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Key implications of Tax Court decision in *Lattice Semiconductor*

The Tax Court's recent decision in *Lattice Semiconductor Corp*, T.C. Memo. 2011-100, addressing IRS denial of Lattice's request to change its method of accounting for prepaid expenses under the "12-month rule," reflects a continuance of the deference given by the court to the IRS in matters pertaining to accounting methods.

In its opinion, the Tax Court skirted the issue of whether Lattice could deduct prepaid expenses under the 12-month rule for the tax year immediately prior to the tax year that the IRS formally changed its position and allowed all taxpayers to do so. The court further limited the scope of its analysis by not addressing Lattice's assertion that the IRS acted arbitrarily in instituting an automatic rejection policy, that is, that the IRS improperly failed to evaluate Lattice's accounting method change request under "traditional application procedures and developing case law." Rather, the court restricted its analysis to whether the IRS acted within its proper discretion in denying Lattice's accounting method change request.

Background

In November 2001, the Seventh Circuit Court of Appeals, reversing the Tax Court, held in *U.S. Freightways* that taxpayers are not required to capitalize prepaid expenditures that last for one year or less (the 12-month rule). An Advance Notice of Proposed Rulemaking (ANPRM) issued in January 2002 indicated that the IRS would accept the 12-month rule prescribed by the Seventh Circuit.

In reliance on the Seventh Circuit case, and aware that the IRS planned to accept the Seventh Circuit holding, hundreds of taxpayers, including Lattice, filed requests for accounting method changes to follow that holding with either a 2001 or 2002 year of change. In December 2002, the IRS issued a Notice of Proposed Rulemaking (NPR) accepting the 12-month rule. However, the NPR proposed that the 12-month rule would be effective only for transactions after the final regulations were issued. Final regulations were issued in December 2003, allowing method changes for the 2003 calendar year and thereafter.

Tax Court case

The parties' positions

Taxpayers such as Lattice that had filed accounting method change requests to use the 12-month rule for the 2002 tax year therefore were faced with a dilemma. Lattice's 2002 tax return was due on or before September 15, 2003, and the IRS had neither ruled on its request nor issued the final regulations specifying the effective date of the 12-month rule. Lattice filed its 2002 tax return using the 12-month rule. The IRS, in mid-2005, denied Lattice's request for an accounting method change to the 12-month rule method for 2002. The IRS subsequently issued a deficiency notice disallowing the relevant deductions.

In response to the deficiency notice, Lattice filed a petition in the Tax Court, asserting that the IRS had ignored developing case law such as *U.S. Freightways* and *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980). In *Zaninovich*, the Ninth Circuit (the precedents of which the Tax Court is required to follow in *Lattice*, under the *Golsen* rule) allowed a cash-method taxpayer to use a 12-month rule for prepaid rent. Lattice further asserted that the IRS instead applied an automatic rejection policy, thus abusing its discretion in denying Lattice's method change request. In response, the IRS argued that Lattice prematurely filed its application for change in accounting method, asserting that the taxpayer was not permitted to do so until final regulations were issued.

Tax Court decision

The Tax Court found in favor of the IRS. In concluding that the IRS did not abuse its discretion in denying Lattice's method change request with respect to prepaid expenses under the 12-month rule, the court relied on the findings in *Blasis v. Commissioner*, T.C. Memo. 2005-214, of "substantial justification for the Commissioner's attempt to capitalize professional fees, despite appellate reversal in U.S. Freightways."

The court's rationale for finding in favor of the IRS in *Lattice* rests on its conclusion that, at the time Lattice filed its method change request, it did not have sufficient authority to deduct 12-month prepaid expenses. Under that rationale, the IRS was justified in denying Lattice's request. The Tax Court declined to concede that the Ninth Circuit, having previously found in favor a of cash-basis taxpayer deducting expenses under a 12-month rule, would follow a 12-month rule for accrual-basis taxpayers. Finally, the court dismissed *U.S. Freightways* as not binding on the IRS outside the Seventh Circuit.

Observations

The *Lattice* case presented the Tax Court with several technical issues, the most important being the validity of the 12-month rule prior to the final regulations issued in late 2003. However, the court decided the case solely on the issue of IRS discretion to deny accounting method changes. In so doing, the Tax Court indirectly affirmed its technical position with regard to the 12-month rule, which had been reversed on appeal by both the Ninth Circuit in *Zaninovich* and the Seventh Circuit in *U.S. Freightways*.

The Tax Court reached this result on the ground that Lattice was an accrual-method taxpayer, while the taxpayer in the Ninth Circuit's *Zaninovich* case was a cash-method taxpayer. The taxpayer in *U.S. Freightways*, like Lattice, was an accrual-method taxpayer, but because that case was decided in the Seventh Circuit, not the Ninth Circuit, the Tax Court was not bound by that decision. Thus, the treatment of similarly situated taxpayers on this issue depends on geography, that is, taxpayers in the Seventh Circuit were allowed to use the 12-month rule prior to the effective date of the final regulations, but those in the Ninth Circuit were not.

As indicated above, the Tax Court, in deciding *Lattice*, was required to follow the precedents of the Ninth Circuit, but the court distinguished *Zaninovich* on the grounds that its acceptance of the 12-month rule was limited to cash-method taxpayers. The Tax Court declined to speculate on whether the Ninth Circuit would apply the 12-month rule to accrual-method taxpayers prior to the effective date of the final regulations. The Ninth Circuit position presumably will be decided if Lattice appeals the Tax Court decision.

In summary, this case, unless reversed on appeal, continues the trend of the Tax Court's deference to the IRS on accounting method change issues.

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