpayers are reminded of the 90-day window available for filing Form 3115. In addition, the IRS has published several rulings that shed light on a variety of tax accounting method issues such as the safe harbor for allocating success based fees, accounting for bonus payments, and modifications of installment sale obligations.

Did you know…?

90-day window available for filing Form 3115

January 1, 2013 is an important date for many calendar-year taxpayers, as it marked the opening of the "90-day window" within which those that have been under exam by the Internal Revenue Service (IRS) for all of 2012 may now voluntarily file an accounting method change.

The 90-day window period provides such taxpayers an opportunity to file a Form 3115, Application for Change in Accounting Method, without first securing the consent of the IRS director (or his delegate, which generally is the revenue agent). The 90-day window often is the only viable option for taxpayers to change from an improper method of accounting because it is typically not prudent to request director consent and alert the IRS to the improper method. Moreover, taxpayers wanting to change from a proper method also may want to file in the 90-day window to avoid the sometimes time-consuming task of seeking director consent. Accordingly, calendar-year taxpayers under exam should consider the opportunity to file any desired Forms 3115 during the 90-day period ending April 1, 2013.

Other guidance

Extension granted to elect safe harbor for allocating success based fees

The IRS concluded in PLR 201250015, that a taxpayer who fails to elect the safe harbor under Rev. Proc. 2011-29 by attaching a statement to its original federal income tax return would be granted 9100 relief, provided the taxpayer can establish that it acted reasonably and in good faith.

Under the safe harbor rule of Rev. Proc. 2011-29, a taxpayer can elect to treat 70 percent of all success-based fees incurred with respect to a particular transaction as non-facilitative and therefore not capitalizable. The remaining 30 percent would be considered facilitative and therefore capitalizable. In order to make the safe harbor election, a taxpayer must attach a statement to its original federal income tax return for the tax year in which the success based fee is paid or incurred. The statement must identify the transaction and the amounts that are being treated as facilitative and non-facilitative. Failure to attach the statement to the original federal income tax return for the year in which the success-based fee is paid or incurred implies that the taxpayer does not want to elect the safe harbor.

The IRS noted in PLR 201250015 that a taxpayer who does not elect the safe harbor by attaching a statement on its original federal income tax return, but who acted in good faith, could be granted relief under Treas. Reg. §§ 301.9100-1 and -3. The IRS stated that granting relief would not prejudice the interests of the government since the taxpayer would not benefit from a lower tax liability simply because the election was not timely made. Therefore, the taxpayer was granted an extension of 45 days from the date of the ruling to file the required statement pursuant to Rev. Proc. 2011-29.

Bonuses must be taken into account in year paid

In CCA 201246029, the IRS concluded that bonuses must be taken into account in the year paid if the liability to make the payment is not 'fixed' at year end.

The taxpayer pays bonuses to employees under an incentive compensation plan. The bonuses are accrued using a formula which is adjusted throughout the year based on the company's performance and the number of eligible employees. Managers are then allotted a bonus pool (in February of the following year) to allocate among the employees. Bonuses are generally paid to employees by March 15 of the following taxable year. However, in order to receive a bonus payment, the employee is required to be employed on the date the bonus is paid. If an employee leaves before the managers allocate the bonus pool, the forfeited amount is re-allocated to the remaining employees. However, if an employee leaves after the bonus pool has been allocated but before receiving the bonus, the forfeited amount reverts back to the taxpayer (and is not re-allocated to the remaining employees).

Even though the taxpayer was uncertain as to whether all of its employees would be employed on the date the bonuses were allocated, the taxpayer argued that its liability for the bonuses was fixed based on the holding in Rev. Rul. 2011-29, which permits employers to deduct accrued bonuses paid under certain pooled arrangements. The taxpayer further argued that any forfeited amounts by employees departing after the allocation had been made were de minimis.

The IRS rejected the taxpayer's reliance on Rev. Rul. 2011-29 by pointing out that it is possible for forfeited bonuses to revert back to the taxpayer if employees left after the bonuses were allocated but before the payout date. As a result, the IRS concluded that the taxpayer's liability was not fixed. In addition, the IRS noted that there is no de minimis exception to this rule. Therefore, the IRS determined that the liability for bonus compensation for the taxpayer should be taken into account in the year the bonuses are paid.

IRS revokes previous ruling on purchase price allocation

The IRS recently announced in PLR 201249013 that it was revoking PLR 201214007 effective for taxable years beginning on or after September 6, 2012. In PLR 201214007, the IRS had ruled that a taxpayer who had acquired wind energy facilities subject to facility-specific power purchase agreements (PPA) was permitted to allocate the purchase price to the wind energy facilities for purposes of determining the adjusted basis of the property.

Since issuing PLR 201214007, the IRS reconsidered its position and determined that the ruling was inconsistent with the current views of the IRS. In issuing the new ruling, the IRS has now concluded that the portion of the purchase price paid by the taxpayer that is attributable to the PPAs is to be allocated to the PPAs and not to the wind energy facilities.

Domestic manufacturing deduction available for pill containers

In CCA 2012246030, the IRS concluded that a taxpayer who repackages and labels pills that it did not manufacture but also engages in eligible manufacturing, production, growing or extraction (MPGE) activities will not be subject to the repackaging and labeling exclusion that would generally prevent a taxpayer from utilizing the §199 domestic manufacturing deduction.

The taxpayer is a provider of pharmaceutical products for nursing homes, assisted living facilities and healthcare facilities and derives its gross receipts from the sale of pharmaceutical products (pills) to these facilities. The taxpayer purchases pills in bulk form and repackages the pills into "blister packs" or bottles before providing the pills to healthcare facilities. Although the taxpayer does not manufacture or produce the pills, the taxpayer produces the blister packs which are used to repackage the pills.

The IRS concluded that the taxpayer was involved in MPGE activities with respect to qualifying production property due to the production of the blister packs. Consequently, while a taxpayer who solely repackages and labels pills into "blister packs" manufactured by a third party would generally be subject to the exclusion from the definition of MPGE activities, in this case, because the taxpayer engages in other MPGE activities (i.e., the production of blister packs) in addition to repackaging and labeling, the taxpayer is not subject to the exclusion.

IRS addresses allowances for meals and incidental expenses provided by travel industry employer

In CCA 201246031, the IRS determined that some allowances for meals and incidental expenses paid to airline employees are not per diem allowances because the amounts are not deductible travel expenses under §162.

The taxpayer is an airline that pays its crew members an allowance for meals and incidental expenses (M&IE) based on a flat, hourly amount for each hour a crew member is on duty. An allowance is provided if: (1) the employees report for training at the duty location (non-travellers); (2) the employees arrive at the duty location for flight duty but return to the duty location the same day (day travellers); and (3) the employees arrive at the duty location for flight duty and have an overnight stay away from the duty location (overnight travelers).

Rev. Procs. 2011-47 and 2008-59 provide the rules for using a per diem allowance to substantiate the amount of ordinary and necessary business expenses paid or incurred while travelling away from home. The IRS stated that the allowances for meals and incidental expenses paid to non-travellers and day travelers are not per diem allowances because they are not deductible travel expenses under §162. However, the allowances paid to overnight travellers may be per diem allowances if they otherwise meet the requirements of §162 and Rev. Procs. 2009-47 and 2008-59.

In addition, the IRS concluded that the taxpayer's per diem allowance arrangement does not meet the accountable plan requirements §62(c) and the accompanying regulations because the amounts were paid regardless of whether the employees incurred or were reasonably expected to incur deductible business expenses. Further, the taxpayer's arrangement had no tracking mechanism to determine whether per diem allowances paid exceeded the amount that could be deemed substantiated. The taxpayer routinely paid allowances in excess of the deemed substantiated amount without requiring actual substantiation of all the expenses or repayment of the excess amount, and the taxpayer failed to include excess allowances as wages. Therefore, the IRS determined that all payments should be treated as paid under a nonaccountable plan.

The IRS also determined that the periodic rule in Rev. Proc. 2008-59 does not allow the taxpayer to average the number of meals provided in kind to an employee in determining whether the allowances provided to employees are includable in wages because the taxpayer failed to establish that the expenses were deductible under §162.

Finally, the IRS concluded that the taxpayer's meal tracking system was a reasonable application of the meals-provided-in-kind rule because the taxpayer has a reasonable belief that an overnight traveller will incur meals and incidental expenses for each day of the overnight traveller's duty assignment if two or fewer meals are provided in kind on any given day during the employee's assignment.

Modification of installment sales obligations is not satisfaction or disposition

The IRS held in each of three private letter rulings (PLR 201248006, PLR 201248007, and PLR 201248008) that a taxpayer who modifies an installment sale obligation to defer the maturity date, substitute a new obligor, and alter the interest rate, has not disposed of or satisfied the installment obligation within the meaning of §453B.

In each case, an employee stock ownership plan (ESOP) entered into a transaction that qualified for installment sale reporting in connection with a purchase of company stock from the taxpayer. As part of the arrangement, the company borrowed money from a bank and lent funds to the ESOP to make the down payment to the former shareholders. The ESOP also borrowed funds from the former shareholders in the form of installment notes to pay the balance of the purchase price.

Previously, under Rev. Rul. 68-419, the IRS held that the modification of the terms of a purchaser's note by deferring the dates of payment of principal by five years and increasing the annual interest rate from 6 percent to 7 percent was not a disposition or satisfaction of an installment obligation. The IRS also held in Rev. Rul. 75-457 that the substitution of obligors, deeds of trust and promissory notes, without any other changes, was not a satisfaction or disposition of an installment obligation. In addition, in Rev. Rul. 82-122 the IRS ruled that the substitution of a new obligor and a change in the rate of interest would not be a satisfaction or disposition of an installment obligation.

Based on its previously issued revenue rulings, the IRS concluded that the proposed modifications to the taxpayer's installment notes would not result in a disposition or satisfaction of the installment obligation.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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