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Tax Accounting

BY JAMES E. SALLES

In this month's column,

- The IRS promises a full platter of tax accounting guidance this year;
- Accounting issues are among tax simplification ideas under consideration following a Joint Committee staff study;
- The Eighth Circuit interprets the "economic performance" rules in *IES Industries, Inc. v. United States*;
- The Tax Court discusses whether there is a de minimis exception to the capitalization requirement in Alacare *Home Health Services, Inc. v. Commissioner*[1];
- The Tax Court holds that reclassifying property between depreciation categories is not a change in accounting method in *Brookshire Brothers Holding, Inc. v. Commissioner*.[2]

IRS GUIDANCE PROMISED

On April 26, the IRS issued its "2001 Business Plan," although because the IRS is changing its planning cycle, the target date for completion of the listed projects is June 30, 2002.[3] Among the numerous tax-accounting related items included are:

- New guidance on notional principal contracts;
- Guidance on prepaid forward contracts (possibly related to the otherwise unspecified guidance promised concerning the receipt of advance payments);
- Guidance on split dollar life insurance;
- General capitalization guidance under Code Sections 162 and 263, as well as guidance addressing such specific issues as "restaurant smallwares"; and
- Some form of formal pronouncement on IRS policy on involuntary method changes and the accompanying adjustments to income.

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Many taxpayers and practitioners have expressed a need for general guidance on capitalization issues. There was even an "*INDOPCO* coalition" formed to lobby the IRS to include the project on its business plan.[4] Christine Turgeon, of the Office of Tax Legislative Counsel, again recently confirmed that work on broad-based rules continued. She added that guidance would be provided on controversial issues such as when "internal costs" of generating or managing intangible property must be capitalized.[5] The Regulations, or related projects, may also provide some safe harbors such as repair allowances and/or a de minimis rule for small expenditures.[6] Specific guidance on issues like website and software development costs is also possible.[7]

TAX SIMPLIFICATION INITIATIVE

Joint Committee Study

Interest, real or make-believe, in "tax simplification" is on the rise again. April saw the release of a voluminous study by the Congressional Joint Committee staff on simplification of the tax system.[8] Some portions of the study describe complex areas of the law but make no specific recommendations to avoid intruding on policy matters. In some cases amenable to narrower solutions, the staff advances specific proposals.

The study considered a number of tax accounting issues. Among the areas identified as offering general potential for simplification were the capitalization rules, the determination of depreciation class lives, and the taxation of financial instruments.[9] Specific proposals advanced included:

- Permitting taxpayers with revenues under $5 million to use the cash method and account for inventory like supplies, along the lines of proposals that have been kicking around Congress for some time;[10]
- Enacting a single provision permitting five-year amortization of all entity organizational costs, in lieu of the current separate provisions addressing corporations and partnerships;[11]

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- Abolishing the "mid-quarter convention,"[12] generally allowing a half-year's depreciation in the year personal property is placed in service;
- Simplifying and expanding the straddle rules,[13] possibly repealing Code Section 1233, which governs short sales; and
- Applying more uniform rules to various sorts of interest-like charges imposed under the Code, including under the installment sales rules and the long-term contract rules, and in relation to the "income forecast" method of depreciation.[14]

Hill Picture Uncertain

The staff proposals remain under study by the Administration, which is expected to craft a simplification initiative later this year. As to where matters might go from there, the crystal ball is even more clouded than usual.

Like much else, the prospects for further tax legislation have been significantly altered by the Senate's mid-session shift to Democratic control. As next year's budget picture permits, the GOP-controlled House can be expected to lob some popular tax cut proposals toward the other side of the Capitol. However, the Chairman-in-waiting of the Senate Finance Committee, Sen. Max Baucus, (D-Mont.), under fire from his caucus for his role in the compromise that allowed the across-the-board tax cut to pass the Senate, has been quoted as saying that he does not expect that the committee will take up any tax bills other than technical corrections and extenders for the rest of this Congress.[15] The change also gives Sen. Tom Daschle (D-S.D.), the new Majority Leader and a staunch opponent of further tax cuts, control over legislation brought to the Senate floor.

Nonetheless, at least *some* further tax legislation later this year remains possible. Individual simplification proposals that are revenue neutral, or close, may slip through. Also, one of the Democrats' priorities is a bill raising the minimum wage, and it is commonly assumed that the spoonful of sugar that makes that medicine go down will be a modest package of small-business-oriented initiatives, in which measures like the cash method proposal might find a place. Even Senator Daschle has expressed himself open toward such a package, provided that any tax breaks are paid for by corresponding tax increases. The Democrats may bend a bit on this principle to get a bill through and signed by the President, particularly if revenue projections increase later this year, although that is not looking especially likely right now.

EIGHTH CIRCUIT INTERPRETS "ECONOMIC PERFORMANCE"

The traditional "all events" test for accrual method taxpayers' deductions and credits was met when "all the events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."[16] Code Section 461(h), enacted in 1984, adds the requirement that "economic performance" with respect to the item has occurred. The recent Eighth Circuit decision in *IES Industries, Inc. v. United States*[17] adds to the sparse but growing case law interpreting this provision.

Background

Code Section 461(h) provides that the "all events" test generally will not be considered met until "economic performance" has occurred. An exception permits taxpayers to take into account certain "recurring items" when the traditional "all events" test is met, so long as economic performance occurs within 8-1/2 months of the close of the taxable year, if that better matches income and deductions or the item is not material in size.

Code Section 461(h) itself specifies that economic performance with respect to liabilities that "arise out of" the provision of goods and services (or the use of property provided to the taxpayer) takes place as these are provided. A rule aimed at abuses involving "structured settlements"[18] provides that performance occurs as to workers' compensation and torts liabilities only when claimants are paid. For other types of liabilities, taxpayers are referred to the Regulations, which specify several more categories of liabilities for which economic performance occurs upon payment. Most of these "payment liabilities" are eligible for the exception for "recurring items," although certain miscellaneous liabilities are not.[19]

IES Industries

IES Industries involved special Federal assessments on nuclear power plants to fund the costs of decontaminating and decommissioning Federally owned uranium enrichment plants. Each utility's assessment was based upon its previous use of the government's uranium enrichment facilities. Although the assessments were actually to be paid over fifteen years, the taxpayer

argued that the "all events" test for its full liability was met in 1992, when the law providing for the assessments was enacted.

The government did not argue that the assessments should be capitalized, probably because they so clearly related to past income-producing activities,[20] but joined battle on "economic performance." In the government's view, the assessments were "miscellaneous liabilities," or possibly taxes, but in any event some sort of "payment liabilities." The taxpayer, on the other hand, argued that the liabilities related to the uranium enrichment services, which had long since been provided. The Eighth Circuit agreed with the taxpayer (and the court below) and allowed a deduction.

The taxpayer probably had the better argument. The assessments resemble either price adjustments or taxes. Had they related to property rather than services, they would have been capitalized as an ancillary cost of acquisition.[21] Code Section 461(h) does not even require that the liabilities form part of "cost" to be treated as performed when the goods or services are provided, but merely that they "arise out of" such a transaction. The government argued that the assessments "arose out of" the legislation and the need to clean up the enrichment facilities. In a sense this was true, but irrelevant. So far as the *taxpayer* was concerned, the assessments clearly arose out of the provision of the uranium enrichment services.

TOO SMALL TO CAPITALIZE?

In *Alacare Home Health Services, Inc. v. Commissioner*,[22] the Tax Court considered whether, and when, a de minimis exception to capitalization might apply, and decided that the answer was "not in this case."

Background

The Regulations' requirement to capitalize expenditures with a useful life that extends "*substantially* beyond the close of the taxable year,"[23] is frequently interpreted to exclude future benefits of less than a year's duration.[24] However, the law is much less clear about what to do with an expenditure that provides a future benefit that extends for some time, but is arguably too small to bother about. Widespread anecdotal evidence, not to mention common sense, indicates that outlays below some threshold are disregarded for capitalization purposes and, as discussed above, some sort of de minimis rule is under consideration in connection with the forthcoming general capitalization regulations. In the meantime, however, the IRS steadfastly refuses to concede that a general de minimis rule exists.[25]

Some passages in the Regulations under Code Section 162 arguably support such a rule, although the issue is wrapped up with questions of useful life. Reg. § 1.162-3 allows "incidental" materials or supplies not recorded as assets to be expensed when purchased, "provided the taxable income is clearly reflected." Reg. § 1.162-6, concerning expenses of professionals, notes that outlays "for books, furniture, and professional instruments and equipment, the useful life of which is short" may be deducted. Finally, Reg. § 1.162-12 allows farmers to deduct "[t]he costs of ordinary tools of short life or small cost." However, only the last specifically refers to size, and this might be explained as part of the special latitude historically granted farmers' accounting.

Court Cases

The major precedent for a de minimis exception is the Court of Claims' decision in *Cincinnati, New Orleans, and Texas Pacific Railway Co. v. United States*.[26] The taxpayer, which had consistently expensed outlays under $100, upped the threshold to $500, following a change in its regulatory accounting. The court upheld both the taxpayer's practice of expensing small items and the change in the threshold on the grounds that the impact on income was "so small as to be unfathomable," and later did the same in *Union Pacific Railroad Co. v. United States*, involving similar facts.[27]

The Tax Court view, by contrast, appears to be that "the relative size of the expenditure is only one factor taken into account for purposes of determining whether the assets may be currently deducted."[28] In one case concerning hotel furnishings, the court observed: "One taxpayer might be justified in capitalizing expenditures for a mattress or a rug, whereas another, operating on a larger scale and with substantially identical recurring expenditures, might be justified in deducting the expenditure as an expense, if it consistently followed such a system of accounting and reporting its income."[29]

The court in *Sharon v. Commissioner*[30] noted in regard to a $25 fee for a lawyer's license to practice that "[s]ince the amount of the fee is small, the petitioner might, ordi-

narily, be allowed to elect to deduct the full amount of the fee in the year of payment, despite its capital nature." The statement was not part of the holding – the taxpayer actually got a microscopic amortization deduction – but *Kohen v. Commissioner*[31] cited *Sharon* in allowing another lawyer to deduct a $90 bar fee. Other decisions appear to continue to consider other factors, such as useful life. For example, one memorandum opinion required capitalizing a $75 used adding machine with a projected useful life of five years,[32] while less than a month later the same judge allowed another taxpayer to deduct a $50 calculator with an asserted two-year life "in light of the relatively minor size of the expenditure and the relatively short useful life."[33]

Alacare

Sharon and the other Tax Court cases discussed above disposed of the de minimis issue in a few paragraphs sandwiched between matters of more moment. In *Alacare*, by contrast, the issue was the focus of the opinion, as it had been in *Cincinnati, New Orleans* and *Union Pacific*. The facts of *Alacare* somewhat recalled those cases as well. The taxpayer was a home health care agency subject to annual compliance audits by the Health Care Financing Administration, which administers Medicare, and obliged to keep its books according to Medicare accounting guidelines. These guidelines included an optional $500 de minimis rule, under authority of which the taxpayer deducted amounts totaling in the mid-six figures. No evidence was presented concerning the nature of the hundreds of individual outlays involved. Alacare thus posed a pure de minimis question: was the fact that a given expenditure fell under the $500 threshold enough to justify deducting it?

The court held that it was not, at least on the facts of *Alacare*. The court noted that *Cincinnati, New Orleans* and *Union Pacific* had not held that a $500 de minimis rule necessarily clearly reflected income, but turned on their specific facts. The deductions the taxpayer sought in *Alacare* were much larger in relation to revenues, outlays, assets, and net income than in those cases. (Indeed, in one of the years before the court the deduction at issue exceeded the reported net income.) Therefore, the court held, the taxpayer had failed to demonstrate that the facts were comparable to the Court of Claims cases or that its chosen accounting method clearly reflected its income for tax purposes.

CHANGING RECOVERY PERIODS

Only a few months after *Pelton & Gunther, Inc. v. Commissioner*,[34] the IRS lost again before the Tax Court on the question of whether a taxpayer changed accounting methods. The issue in *Brookshire Brothers Holding, Inc. v. Commissioner*[35] was whether a change in method took place when the taxpayer reclassified property as falling under a different recovery period for depreciation purposes.

Background

Changing from expensing an outlay to treating it as creating a depreciable asset is unquestionably a change in accounting method.[36] However, there is some confusion about which other changes that affect depreciation are changes of method.

Under traditional depreciation accounting under Code Section 167, the particular method of computing depreciation (such as "straight-line," "150% declining balance," or "200% declining balance") that was applied to the property in a particular depreciation account was treated as a method of accounting.[37] However, useful life and projected salvage values were determined individually as to each property and treated as questions of fact.

Since 1981, the depreciation of most personal property has been governed by the ACRS ("accelerated cost recovery system") method, and its successor the MACRS ("modified cost recovery system") under Code Section 168. Under ACRS and MACRS, depreciation *methods* are governed by specific statutory elections that are irrevocable as to the property concerned,[38] making their status as methods of accounting irrelevant. However, useful lives are no longer individually determined. The statute assigns different types of property to categories allowed a specified "recovery period," such as "5-year property," or "7-year property." The issue in *Brookshire* was what happens when a taxpayer realizes that it has made a mistake and seeks to move particular property from one category to another, thus changing its recovery period.

The "Useful Life" Problem

In language that survives from the pre-1981 era, the Regulations provide that "a change in the method of accounting does not include . . . an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally

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corrected by adjustments in the current and future years."[39] ACRS and MACRS make the useful life no longer a question of fact, but the automatic result of assigning property to a given category. Moreover, unlike re-estimating useful life under the traditional rules, correcting a miscategorization under ACRS can affect depreciation allowances in past years.

The IRS position is that the Regulations' reasoning does not apply under Code Section 168, and that moving a particular property from one recovery period category to another is a change in accounting method. The government won precisely that argument last year before a Texas district court in *H.E. Butt Grocery Co. v. United States*.[40] The taxpayer in *Butt Grocery*, contending that it had incorrectly treated some costs incurred upon opening new stores as nonresidential real property rather than personal property subject to a shorter recovery period, filed amended returns and ultimately sued for a refund. The court granted the government summary judgment on this issue, holding that the above-quoted passage from the Regulations was irrelevant under MACRS and that the taxpayer was attempting to change accounting methods retroactively, which is not allowed.

Brookshire Brothers

The facts in *Brookshire* were very similar to those in *Butt Grocery* – the taxpayer sought to reclassify its gas station convenience stores from real property to personal property with a shorter recovery period – but the result was different. While noting that MACRS classification can affect the depreciation method as well as the recovery period, the court held that "the similarities between a change in MACRS classification and a change in useful life [under pre-1981 law] are greater than the differences," and held that the taxpayer therefore did not impermissibly change methods when it changed classifications. While the court in *Butt Grocery* seems to have assumed that the controversial passage reflected the general rule for changes in factual determinations, Judge Nims saw it as a relief provision. The opinion noted that the drafters "clearly intended to permit taxpayers to alter their depreciation schedules," and the IRS' interpretation would have "severely limit[ed] the intended relief."

That *Brookshire* was released as a memorandum opinion seems somewhat surprising. The issue is of potentially broad interest, and the court resolved it essentially as an issue of first impression, by reference to the Regulations' purpose and basic principles governing accounting method changes. The opinion did not even cite *Butt Grocery*, an unreported case of which the court may not have been aware. The case may well be appealed, as it otherwise arguably provides "substantial authority" for reclassifying property among depreciation categories without disclosure,[41] which may cause the government whipsaw concerns.

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1. T.C.M. 2001-149 (June 22, 2001).

2. T.C.M. 2001-150 (June 22, 2001).

3. News Release IR2001-48 (Apr. 26, 2001). The plan is reprinted in full in "2001 IRS/Treasury Business Plan Goes to Fiscal Year," 91 Tax Notes 708 (Apr. 30, 2001).

4. *See* letter from Harry L. Gutman, Fred Goldberg, and Robert J. Leonard (Feb. 28, 2001), Tax Analysts Doc. No. 2001-6799.

5. *See, e.g.,* PNC Bancorp v. Commissioner, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998), discussed in J. Salles, "Tax Accounting," 1(11) *Corp. Bus. Tax'n Monthly* 26, 26-28 (Aug. 2000); Lychuk v. Commissioner, 116 T.C. No. 27 (May 31, 2001).

6. "Broad Guidance in Works for Cost Treatment for Self-Created Intangibles, Official Says," Daily Tax Report, June 8, 2001, at G-3; *see also* L. Sheppard, "Participants Consider INDOPCO, Alternative Minimum Tax," 90 Tax Notes 992, 992-94 (Feb. 19, 2001)

7. "Capitalization Issues, Installment Method Addressed by Tax Accounting Panel," CCH TaxDay 03/05/01, Item M.3.

8. JCS-3-01, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986," (Jt. Comm. Print, April, 2001), hereafter "JC Study."

9. JC Study, VII.A, and VIII.A, pp. 322-27, 336-38.

10. J. Salles, "Tax Accounting," 2(4) *Corp. Bus. Tax'n Monthly* 31, 31 (Jan. 2001); J. Salles, "Tax Accounting," 1(9) *Corp. Bus. Tax'n Monthly* 34, 37 (June 2000).

11. I.R.C. §§ 248, 709.

12. *See* I.R.C. §168(d)(3).

13. I.R.C. §§ 263(g), 1092.

14. JC Study, VII.B-D and VIII.B-C, pp. 328-35, 339-55.

15. "Jeffords Move Gives Dems Control of Senate, Agenda – After Tax Cut," 91 Tax Notes 1491, 1492 (May 28, 2001).

16. *See* I.R.C. §461(h)(4); United States v. Anderson, 269 U.S. 422, 441 (1926).

17. 87 A.F.T.R.2d ¶ 2001-2492 (8th Cir. June 14, 2001).

18. *See, e.g.,* Ford Motor Co. v. Commissioner, 102 T.C. 87 (1994) (reviewed), *aff'd*, 71 F.3d 209 (6th Cir. 1995).

19. Reg. §§1.461-4(g), -5(c).

20. *Cf., e.g.,* Steger v. Commissioner, 113 T.C. 227 (1999).

21. *Cf., e.g.,* Woodward v. Commissioner, 397 U.S. 572 (1970) and United States v. Hilton Hotels Corporation, 397 U.S. 580 (1970).

22. T.C.M. 2001-149 (June 22, 2001).

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23. Regs. §1.461-1(a)(1)-(2); *see also* Regs. §§ 1,263(a)-2, 1.446-1(c)(1)(ii)(A).

24. *See, e.g.,* United States v. Wehrli, 400 F.2d 686, 689 & n.4 (10th Cir. 1968), collecting cases.

25. *See, e.g.,* ILM 199952010 (Sept. 29, 1999) (internal transmittal accompanying denial of change of accounting method), discussed in J. Salles, "Tax Accounting," 1(6) *Corp. Bus. Tax'n Monthly 29*, 32 (March, 2000).

26. 424 F.2d 563 (Ct. Cl. 1970).

27. 524 F.2d 1343, 1347-48 (Ct. Cl. 1975).

28. Klutz v. Commissioner, 38 T.C.M. (CCH) 724, 725-26 (1979).

29. Manger Hotel Corp. v. Commissioner, 10 T.C. 520, 522 (1948).

30. 66 T.C. 515, 526-27 (1976), *aff'd per curiam without discussion of this issue*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979).

31. 44 T.C.M. (CCH) 1518, 1521 (1982).

32. Klutz*, supra*.

33. Galazin v. Commissioner, 38 T.C.M. (CCH) 851, 853 (1979).

34. 78 T.C.M. (CCH) 578 (1999), discussed in J. Salles, "Tax Accounting," 1(5) *Corp. Bus. Tax'n Monthly* 29 (Feb. 2000).

35. T.C.M. 2001-150 (June 22, 2001).

36. Reg. § 1.446-1(e)(2)(ii)(*b*); *e.g.,* Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324, 1337-38 (1971), *acq. on other issues*, 1973-2 C.B. 1, *aff'd without opinion*, 496 F.2d 876 (5th Cir. 1974).

37. Reg. § 1.167(e)-1(a); *see, e.g.*, Silver Queen Motel v. Commissioner, 55 T.C. 1101 (1971), *acq.* 1972-2 C.B. 3; Foley v. Commissioner, 56 T.C. 765 (1971), *acq.* 1972-2 C.B. 2; Rev. Rul. 72-491, 1972-2 C.B. 104.

38. I.R.C. §168(b)(5), (g)(7).

39. Reg. §1.446-1(e)(2)(ii)(*b*).

40. 86 A.F.T.R.2d ¶ 2000-5048 (W.D. Tex. Feb. 9, 2000), discussed in J. Salles, "Tax Accounting," 2(1) *Corp. Bus. Tax'n Monthly* 36, 40 (Oct. 2000).

41. *Cf.* I.R.C. § 6662(d)(2)(B)(i).