

Current Developments in Accounting Methods

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Agenda

- Accounting Methods
 - Review relevant procedures for method changes
 - Intangibles regulations (1.263(a)-4,5)
 - Treatment of costs of tangible assets
 - Depreciation
 - Advance payments
 - Other accounting methods developments
 - IRS business plan

Accounting Methods – In General

Section 446 - method of accounting involves:

- Timing:
 - Year in which item is reported
- Consistency
 - Rev. Rul. 90-38:
 - Proper method = used on a single return
 - Improper method = used on two consecutively filed returns.
 - *Silver Queen Motel v. Comm.* = statute of limitations still open

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Terminology – Method Changes

- Voluntary Method Change – Initiated by the Taxpayer by filing a Form 3115 and, generally, by computing a section 481(a) adjustment.
- Involuntary Method Change – Initiated by the IRS during an examination. The change is made in the earliest open year and is made without a spread of the section 481(a) adjustment.

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Terminology – Voluntary Method Changes

- Automatic Method Changes – IRS National office approval is deemed granted. List of automatic method changes is published in Rev. Proc. 2002-9, as updated.
- Non-Automatic Method Changes – Advance permission is required to change the method. All method changes which are not on the list as automatic method changes are non-automatic accounting method changes. Rev. Proc. 97-27 governs these changes.

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Terminology – Section 481(a) Adjustments

- Positive – Results in an increase in taxable income. Associated with an “unfavorable” method change.
- Negative – Results in a decrease in taxable income. Associated with a “favorable” method change.

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Method Change Procedures – Non-Automatic Changes

Highlights of Non-Automatic Method Changes (Rev. Proc. 97-27):

- Form 3115 due by the last day of the year of change
- Negative adjustment – 1 year spread
- Positive adjustment – 4 year spread
- Cut-off method change in limited situations
- \$1,500 filing fee (additional \$45 per each additional legal entity)
- Special Rules for Taxpayers under examination

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Method Change Procedures – Automatic Changes

Highlights of Automatic Method Changes (Rev. Proc. 2002-9):

- Due with timely filed tax return (including extensions) -
Form 3115 filed with tax return and copy filed with IRS
National Office
- Negative adjustment – 1 year spread
- Positive adjustment – 4 year spread
- Cut-off method change in limited situations
- Special rules for Taxpayers under examination
- No filing fee

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Method Change Procedures – Window Periods

Effect of Examination Status on Method Changes

- General rule: Taxpayers under IRS examination cannot file Forms 3115 (automatic or non-automatic).
- Exceptions:
 - Can file during 120 day window.
 - Can file during 90-day window.
 - Can secure Director consent (practically speaking, only relevant for negative adjustment changes).

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Window Periods

120-day window:

- During the 120 days following the date an examination ends, even if subsequent exam has begun
- Method not an issue under consideration or placed in suspense

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Window Periods

90-day window:

- For taxpayers under audit for at least 12 consecutive months prior to 90-day window
- Window is first 90 days of taxable year
- Method not an issue under consideration or placed in suspense

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Method Change Procedures

Director of Consent

- May file outside of a window period if obtain consent from Director
- Director will consent if the method of accounting to be changed would ordinarily not be included as an item of adjustment in the year(s) for which the taxpayer is under exam (consent for changes resulting in a negative adjustment is routinely granted)

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Final Capitalization of Intangibles Regulations

- On December 22, 2003, the Treasury released final regulations relating to the capitalization of costs incurred in connection with the acquisition or creation of intangible assets.
- In general, the final regulations apply to amounts paid or incurred on or after December 31, 2003.
- Purpose of the final regulations is to deal with the aftermath of the *INDOPCO* decision.
- In *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), the Supreme Court concluded that an expenditure generally must be capitalized if it results in a significant future benefit to the taxpayer even if the expenditure does not create a separate and distinct asset.

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Presumption Against Capitalization

- List of items included in regulations as requiring capitalization are intended to be all-inclusive.
- Items not listed are not required to be capitalized.
- If new items are identified in the future, guidance would be released to capitalize those items on a prospective basis.

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Items Requiring Capitalization under 1.263(a)-4 Creation of Intangible Property

- Categories of created intangible expenditures requiring capitalization:
 1. Amounts paid for financial interests
 2. Prepaid expenses *
 3. Amounts paid for memberships and privileges *
 4. Amount paid for rights from government agency
 5. Amounts paid for contract rights *
 6. Amounts paid to terminate certain contracts *
 7. Amounts paid to acquire, produce or improve real property owned by another person *
 8. Amounts paid to defend or perfect title to intangible property *
 9. Amounts paid to create or enhance a separate and distinct intangible asset.
- * Item is subject to the 12-month rule.

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Items Requiring Capitalization Prepaid Expenses

- Prepaid expenses must be capitalized – subject to the 12-month rule.
- Coordination with section 461 is required to obtain the deduction in the year paid. Therefore, to obtain the deduction for the prepayment, the liability must be (1) fixed, (2) reasonably determinable, and (3) economic performance must occur (subject to the recurring item exception).
- Examples: Prepaid insurance, fees, licenses, permits.

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Items Requiring Capitalization Election to Capitalize Items Deductible Under the 12-Month Rule

Taxpayers may elect not to apply the 12-month rule and therefore capitalize items under regulation 1.263(a)-4.

- An election applies to all similar transactions during the taxable year.
- The election is made by treating costs as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid.
- An election for a consolidated group is made separately with respect to each member of the group, and not with respect to the group as a whole.
- An election is revocable with respect to each year for which made only with the consent of the Commissioner.

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Items Requiring Capitalization Examples Provided of Deductible Items

- Business process re-engineering
- Defense of business reputation
- Product launch costs (e.g., marketing strategy, advertising campaign, training)
- Stocklifting costs (i.e., removing competitor products from customer shelves)
- Package design costs

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Items Requiring Capitalization Effective Dates and Changes in Methods of Accounting

- The final regulations apply to amounts paid or incurred on or after December 31, 2003.
- A method change to deduct expenses following the regulations under section 1.263(a)-4 is an automatic method change for the first year the final regulations are effective.
- The section 481(a) adjustment is calculated on a modified cut-off basis, taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002 (the date the Advanced Notice of proposed Rulemaking was issued), and before December 31, 2003.
- Method changes filed effective for a taxable year prior to the effective date of the regulations still unresolved.

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Accounting Method Changes for 1.263(a)-4 and -5 Rev. Proc. 2004-23

- Automatic for the FIRST tax year ending after 12-31-03 – will issue further guidance for subsequent tax years
(This guidance is expected imminently)
- Calculation of 481(a) adjustment through 12-31-03
- Previous changes for 2003 tax year – transition rules.
- Previous changes before 2003 tax year – Status unclear

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Transaction Costs – 1.263(a)-5

A taxpayer must capitalize amounts paid to facilitate the following transactions:

- Acquisition of assets that constitute a trade or business
- Acquisition of an ownership interest of the taxpayer (other than an acquisition by the taxpayer)
- Restructuring, recapitalization, or reorganization of the capital structure
- Transfers as described in section 351 or 721
- Formation or organization of a disregarded entity

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Transaction Costs

A taxpayer must capitalize amounts paid to facilitate the following transactions (continued):

- Acquisition of capital
- Stock Issuance
- Borrowing
- Writing an option

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Transaction Costs

Replacement of Rev. Rul. 99-23 and Whether and Which date to determine “final decision”

- Whether and Which were two decisions
- Rev. Rul. 99-23 focused on nature of activities
- Factual inquiry invited controversy
- Final Regs. adopt “bright-line” standard
 - Earlier of board approval or letter of intent, etc.

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ERP Costs

Treasury deferred addressing software development issues in final regulations

LTR 200236028 provides:

- Capitalize and amortize ratably over 36 months
 - Costs to acquire software package
 - Installation and configuration via use of templates/options embedded in the software
- Deduct
 - Employee training and related costs (under section 461)
 - Costs of writing machine readable code software (under Rev. Proc. 2000-50)

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Timing of Deductions Cyclical Repairs and Maintenance

Rev. Rul. 2001-4 and *Ingram Industries*:

- Cyclical repairs and maintenance costs held to be deductible.
- Articulates 3-prong test for capitalization:
 - Adapted for new or different use?
 - Appreciably prolonged life?
 - Materially increased value of property?
- Incidental repairs vs. overhaul
- *FedEx Case*
 - Periodic aircraft engine maintenance is deductible

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Bonus Depreciation

Background

- Bonus depreciation enacted in 2002 as temporary economic stimulus
 - 30 percent beginning 9/11/2001
 - 50 percent beginning after 5/5/2003
- Generally set to expire 12/31/2004

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Bonus Depreciation

Sunset

- General Rule
 - Must be placed in service by 12/31/2004
 - Place in service date for components?

Long Production Period Property

- Basis as of 12/31/2004
- Placed in service by 12/31/2005
- Scope of Rule:
 - Rule applied to unit of property

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Recent Developments in Depreciation

Bonus Depreciation (Treas. Reg. § 1.168(k)-1T)

- Published on September 5, 2003
- Regulations apply retroactively to all 30-percent and 50-percent bonus depreciation property
- Regulations define a Binding Contract for bonus depreciation purposes
- Bonus depreciation will apply to property received in a like-kind exchange transaction or an involuntary conversion.
- Bonus depreciation may not be taken for purposes of computing earnings and profits.

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Recent Developments in Depreciation

Brookshire Brothers and Green Forest Manufacturing (5th Circuit Court of Appeals) - *O'Shaughnessy* (8th Circuit - June 2003)

- Held that a taxpayer did not change its method of accounting when it changed the recovery period of its depreciable assets
- IRS issued Rev. Proc. 2004-11 / Treas. Reg. 1.446-1T on December 30, 2003 to address these issues

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Recent Developments in Depreciation

Treas. Reg. 1.446-1T

- Treas. Reg. 1.446-1T provides that a change in the recovery period of an asset which is specifically assigned by the Code, regulations or other published guidance, is a change in method of accounting
- Change in salvage value to zero for an asset wherein the salvage value is expressly treated as zero by the Code, regulations or other published guidance, is a change in method of accounting
- Change from depreciable to/from non-depreciable is a change in method of accounting
- Change in pooling methodology (multiple asset accounting) is generally a change in method of accounting
- Section 1016(a)(2)'s allowed or allowable provisions are deemed not to affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation is a change in method of accounting

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Recent Developments in Depreciation

Rev Proc 2004-11

- Rev Proc 2004-11 provides that use of an erroneous method of accounting for depreciation on a single tax return constitutes a method of accounting (in contrast to general rule outlined in Rev. Rul. 90-38)
- Rev Proc 2004-11 provides that taxpayers can catch-up missed depreciation on property that has been disposed of but change must also involve an amended return

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Recent Developments in Depreciation

Chief Counsel Notice 2004-7

- The IRS announced a change in its litigating position regarding whether a change in recovery period is a change in method of accounting.
- The IRS position provides taxpayers with flexibility to resolve misclassifications of depreciable property.
- Clarifies certain items that are NOT a change in method of accounting.
- Additional internal IRS guidance

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Revenue Recognition

Section 451 - Taxable year of income inclusion

Two-prong test under § 451 regulations:

- “All-events” test (right to receive is fixed)
- Amount determinable (with reasonable accuracy)

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Revenue Recognition

All Events Test for Goods

- Could be met at one of several points in time:
 - Shipment
 - Delivery
 - Transfer of title
 - Acceptance

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Revenue Recognition

All Events Test for Services

- Generally, met at the earlier of when:
 - Performance occurs
 - Payment is due
 - Payment is made

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Revenue Recognition

Advanced Payments under Rev. Proc. 2004-34

- Major Recent Development: Rev. Proc. 2004-34
- Updates Rev. Proc. 71-21 (Regs. § 1.451-5 unchanged)
- Relaxes certain critical rules
- Three requirements for deferral of revenue:
 - Permissible to include in income currently.
 - Portion or all of revenue deferred for financial statement purposes.
 - Qualifying advance payment.

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Rev. Proc. 2004-34

Examples of qualifying advance payments:

- Services
- Goods (other than those utilizing §1.451-5)
- Use of intellectual property (i.e., copyrights, patents, trademarks, service marks, trade names, and similar items)
- Sale, lease, or license of computer software
- Certain warranties

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Rev. Proc. 2004-34

Examples of non-qualifying advance payments:

- Rent
- Insurance premiums
- Payments with respect to financial instruments (including purported prepayments of interest)
- Payments with respect to warranty or guarantee contracts under which a third party is the primary obligor

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Revenue Recognition Advanced Payments under Rev. Proc. 2004-34

EXAMPLE:

On day 1 of year 1 receive a \$36,000,000 qualifying advanced payment for a three year contract. For book purposes, the payment is recognized ratably over the contract period.

Revenue Recognition under Rev. Proc. 2004-34

- Year 1 – follow book reporting of income (i.e., recognize \$12M as income). Result: No book/tax difference.
- Year 2 - Report remaining advanced payment as income (i.e., recognize \$24M as income). Result: Book/tax difference of \$12M tax greater than book income.
- Year 3 – No taxable income. Result: Book/tax difference of \$12M book greater than tax income.

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Revenue Recognition Advanced Payments under Rev. Proc. 2004-34

COMPARE WITH RESULTS UNDER REV. PROC. 71-21

- Under Rev. Proc. 71-21, NO DEFERRAL
- Reason – Contract lasts beyond end of year

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Rev. Proc. 2004-34

Effective Date:

- Generally effective for tax years ending on or after May 6, 2004.
- Exception – automatic method change may be filed for tax years ending on or after December 31, 2003.

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Rev. Proc. 2004-34

Accounting Method Change Procedures:

- Generally automatic method change
- However, may be non-automatic in some circumstances
 - Allocation between services and other items not eligible for deferral
 - Statistical sampling for when revenue should be recognized
- Taxpayers should analyze their advance payments to determine the most advantageous deferral method

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New Schedule M-3

Purpose

- Increase the transparency of corporate tax return filings by disclosing differences between financial accounting net income and taxable income on a consistent, detailed basis.
- Enable the IRS to swiftly focus on emerging issues and evolving business trends.
- Allow the IRS to target examinations on high-risk areas.
- Help the IRS speed and improve the audit process.
- Rev. Proc. 2004-45 provides that filing Schedule M-3 meets the disclosure requirements of significant book-tax differences (Form 8886 for significant book-tax differences no longer required if Schedule M-3 completed).

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New Schedule M-3

Who is required to file Schedule M-3?

- Any C corporation (or U.S. consolidated tax group) required to file Form 1120 that reports total assets at the end of the corporation's taxable year on Schedule L equaling or exceeding \$10 million.
- This is the same criterion used to determine whether a corporation is within the jurisdiction of the IRS' Large and Mid-Size Business (LMSB) Division.
- Schedule M-3 only affects C corporations. Schedules M-3 for partnerships, S corporations, insurance companies, etc. will be drafted when the Schedule M-3 and instructions for corporations are finalized. Anticipated these will be released in 2005 with, potentially 2006 effective dates.

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New Schedule M-3

Key Schedule M-3 Dates

- Tax years ending before December 31, 2004 – Schedule M-3 optional.
- Tax years ending on or after December 31, 2004 – Schedule M-3 required for most corporations, but only Part I and Columns (b) and (c) of Parts II and III. Companies should conduct trial run(s) to map trial balances to Column (a) in order to identify mapping issues.
- Tax years ending on or after December 31, 2005 – Full implementation of Schedule M-3 required.

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Environmental Remediation Costs

- Rev. Rul. 94-38
 - Environmental remediation costs generally deductible
- Revenue Rulings 2004-18 –
 - Environmental remediation costs subject to 263A
 - Unanswered question: To what inventories are costs allocated?
 - Automatic method change for first taxable year ending on or after February 6, 2004.
 - Coordination with sections 172(f), 198

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Section 59(e)

July 19, 2004 – Proposed Regulations under Sec. 59(e)

- These proposed regulations specify the time and manner for making a Sec. 59(e) election, and how to revoke a Sec. 59(e) election.
- The proposed regulations apply to a Sec. 59(e) election made for a taxable year ending on or after the date final regulations are published in the Federal Register. Currently, there is no deadline for filing these elections. Thus retroactive Sec. 59(e) elections are allowed for tax years before the tax year in which final regulations are published.

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IRS Priority Guidance Plan

- Regulations under sections 162 and 263 regarding the deduction and capitalization of expenditures for tangible assets
- Regulations under section 263(a) regarding the subsequent treatment of capitalized transaction costs
- Regulations under section 446 regarding methods of accounting
- Revenue ruling under section 461 regarding the proper year for deduction of payroll taxes on deferred compensation by accrual method taxpayers
- Regulations under section 6655 regarding estimated tax payments by corporations

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IRS Priority Guidance Plan (Continued)

- Guidance on moving average cost to value inventories
- Guidance on post-production costs under Section 263A
- Regulations on Sec. 381 Regarding changes in methods of accounting