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WILLIAM & MARY TAX CONFERENCE

TAX ACCOUNTING METHODS

AND

ECONOMIC PERFORMANCE

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TAX ACCOUNTING METHODS

I. New Rules Effective in 1992

A. Rev. Proc. 92-20, 1992-12 I.R.B. 10, was issued by the IRS on March 2, 1992.

B. Rev. Proc. 92-20 replaces Rev. Proc. 84-74 as the general guidance for taxpayers to follow in making requests to change accounting methods.

C. Rev. Proc. 92-20 became effective for forms 3115 filed on or after March 23, 1992. Special transitional rules applied for taxpayers under examination on March 23, 1992; these rules expired September 19, 1992.

II. Expanded Definition of a Category A Method

A. The basic definition remains the same -- a Category A method is one "that is specifically not permitted to be used by the taxpayer by the Code, regulations, or by a decision of the Supreme Court of the United States."

B. Rev. Proc. 92-20 eliminates the language in Rev. Proc. 84-74 holding out the possibility that a method that is "clearly erroneous" will be treated as a Category A method.

C. Rev. Proc. 92-20 expands the definition of a Category "A" method by including any method of accounting that "differs from a method the taxpayer is specifically required to use under the Code, the regulations or a decision of the Supreme Court of the United States ."

III. New "Designated" Category A Methods

A. Rev. Proc. 92-20 creates a new special subset of Category A methods referred to as "Designated A" methods.

B. The terms and conditions associated with changing a Designated A method are more harsh than those associated with a regular A method. In order to make the change, taxpayers must either:

1. file amended returns for all applicable open years with a §481(a) adjustment in the earliest open year (if needed); or

2. adopt the change on a prospective basis under the

following conditions:

a. include the entire §481(a) adjustment in income in the year of change; and

b. make a special payment which approximates the time value of money and higher rates that would have been realized by the government had the change been made in accordance with the amended return procedure.

C. The IRS may indicate that a Category A method is a "Designated A" method by so stating in a document published in the Internal Revenue Bulletin.

D. It is contemplated that methods specifically contrary to a tax law change will become Designated A methods shortly after the law is changed so as to encourage timely compliance with such changes.

E. Taxpayers using a method that is likely to be classified as a Designated A method should consider prompt filing of a change request in order to receive more favorable treatment. It is unlikely that taxpayers will have any advance warning before a method becomes a Designated A.

F. Designated A methods are to receive special treatment for a period of six taxable years beginning:

1. with the first taxable year the method was adopted; or

2. with the first taxable year the taxpayer was required to change from a Designated A.

Following this 6-year period, Designated A methods will be treated as Category A methods. It is not clear from Rev. Proc. 92-20 whether the 6-year period may apply prospectively from the date of designation for tax law changes enacted many years ago. For example, may IRS treat methods other than those required by Code §448 as Designated A methods prospectively from the date of designation even though 6 taxable years have elapsed for most taxpayers?

IV. New 90-Day Window for Taxpayers under Exam

A. Rev. Proc. 92-20 introduces a new 90-day window that applies during the first 90 days that a taxpayer is under exam. This new window applies in addition to the 30-day and 120-day windows provided in Rev. Proc. 84-74, which are retained (and modified as noted below).

B. During the 90-day window, a taxpayer may file a request to change a method of accounting, other than a Designated A method, without first obtaining the permission of the district director. (Rev. Proc. 92-20 generally requires taxpayers under examination to seek the permission of the district director to change a method of accounting. This new requirement applies not only to changes from Category A methods, but to changes from Category B methods as well.)

C. Terms and conditions -- The year of change is less favorable than the rules applicable to taxpayers not under exam:

1. For positive Category A methods and LIFO changes, the year of change is the earliest year under exam.

2. For negative Category A methods and for Category B method changes, the year of change is the year for which the Form 3115 is timely filed.

3. See Exhibit I for the applicable periods for taking §481 adjustments into account. Note that the period for taking into account a positive §481(a) adjustment applicable to a Category B method change is one year.

D. Unlike Rev. Proc. 84-74, Rev. Proc. 92-20 permits taxpayers to request changes from Category A methods of accounting at the start of an examination.

V. New application of 30-day and 120-day windows

A. Rev. Proc. 92-20 continues the 30-day and 120-day windows described in Rev. Proc. 84-74:

1. The 30-day window occurs during the first 30 days of the taxable year if the taxpayer was under examination for at least 18 consecutive months prior to the start of the window and if the item to be changed has not been raised during the exam.

   a. The year of change is the taxable year that

includes the first day of the 30-day window.

b. Adjustments required under §481(a) are taken into account as follows:

(1) Positive adjustments for Category A method changes are taken into account ratably over three years beginning with the year of change. Negative adjustments resulting from Category A method changes are taken into account in the year of change.

(2) Changes from Category B methods are taken into account ratably over six taxable years beginning with the year of change.

(3) Changes within the LIFO method are taken into account using a cut-off method.

2. A taxpayer was in the 120-day window following the date the examination ended (even though a subsequent examination had commenced) and if the item to be changed is not an exam issue.

a. The year of change is the taxable year that includes the first day of the 120-day window.

b. Adjustments required under §481(a) are taken into account as follows:

(1) Positive adjustments for Category A method changes are taken into account ratably over three years beginning with the year of change. Negative adjustments resulting from Category A method changes are taken into account in the year of change.

(2) Changes from Category B methods are taken into account ratably over six taxable years beginning with the year of change.

(3) Changes within the LIFO method are taken into account using a cut-off method.

B. Because of other changes contained in Rev. Proc. 92-20, the 30-day and 120-day windows will have broader applications. For example, Taxpayers under exam who did not file a Category B method change during the first 90

days of the exam must now either get permission from the district director before doing so or wait until one of these window periods occur.

VI. LIFO changes

A. Rev. Proc. 92-20 states that changes from one LIFO submethod to another are to generally be accomplished on a cut-off basis with no §481 adjustment. This publicly states a longstanding internal position of the IRS National Office. There are exceptions to this general rule:

1. The IRS may publish a list of LIFO changes which require a §481(a) adjustment. Currently, only changes relative to the definition of an item acquired in a bulk bargain purchase of inventory in order to comply with Hamilton Industries, Inc. (97 TC 120) are included on this list.

2. Taxpayers who make a change during the 90-day window period must compute a modified §481(a) by revaluing the inventory activity during the ten taxable years preceding the earliest year under examination. If the taxpayer does not change during the 90-day window and the IRS makes the change on examination, the IRS may require the adjustment be computed from the year LIFO was adopted. NOTE: A change in method of accounting for inventory for a LIFO taxpayer will not be implemented on a cut-off approach if such change would have been implemented if the taxpayer was on FIFO (e.g., a §263A adjustment).

B. Rev. Proc. 92-20 states a net §481(a) adjustment is required for changes from one LIFO inventory method to another LIFO inventory method where the change is outside the scope of the procedures outlined in the revenue procedure. This highlights the issue of whether a net §481(a) adjustment is required for transactions within the scope of Treas. Reg. §1.381(c)(5)-1.

C. The period that taxpayers who have changed from LIFO to another method must wait before readopting LIFO has been reduced from the Rev. Proc. 84-74 10 years to 5 years. (This 5 year period may be reduced where extraordinary circumstances can be shown.) A taxpayer is required to file a Form 3115 in order to make the change back to LIFO after the 5-year period elapses.

VII. Category B Terms and Conditions

A. Rev. Proc. 92-20 eliminates the condition, previously imposed as a condition for approving a positive Category B change, that the portion of the §481(a) adjustment allocable to the year of change could not be offset by NOL and credit carryforwards. NOTE: This condition is still present in various automatic change procedures (e.g., Rev. Proc. 88-15 dealing with certain LIFO to FIFO changes).

B. Rev. Proc. 92-20 states that the entire §481(a) adjustment must be included in the year preceding the year of change if 90% or more of the §481(a) adjustment is attributable to that year. The Rev. Proc. 84-74 rules modifying the period over which a §481(a) adjustment was taken into account if 67% or more of the adjustment was attributable to either the 1, 2 or 3 year period prior to the year of change have been eliminated. The 75% rule for methods used no more than 4 years has also been eliminated.

VIII. Special Consolidated Group Rules

A. The parent may request permission to change a method of a subsidiary during the 90-day period after affiliation if a subsidiary not under examination joins a consolidated group which is under examination. The year of change is the taxable year that includes the first day of the 90-day post-affiliation period.

B. Generally §481(a) adjustments are accelerated if the taxpayer ceases to engage in the trade or business that gave rise to the adjustment. When applying this rule, a taxpayer is treated as ceasing to engage in a trade or business if substantially all of the assets of the trade or business are transferred to another taxpayer. An exception to this rule is now provided if the transfer is made to another member of the consolidated group pursuant to a §351 exchange and that the transferee member uses the same accounting method and agrees to follow the terms and conditions agreed to by transferor with the IRS.

IX. IRS Audit Protection

A. Where a taxpayer timely files a Form 3115 under Rev. Proc. 92-20, the new revenue procedure makes it clear that an examining agent may not propose that the taxpayer change the same method of accounting for a year prior to the year of change prescribed by Rev. Proc. 92-20.

B. Rev. Proc. 92-20 also states that any substantial understatement penalties and preparer penalties will not be assessed with respect to an item changed where a taxpayer timely files a Form 3115.

X. Appeals Given More Authority to Settle -- Rev. Proc. 92-20 permits an Appeals Officer to change a method of accounting in order to settle a case and to do so under terms and conditions that differ from those specified in Rev. Proc. 92-20. Rev. Proc. 84-74 had specified that the terms and conditions applicable to these changes be no more favorable the terms and conditions of Rev. Proc. 84-74.

XI. Special Transitional Rule -- Rev. Proc. 92-20 contained a special transitional period that expired on September 19, 1992 applicable to taxpayers under examination on March 23, 1992 (and to taxpayers that became under examination between March 23, 1992 and September 19, 1992). Taxpayers who filed Forms 3115 during this transitional period requesting changes from methods of accounting thought to be Category B methods of accounting should consider the implications of Category A treatment by IRS:

A. Changes from Category B methods during the transition period were subject to the following terms and conditions:

1. Year of change -- Year for which a Form 3115 would be timely filed (unless the issue was pending, in which case the most recent taxable year being examined would be the year of change -- See LTR 9237010 re: "issue pending".)

2. Adjustment period -- Six taxable years beginning with the year of change, whether the §481(a) adjustment is positive or negative.

B. Changes from Category A methods during the transition period were subject to the following terms and conditions:

1. Year of change -- Generally the earliest taxable year under examination. Where the change results in a net negative adjustment, however, the year of change would be the year for which a Form 3115 would be timely filed.

2. Adjustment period -- Three taxable years for positive §481(a) adjustments computed as of the beginning of the year of change; No spread of the adjustment for negative §481(a) adjustments.

XII. Error v. Accounting Method

A. "The term 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such overall methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Treas. Reg. §1.446-1(a)(1).

B. "a method of accounting may exist . . . without the necessity of a pattern of consistent treatment of an item, in most cases a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Treas. Reg. 1.446-(1)(e)(2)(ii)(a).

Rev. Proc. 91-31, IRB 1991-21, May 9, 1991 concludes:

> "In determining whether a practice involves the proper time for the inclusion of items in income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer's lifetime. If the accounting practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is therefore considered a method of accounting." Citing <u>Knight-Ridder Newspapers, Inc. v. United States</u>, 743 F.2d 781, 799 (11th Cir. 1984); <u>People Bank & Trust Co. v. Commissioner</u>, 415 F.2d 1341, 1344 (7th Cir. 1969).

C. Adoption of a method -- Permissible method

A taxpayer adopts a permissible method of accounting by treating an item properly in the first return that reflects the item. It is not necessary for the taxpayer to treat the item consistently in 2 or more consecutive

tax returns. Rev. Rul. 90-38, 1990-2 C.B. 363.

D. Adoption of a method -- Erroneous method

"The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of §1.446-1(e)(2)(ii)(a) of the regulations." Rev. Rul. 90-38, supra, citing Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989).

E. Manner of effecting changes in accounting methods

1. An amended return may be filed to change from a permissible method before expiration of time to file initial return. Rev. Rul. 90-38 states:

> the Supreme Court has held that once a permissible election as to a method of accounting for an item has been made on a return, it may not be changed after the time for filing the return has expired.

Rev. Rul. 90-38 citing Pacific National Co. v. Welch, 304 U.S. 191 (1938), 1938-1 C.B. 274; see also Lord v. United States, 296 F.2d 333 (9th Cir. 1961); National Western Life Insurance Co. v. Commissioner, 54 T.C. 33 (1970); Rev. Rul. 74-154, 1974-1 C.B. 59."

2. Generally permission must be obtained to change from a permissible method after expiration of time to file initial return. Treas. Reg. §1.446-(1)(e)(2)(i) states:

> Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

3. An amended return should be filed to change from an erroneous method before the filing of a second consecutive return. Diebold, Inc. 891 F.2d 1579 (Fed. Cir. 1989) and Rev. Rul. 90-38, 1990-2 C.B. 363;

4. Permission must be obtained from the Commissioner to change an erroneous method after filing of the second return. Treas. Reg. §1.446-(1)(e)(2)(i).

F. Changes in methods of accounting are generally governed by Rev. Proc. 92-20 as discussed above.

XIII. Treatments that are Not Methods of Accounting

A. Treas. Reg. 1.446-(1)(e)(2)(ii)(b) provides that the following are not methods of accounting:

1. items of a mathematical nature such as posting errors, computational errors, footing errors, etc.;

2. adjustments of an item which do not involve the proper time for income inclusion or the taking of a deduction, e.g., correction of items deducted as interest or salary but are rather dividends;

3. changes in facts surrounding the business. Thus, a change to the treatment of an item arising from a change in the underlying facts is not a change in a method of accounting.

B. The deferral and restoration adjustments required by Treas. Reg. 1.1502-13 are not a method of accounting. They are merely a series of adjustments that are required by the consolidated return regulations in order to place the group of corporations on a tax parity with a single corporate entity. (PLR 9002006) The ruling also states that no §481(a) adjustment is required when changing to the deferral mandated by Treas. Reg. 1.1502-13.

C. Correction of the wrong life or wrong class of a single depreciable asset may be the correction of an error. Consistent treatment of a type of asset may be a method of accounting.

D. Failure to claim depreciation is probably an error that may be corrected through filing an amended return. Under the §1016(a)(2) "allowed or allowable" rule the basis of the property must be reduced even if depreciation deductions are not taken. Thus, the taxpayer's lifetime taxable income would be permanently increased. Therefore, applying the logic from Rev. Proc. 91-31, it would not be a change in method but rather a correction of an error.

XIV. Wayne Bolt and Nut Company

In Wayne Bolt and Nut Co. v. Commissioner, 93 TC 500, the taxpayer prior to 1982 determined opening and ending inventory using a perpetual book inventory recordkeeping system with periodic verification occurring by the taking of a partial physical inventory. In 1982 the taxpayer determined opening and ending inventory on the basis of a complete physical inventory which occurred during the year. The Tax Court held that a change in accounting method had occurred and an adjustment under §481 is required.

XV. Changes to the Accrual Method -- On August 27, 1992, IRS released Revenue Procedures 92-74 & 92-75 providing expeditious consent procedures for:

A. taxpayers desiring to change to the accrual method of accounting as an overall method of accounting, or

B. taxpayers desiring to change to the accrual method of accounting and in conjunction therewith request to change to a special method of accounting.

Rev. Proc. 92-74 applies to taxpayers required to use inventories and supersedes Rev. Proc. 85-36; Rev. Proc. 92-75 applies to taxpayers not required to use inventories and supersedes Rev. Proc. 85-37.

XVI. These revenue procedures expand prior guidance in the certain areas:

A. organizations exempt from tax under Code §501(a) and other persons not subject to internal revenue taxes may use these procedures; and

B. the revenue procedures clarify the definition of financial institutions to state that bank holding companies may use these procedures; and

C. the procedures are expanded so that taxpayers may change to the accrual method and in conjunction therewith change to a special method:

1. Accounting for advanced payments under Rev. Proc. 71-21;

2. Accounting for advanced payments under Treas. Reg. §1.451-5;

3. the long-term contract method; and

4. the use of Code §455 for prepaid subscription

income.

Note that changes to these "special" methods are not automatic and therefore require permission. Taxpayers filing automatic changes pursuant to Rev. Proc. 92-74 & 92-75 with their tax returns may find that the year of change for these special methods is not the same as the year of change to the accrual method under either of these revenue procedures.

D. A taxpayer may also adopt the recurring item exception of §461(h)(3) as part of the change to the accrual method.

E. In accordance with the changes contained in Rev. Proc. 92-20, Rev. Proc. 92-74 & 92-75 eliminate the prior law limitation on the use of net operating loss and credit carryovers when making changes to the accrual method of accounting under these procedures.

ECONOMIC PERFORMANCE

I. OVERVIEW AND BACKGROUND ON SECTION 461(h) - ECONOMIC PERFORMANCE

A. Reason for Economic Performance The economic performance provisions were enacted as part of the Tax Reform Act of 1984 due to Congress' concern over the drain on the Treasury resulting from taxpayers taking a deduction in the current year for the full face value of a liability even though the payment may not take place until many years in the future. The House Ways and Means Committee Report on the Tax Reform Act of 1984 provides the following example which illustrates the concern of Congress.

> Assume that a taxpayer using the accrual method of accounting closes a manufacturing plant. Under a negotiated contract, the corporation becomes liable to provide medical benefits to the terminated employees for a period ending with the earlier of the death of the employee or 20 years. The corporation's estimated liability (undiscounted) per employee is $200,000 - an average of $10,000 per year for 20 years. Assume also that the estimated costs meet the requirement that they can be determined with reasonable accuracy. The present value of the estimated liability is $50,000. In year 5, the corporation's actual liability is $12,000.
>
> Under present law, the corporation may assert a deduction of $200,000, the full face amount of the estimated liability. Under the bill, the corporation could deduct each year only the amount of the actual expense incurred for health benefits provided that year. In year 5, for instance, the corporation would be allowed to deduct $12,000.

B. Scope of economic performance rules. An item may not be taken into account (deducted, absorbed into inventory, or capitalized) by an accrual-basis taxpayer until

1. all events have occurred that establish the fact of the liability;

2. the amount of the liability can be determined with

reasonable accuracy; and

3. economic performance has occurred.

For an accrual-basis taxpayer, economic performance is a prerequisite to the addition of an item to basis, as well as for the current deduction of expenditures. A liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is therefore taken into account through capitalization in the taxable year it is incurred and economically performed.

C. Economic performance is a test in addition to the all events test. Section 461(h)(1) states, "In determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." [emphasis added] Therefore the liability is considered incurred only if all events have occurred which determine the fact of liability, the amount of the liability can be determined with reasonable accuracy and economic performance has occurred. See §461(h)(4) and (1). Note: This is a point that is often missed by many practitioners. This point was also missed in the drafting of Proposed Reg. §1.461-4(d)(6) issued June 1990. Following is example 9 of Proposed Reg. §1.461-4(d)(6):

> W corporation, a calendar year, accrual method taxpayer, is an investment banking firm. W has an ongoing contract with Z, an office supply vendor, under which Z is obligated to provide office supplies to W. On December 15, 1990, W pays Z $2,000 for office supplies that W reasonably expects Z to deliver by the end of January 1991. Economic performance with respect to W's liability for property to be provided by Z occurs as Z provides the property. However, under Prop. Reg. §1.461-4(d)(5)(ii), W is permitted to treat the supplies as provided to W as W makes payments to Z for the supplies. If W so treats the property as provided, W incurs $2,000 for the 1990 taxable year.

Note that even if economic performance is deemed to have occurred by year end, it appears that there is not a fixed and determinable liability. In the example, the goods were merely ordered -- a fixed and determinable liability would not occur prior to delivery. Therefore, the all events test has not been met and the deduction

would not be allowable until delivery. Fortunately this point was acknowledged by the Service and the example was removed from the final regulations.

II. ECONOMIC PERFORMANCE -- GENERAL RULES

A. Services and property provided to the taxpayer or used by him

1. Generally, if a liability of a taxpayer arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided. (Treas. Reg. §1.461-4(d)(2)(i)) For property used by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property.

2. Illustration of services provided to taxpayer. X corporation is an automobile dealer, and a calendar year, accrual method taxpayer. On January 15, 1990, X agrees to pay an additional $10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X. During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional $10,000 as provided in the agreement. Y, in turn, uses this $10,000 to provide advertising and promotional activities during 1992. Economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, $10,000 is incurred by X for the 1992 taxable year. (Treas. Reg. §1.461-4(d)(7) Example 5) The key item to note from this example is that although payment did occur in 1990, economic performance does not result until 1992.

3. Illustration of property used by taxpayer. X corporation, a calendar year, accrual method taxpayer, enters into a five-year product distribution agreement with Y, on January 1, 1992. The agreement provides for a payment of $100,000 on January 1, 1992, plus 10 percent of the gross profits earned by X from distribution of the product. The variable income portion of X's liability is payable on April 1 of each subsequent year. On January 1, 1992, X pays Y $100,000. On April 1, 1993, X pays Y $3 million representing 10 percent of X's gross profits from January 1 through December 31, 1992. Economic performance

with respect to X's $100,000 payment occurs ratably over the period of time X is entitled to use the product. Consequently, $20,000 is incurred by X for each year of the agreement beginning with 1992. Economic performance with respect to X's variable income portion of the liability occurs as the income is earned by X. Thus, the $3 million variable-income liability is incurred by X for the 1992 taxable year. (Treas. Reg. §1.461-4(d)(7) Example 9)

B. <u>Services and property provided **by** the taxpayer</u>

1. Generally, if a liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs in satisfaction of the liability. (Treas. Reg. §1.461-4(d)(4)(i))

2. Illustration of the provision of property or services. X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease with Y. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of $200,000. Economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services. Consequently, X incurs $200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z $130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. X does not incur this cost until Z performs the services. Thus, economic performance with respect to the $130,000 X pays Z occurs in 1998. (Treas. Reg. §1.461-4(d)(7) Example 1)

C. <u>Economic Performance Occurs for Certain Items Only When Payment is Made.</u> For liabilities described below, the rules described in II.A and II.B. above do **not** apply. Note, however, that the recurring item exception may apply.

1. Statutorily defined liabilities. § 461(h)(2)(C) states, "If the liability of the taxpayer requires

a payment to another person and arises under any <u>workers compensation act</u>, or arises out of any <u>tort</u>, economic performance occurs as the payments to such person are made." [emphasis added]

2. Other Liabilities Defined in the Regulations

a. Rebates and refunds

(1) If a liability of a taxpayer is to pay a rebate, refund, or similar payment (e.g. sales returns, sales allowances, quantity discounts) to another person economic performance occurs as payment is made to the person to which the liability is owed. This holds whether paid in property, money or as a reduction in the price of goods or services to be performed in the future by the taxpayer. (Treas. Reg. §1.461-4(g)(3))

(2) The rule applies regardless of whether the "rebate" is treated as a deduction from gross income, an adjustment to gross receipts, or cost of goods sold. (Treas. Reg. §1.461-4(g)(3))

(3) In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. (Treas. Reg. §1.461-4(g)(3))

(4) LTR 9204003 on co-op advertising deduction (note the "all events test" issue is emphasized rather than an economic performance issue.)

(a) Facts: The vendor permitted customers qualifying for the co-op advertising allowance to receive it either by taking a discount against the invoice for merchandise purchased or through the issuance of a rebate check. The taxpayer required the customer to submit documentation (tear sheets, etc.) substantiating that the advertising

took place and that it met certain predetermined standards. However, in the event the customer did not conform to the requirements or failed to submit documentation, the customer was required to pay back the amount deducted from the invoice, or the taxpayer would not issue the rebate check, as applicable. The policy of the taxpayer was to approve promotion allowance claims except in the case of blatant default.

(b) IRS position: The National Office of the IRS ruled that the taxpayer can take the deduction at the point in time the retailer runs the ad as opposed to when the claim for reimbursement is approved by the manufacturer. The IRS's rationale for allowing the taxpayer to accrue the deduction at the time the ad runs is that the act of approval is just a ministerial act because the taxpayer approves most advertisements, other than in the case of blatant default. Consequently, the liability becomes fixed when the ad runs as this is when substantial performance occurs under the promotion agreement.

(c) Observation. The LTR does distinguish <u>General Dynamics</u>. (87-1 USTC ¶ 9280) In <u>General Dynamics</u> the Supreme Court noted that the filing of a claim was a condition precedent for both the liability and payment because individuals may never file a medical claim fearing disclosure to the employer of services rendered, etc. This may be contrasted with the taxpayer in LTR 9204003 who often would make payments or permit offset even before the actual receipt of the documentation (on the basis there was no question it was owed to the retailer.)

(d) Note: This item would be subject

to the cash payment rules of the §461 regulations. The recurring item exception would thus be available.

(e) Change in treatment of this item is a change of accounting method.

b. Awards, prizes and jackpots

(1) Economic performance occurs as a payment is made to the person to which the liability is owed. (Treas. Reg. §1.461-4(g)(3))

(2) W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to $10,000 per year for a period of 20 years. On December 1, 1992, A is declared the winner of the contest and is paid $10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays $10,000 to A. Economic performance with respect to the $200,000 contest liability occurs as each of the $10,000 payments is made by W to A. Consequently, $10,000 is incurred by W for the 1992 taxable year and for each of the succeeding nineteen taxable years. (Reg. §1.461-4(g)(8) Example 3).

(3) Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1993, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of $50,000. On October 1, 1994, the $50,000 jackpot is paid to B. Economic performance with respect to the $50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, $50,000 is incurred by Y for the 1994 taxable year. (Reg. §1.461-4(g)(8) Example 4).

(4) In U.S. v. Hughes Properties, Inc. (86-1 USTC ¶ 9440), the U.S. Supreme Court held that a Nevada casino operator may deduct progressive jackpots as accrued because the liability was "fixed and certain" under Nevada law even though the person to whom the liability was not known at year end. As a result of the economic performance rules the liability will not be deductible until paid.

(5) Note that placing amounts legally owed into an irrevocable fund will not satisfy this requirement because the amounts must be paid to the person to whom they are owed.

c. Insurance, warranties and service contracts

(1) Economic performance occurs as payment is made to the person to which the liability is owed. (Reg § 1.461-4(g)(5))

(2) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specific circumstances. (Treas. Reg. §1.461-4(g)(5)(i))

(3) The term 'insurance' has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under 162. (Treas. Reg. §1.461-4(g)(5)(ii))

(4) Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1992, Y enters into a contract with X, an unrelated insurance company, under which Z must satisfy any liability of Y that arises during the succeeding 5 years for damages under a workers compensation act or out of any tort, provided the event that causes the damages occurs during 1993 or 1994. Under the contract, Y pays $360,000 to Z on December 31, 1993. Assuming the arrangement constitutes insurance, economic performance occurs as the

premium is paid. Consequently, $360,000 is incurred by Y for the 1993 taxable year. The period for which the $360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year. (Treas. Reg. §1.461-4(g)(8) Example 6)

(5) How much of the premium is currently deductible in the following example? Corporation A, a calendar year, accrual method taxpayer, purchases a 1 year earthquake insurance policy on 12/1/92 for a $120 premium. One-half of the premium is due on 12/1/92 and the other one-half of the premium ($60) is payable on April 1, 1993. Assume also that the taxpayer does not elect the recurring item exception (discussed below). At least $110 of the premium would not be deductible in 1992 under the capitalization rules because the contract is an asset having a useful life extending substantially beyond the close of the taxable year. So the answer is either $10 or $5.

The issue is whether economic performance has occurred for the full premium where only one-half of the total liability has been satisfied (i.e., paid). The more reasonable result appears to be that economic performance has occurred for the full $10 because the amount paid is greater than this. This result is also supported by reasoning that the 2 installment payments represent individual policies for a six month service, i.e., if you failed to make the second payment, the carrier would cancel the insurance. Additionally, the logic to say we should be entitled to a $10 deduction is similar to that used in Rev. Proc. 92-29 dealing with how the economic performance rules are to be applied to estimate costs of common improvements. (See V., below)

d. Taxes

(1) Real property taxes accrue ratably if the taxpayer has a valid ratable accrual method election in effect. (Treas. Reg. §1.461-4(g)(6)(iii)(A)) [Otherwise economic performance occurs when the real estate taxes are paid.]

(2) Foreign income taxes accrue when the taxes become fixed and determinable without regard to the economic performance requirements (i.e., when the all events test as described in Reg. 1.446-1(1)(ii) is met). (Treas. Reg. §1.461-4(g)(6)(iii)(B))

(3) Income taxes. Payment includes payments of estimated income tax and payments of tax where the taxpayer subsequently files a claim for credit or refund. (Treas. Reg. §1.461-4(g)(6))

e. Treas. Reg. §1.461-4(g)(7) indicates that a liability of the taxpayer to make a payment to another person where the liability is not properly described as either a property/service liability or a payment liability may also be subject to these rules. This category was created to give the IRS the ability to attack creative approaches which might be abusive.

III. THE RECURRING ITEM EXCEPTION

A. Application The recurring item exception is available for the other liabilities defined in regulations described up above. It is not available for statutorily defined liabilities (i.e., workers compensation, tort, etc.) or other liabilities of Reg. §1.461-4. It is also not available for any liability of a tax shelter. The recurring item exception allows a taxpayer who makes an election to treat a liability as incurred as of the end of a taxable year if certain conditions described below are fulfilled. (Reg § 1.461-5(a) and (c))

B. Requirements and Definitions

1. Under Treas. Reg. §1.461-5, recurring items generally may be taken into account in a taxable year if:

a. the all-events test is otherwise satisfied at the end of that year (i.e. the liability is fixed and determinable);

b. economic performance occurs within 8½ months of the end of the taxable year; and

c. the item either is not material or its inclusion in the earlier year results in a better matching of income and expense.

2. An item is <u>recurring</u> if it generally can be expected to be incurred from one taxable year to the next. However, a recurring item need not be incurred in every taxable year, and it may be treated as recurring upon its first occurrence if it is reasonably expected to be incurred on a recurring basis in the future. (Treas. Reg. §1.461-5(b)(3))

3. An item is <u>material</u> if it is material for financial accounting purposes or if it is otherwise material either in absolute terms or in relation to the amount of other items of income and expense attributable to the same activity. (Treas. Reg. §1.461-5(b)(4))

4. The recurring item exception applies to the economic performance requirement. It does not otherwise accelerate deduction to a taxable year <u>prior</u> to the year in which the all-events test is otherwise satisfied. Thus, the all events test must be met by the end of the taxable year. (Treas. Reg. §1.461-5(b)(1)) For example, assume an employee of corporation A, which is an accrual basis, calendar year taxpayer receives medical treatment in December 1991. The employee is covered by A's medical care plan which requires that a claim reimbursement form be submitted and that form be approved in order for the employee to be reimbursed. The employee submits the claim is in February 1992. It is subsequently approved and payment is made by March 1, 1992. Even though the medical services were performed in 1991 and paid within 8½ months, the item is not deductible in 1991 because at a minimum the claim was not submitted until after year end. The liability is not yet fixed at December 31, 1991 under the principal of <u>General Dynamics</u>.

5. The matching requirement is deemed satisfied in the case of liabilities for:

a. taxes (other than creditable foreign taxes);

b. rebates and refunds;

c. awards, prizes, and jackpots; and

d. insurance, warranty, and service contracts.

Because either the matching or materiality requirement must be satisfied, these items need not be tested for materiality to be eligible for recurring item treatment. (Treas. Reg. §1.461-5(b)(5))

6. The final rules require that economic performance occur by the <u>earlier</u> of 8½ months after year-end or the date the return is filed to apply the recurring item exception on an original return. Liabilities for which economic performance occurs after the date the return is filed but within 8½ months after year-end may be taken into account through an amended return. If an amended return is not filed for these items then they are deductible in the year paid. (Treas. Reg. §1.461-5(b)(5))

C. <u>Adoption of the Recurring Item Exception</u>

1. A taxpayer may adopt the recurring item exception merely by using the exception when accounting for a liability on a timely filed return for its first taxable year beginning after 1991. A requirement that had been contained in the proposed regulations that would have required the filing of a statement indicating the types of liabilities with respect to which the exception was adopted was not deleted from the final rules.

(Treas. Reg. §1.461-5(d) provided an election permitting the adoption of the recurring item exception for a taxpayer's first taxable years beginning after either 1989 or 1990. In order to use this election, amended returns must have been filed prior to October 7, 1992.)

2. Note that taxpayers may adopt the recurring item exception when changing from either the cash method or a hybrid method to the accrual method in accordance with Rev. Proc. 92-74 or 92-75.

IV. MISCELLANEOUS ISSUES

A. Payments to third parties. Satisfaction of liabilities through the use of borrowed funds may raise economic performance issues if the lender is directed by the borrower to pay loan proceeds to a third party. Payment (and therefore economic performance) may not occur until the loan is repaid. This issue is probably avoided if the borrower receives the loan proceeds and pays the third party directly. A similar result may arise in situations where third party administrator is used to settle claims. (Treas. Reg. §1.461-4(g)(1))

B. Barter transactions. If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of (A) the cumulative extent to which the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with its liability to provide the services or property; or (B) the cumulative extent to which the services or property is provided to the taxpayer. (Treas. Reg. §1.461-4(d)(5)) This rule can produce some interesting results. For example, suppose a calendar year grocery store receives on December 30, 100 cases of frozen pizza at no monetary charge. In exchange the grocery agrees to provide shelf space during the following year for the manufacture's product. The grocer most likely records the 100 cases at zero in inventory. In this fact pattern the grocer will probably pick up the income when it sells the product in the following year. However, it technically may have income (i.e., advance payment of rent under § 451) in the year the goods are received. It will not incur the expense associated with the providing of the shelf space until the following year, thus the amounts will be deductible when incurred.

C. Liabilities to certain employee benefit plans. The economic performance requirement is deemed satisfied for amounts deductible under §404 (employer contributions to a deferred compensation plan), §404A (foreign deferred compensation plans), or §419 (welfare benefit funds). (Treas. Reg. §1.461-4(d)(2)(iii))

D. Definition of payment. A narrow, two-pronged definition of payment is provided.

1. Treas. Reg. §1.461-4(g)(1)(ii)(A) states:

> The term payment has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency). As a further example, payment does not include a promise of the taxpayer to provide services or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

2. Payment to a particular person is accomplished if "a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of §451 (without regard to §104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person."

E. Transitional rules for regulatory payment liabilities

1. Year of change:

   a. Generally the first taxable year beginning after December 31, 1991; and the taxpayer is deemed to have the consent of the Commissioner to change. (Treas. Reg. §1.461-4(m)(2)(i))

   b. Treas. Reg. §1.461-4(m)(2)(ii) provides that a taxpayer may make the change (with the deemed consent of the Commissioner) in either the first taxable year beginning after

December 31, 1989, or December 31, 1990. However, taxpayers must have filed amend returns prior to October 7, 1992 in order to make this change with deemed consent.

c. The effective date for statutory liabilities (i.e., workers compensation, tort, etc.) is for items incurred after July 18, 1984. To now make the change for a statutory liability, a Form 3115, Application for Change in Accounting Method, must be filed to request permission from the commissioner.

2. Cut-off v. 481(a) adjustment -- The final regulations allow a taxpayer a choice between the cut-off method or a §481(a) adjustment of each of the taxpayer's trade or businesses as it relates to the implementation of the rules relating to the regulatory liabilities for which <u>payment</u> constitutes economic performance (exclusive of workers compensation, tort liabilities, etc.). The approach selected must be consistently applied to all items in a particular trade or business; a liability by liability approach is prohibited.

   a. Under the cut-off method, items previously deducted in prior returns are not deducted again when payment is made and economic performance occurs.

   b. Under the §481(a) method, the cumulative difference between the amount deductible under the economic performance rules and that deducted under the taxpayer's old method would be spread into income <u>generally</u> over a 3-year period with the current year as the year of change. The taxpayer would then deduct the item again in the year in which economic performance occurred. The §481(a) approach is probably more favorable where the items are expected to turn quickly because the taxpayer will get a second deduction quickly but will include the positive §481(a) adjustment over a 3-year period.

3. Action required to make the change. To implement the cut-off approach, just file the original return for the year of change using the payment rule for the applicable liabilities, other than those which were accrued and deducted for tax purposes in prior years under the prior method. (Treas. Reg. §1.461-4(m)(1)(iii)) <u>Note</u>: The

taxpayer may wish to include, but is not required to do so, an informational statement in the return for the year of change indicating that the cut-off method is being used. To implement the §481(a) method, an election statement must be included in the return for the year of change. (Reg. 1.461-4(m)(1)(ii) and Q&A-2 through Q&A-6, and Q&A-8 of Treas. Reg. §1.461-7T)

V. IMPACT OF ECONOMIC PERFORMANCE ON REAL ESTATE DEVELOPERS

A. Industry background. Developers will often start selling homes for example in a subdivision before all the common or area improvements are complete (e.g., sidewalks, pools, street lighting, etc.). The question developers faced was how to account for these future costs when parcels of property are sold. If the developer deducted the expenses of the common improvement at the time the improvement was complete a real mismatch of revenue and expense could occur (e.g., recognize income on the home sale in year one, but be allowed a deduction for the expense in year two when the improvement is made).

B. Historical Treatment under Rev. Proc. 75-25 -- Allocation of common improvements to the basis of individual lots sold

1. This procedure allowed a developer to determine gain or loss from the sale of homes by adding:

   a. the actual cost or other basis of property sold; and

   b. the estimated costs of future improvements to such property that the developer is contractually obligated to make (including only those items the cost of which is not properly recoverable through depreciation).

2. An administratively burdensome procedure. In order to use Rev. Proc. 75-25, a taxpayer was required to fulfill a number of requirements (e.g., provide copies of contracts, timetables, descriptions, etc. to the District Director, extension of statute of limitation, etc.).

C. The 461(h) problem. §3 of Rev. Proc. 92-29 sets out the IRS thinking on the economic performance "problem" pertaining to common improvement costs:

The enactment of §461(h) of the Code changed the

time for adding common improvements to the basis of property. In general, under §461, common improvement costs may not be added to the basis of benefitted properties until the common improvement costs are incurred with in the meaning of §461(h). Common improvement costs that have not been incurred under §461(h) when benefitted properties are sold may not be included in the basis of the properties in determining the gain or loss resulting from the sale.

D. Allocation of Common Improvements as Limited by Economic Performance

1. Under Rev. Proc. 92-29, estimated costs of common improvements may be included in the basis of property sold, if the taxpayer so elects. However, the total amount of common improvement costs included in the basis of (or otherwise taken into account with respect to) the properties sold may not exceed the amount of common improvement costs that have been incurred to date under §461(h) of the Code. Rev. Proc. 92-29 refers to this limitation as the "alternative cost limitation".

   Example: During the first taxable year of a project, C sells 10 out of 50 lots in its new development (i.e., 20% sold). C estimates the total common improvement costs for the project will be $500,000 and these costs will be incurred over seven years. Through the end of the first year, C actually incurs $75,000.

   Under Rev. Proc. 75-25, C would have added $100,000 ($500,000 x 20%) to the basis of the lots sold in the first year.

   Using the alternative cost method under Rev. Proc. 92-29, C would add $75,000 to the basis of the lots sold. The allocable costs are determined in a manner similar to the calculation under Rev. Proc. 75-25 but are limited to the costs incurred under §461(h) through the end of the year (the alternative cost limitation). ($500,000 x 20%; limited to costs incurred of $75,000.)

2. Common improvement costs incurred within the meaning of 461(h) in subsequent taxable years are taken into account in the year incurred where the alternative cost limitation precludes a developer from including the entire allocable share of the

estimated cost of common improvements in the basis of the properties sold.

Example: Assume the same facts as the example above; In the second taxable year of the project, C incurs an additional $50,000 of common improvement costs, but sells no lots. Rev. Proc. 92-29 allows a $25,000 deduction despite the fact no lots were sold. The alternative cost limitation prevented a developer from including the entire allocable share of estimated costs in the basis of the 10 lots sold in Year 1, but these costs are "carried over" and taken into account in Year 2.

3. Taxpayers failing to elect the "alternative cost limitation" may not add the costs of future improvements to the basis of benefitted properties until the costs are incurred within the meaning of §461(h).

   Example: Assume the same facts as the example above. In year 1, C would only be able to add $15,000 to the basis of the lots sold ($75,000 x 20%) using the 461(h) rules. In year 2, the economic performance regulations would allow a $10,000 ($50,000 x 20%) deduction in Year 2 because of the additional basis created and allocated to the properties sold. Thus, under the economic performance rules total costs allocated would be $25,000 (($75,000 + $50,000) x 20%). In comparison, the amount of basis allocated to the properties through Year 2 would total $100,000 under both Rev. Proc. 75-25 and Rev. Proc. 92-29.

E. <u>Common Improvements Treated as Incurred Under the Alternative Cost Limitation</u>

1. Common improvements are defined as:

   > any real property or improvements to real property that benefit two or more properties that are separately held for sale by a developer.

2. The developer must be obligated to provide the common improvements by either:

   a. a contractual obligation; or

   b. by law.

3. Costs properly recoverable through depreciation by the developer are excluded from common improvement costs.

4. Costs incurred outside the "ten-taxable year horizon" are generally excluded from common improvement costs.

5. Common improvements are determined and allocated on a project-by-project basis. A developer may use any reasonable method to define a project. Thus, for example, it may be possible to define phases of a development as separate projects and allocate common improvements that will be completed during the first phase (such as a swimming pool and clubhouse) to the lots to be sold in that phase.

F. Method of Electing the "Alternative Cost Limitation"

1. Requests pursuant to Rev. Proc. 92-29 must include certain enumerated information including:

   a. A description of the project;

   b. A schedule detailing the basis of property sold;

   c. A schedule describing the common improvements and estimating the costs thereof; and

   d. A perjury statement pertaining to the estimates of common improvement costs.

   [See Exhibit II]

2. Requests pursuant to Rev. Proc. 92-29 must be filed on or before the due date (including extensions) of the developer's tax return for the first year in which a property benefitted by the allocation is sold:

   a. with the District Director; and

   b. with the developer's original, timely-filed income tax return.

   Permission to use the alternative costs allocation method is automatic.

G. Additional Alternative Cost Method Requirements

1. The developer must consent to extent the statute of limitations on assessments of income tax with respect to the use of the "alternative cost limitation" until one year after the return is filed for the year of completion of the project.

2. A statement highlighting the date of expiration of the period of limitations (as extended) and detailing common improvement and lot basis information (and certain other specified information) must be filed annually:

   a. with the District Director; and

   b. with the developer's original, timely-filed income tax return.

   [See Exhibit III]

VI. <u>REAL ESTATE TAXES</u>

A. <u>Cash Method Requirement</u> Except for taxpayers who have made a valid election under 461(c) (discussed below) taxes are to be deducted on a paid basis. Therefore, taxpayers can not use the lien date method. (Treas. Reg. §1.461-4(g)(6))

B. <u>Alternatives</u>

1. The recurring item exception is available with respect to taxes. In many cases the result using the recurring item exception will be the same as that obtained under the lien date method and ratable accrual method.

   For example, assume Corporation X, an accrual basis calendar year taxpayer owns real property in state Y. The lien attaches to the property on December 1, 1992 for the tax year covering January 1 to December 31, 1992. Payments for this year are due on March 15, 1993, and June 30, 1993. The taxpayer will file its 1992 federal income tax return on September 15, 1993. Using the recurring item exception the taxpayer would still be able to deduct the taxes in 1992. The liability becomes fixed and determinable at the time of the lien. Under the recurring item exception economic performance is deemed to occur since payments occur in the appropriate interval (i.e., within 8½ months after the end of the year and before the filing of the return).

2. Consider electing the ratable accrual method. The ratable accrual method provides a statutory exception to the payment rule for taxes. Under the ratable accrual method real property taxes are deductible ratably over the period covered by the tax. (§ 461(c)) Note: This election is available only for real property. It does not apply to personal property.

3. Note: The method selected must be used for all taxing jurisdictions in a taxpayer's particular trade or business. A taxpayer can use a different method for different trades or businesses.

C. Electing the Ratable Accrual Method

1. Automatic Adoption -- Rev. Proc. 92-28 allowed taxpayers to automatically adopt or change from the ratable accrual method for the first tax year beginning after December 31, 1989, 1990 or 1991.

    a. A taxpayer who qualified was permitted to make or revoke the election in accordance with Rev. Proc. 92-28 by attaching a statement to its timely filed original return for the year of change (including extensions) or an amended return for that year. A Form 3115 was not required. However, Rev. Proc. 92-28 required that the return be filed on or before October 6, 1992.

    b. Rev. Proc. 92-28 is not available for taxpayers with the following status as of April 9, 1992:

        (1) those whose method of accounting is a pending issue (as expressed in written notification from the IRS proposing an adjustment);

        (2) those who have been contacted by the IRS for examination or are undergoing an examination;

        (3) those whose case is under consideration by the Appeals office of the IRS; or

        (4) those who are before any federal court with respect to an income tax issue.

2. If Rev. Proc. 92-28 is not available, advance permission is required:

a. To make the election, file a statement requesting permission within the first 90 days of the taxable year of change with the Commissioner. See Treas. Reg. §1.461-1(c)(3)(ii) for information to be included in the statement. Note: Rev. Proc. 83-77, provides a procedure whereby a taxpayer may automatically obtain a 90 day extension of the time in which to file the request, which results in a total election period of 180 days.

b. To revoke a §461(c) election, a taxpayer must file a Form 3115 with the IRS within 180 days after the beginning of the taxable year for which the revocation is to be effective. (Rev. Proc. 92-28).

VII. SETTLEMENT FUNDS AND ECONOMIC PERFORMANCE

A. Background. Two provisions in the code, §468B and §461(f), provide ways in which taxpayers can make payments and obtain a current deduction for a liability even though the funds will not be paid over to the person to whom the liability is owed until some point in the future. EPA and contested liabilities often involve the use of funds that raise these issues.

B. Designated Settlement Funds (§468B)

1. Where a taxpayer elects, a fund established by a court order which extinguishes completely the taxpayer's tort liability for claims arising from personal injury, death or property damage may be treated as a designated settlement fund. (§468B(d)(2)).

   The fund must be administered by persons a majority of whom are independent from the taxpayer. The taxpayer may not hold any interest in the fund and the taxpayer's may not recover any portion of its contributions to the fund. These funds are often used to settle Superfund, state environmental issues, etc.

2. Taxation of the fund. The rate of tax on earnings of the fund is equal to that imposed on trusts and estates. Transfers to the funds are exempt from income. (§468B(b))

3. Arbitrage. Because the rate of tax is lower than the corporate rate (31% v. 34%) and because the

taxpayer gets a deduction currently but the entire payment can be invested, positive cash flow can be achieved.

C. Section 461(f) Funds For Contested Liabilities -- A deduction is allowed in the year of transfer provided:

1. the taxpayer contests an asserted liability;

2. the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability;

3. the contest with respect to the asserted liability exists after the time of transfer, and;

4. but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of transfer (or for an earlier taxable year determined after application of the economic performance rules of §461(h)). (§461(f)(1) to (4)).

5. Transfer must be beyond the taxpayer's control.

   a. Claimant must be a party to the fund agreement:

      "If the claimants are aware of the trust arrangement, as they are required to be under the Regulation, they can ensure that its assets remain beyond the taxpayer's control. While it is true that the trustee has an independent duty to safeguard trust property, only the person asserting the liability is likely to be zealous in objecting to a breach of that duty. In a trust... where claimants were never aware of its existence, this important prophylactic measure was lost." Poirier & McLane Corp. (76-2 USTC ¶9793). Note: The Regulations at 1.461-2(c)(1) require a written agreement among the trustee, the taxpayer and the person asserting the liability.

   b. Claimant does not actually have to sign the agreement to be a party to it.

      In Chem Aero, Inc. (82-2 USTC ¶9712) the 9th Circuit Court of Appeals held that the claimant does not have to sign the agreement establishing the fund. In this case the

taxpayer was required to post a "bond" for a judgement it was appealing. It was held that the taxpayer had met the requirement of the Regulations, in that the claimant had implied assent because the claimant had both a judgement against the taxpayer and a fully collateralized bond.

LIFO AND BARGAIN PURCHASES OF ASSETS
IMPACT OF HAMILTON INDUSTRIES

I. BACKGROUND - Historically, it has been a common practice to adopt LIFO whenever a company acquires the assets, including inventories, of a business at a bargain price and values those inventories at less than their replacement/reproduction cost for tax purposes. The use of LIFO - including the adoption of certain advantageous submethods such as the natural business unit (NBU) method of pooling, link-chain indexing and valuing increments at the cost of earliest purchases or production - has been viewed as a means of indefinitely deferring recognition of the inventory discount as taxable income.

II. In Hamilton Industries v. Commissioner, 97 TC No. 9, 7/30/91, the Tax Court dealt a severe blow to the use of LIFO for bargain-purchased inventories:

A. The Tax Court held that the inventory items acquired in the acquisition were not the same "items" as the raw materials purchased and finished goods produced after the acquisition for purposes of the dollar-value double-extensions.

1. The Court reached this conclusion notwithstanding the fact that there were no physical differences between the bargain "items" and the later purchased or manufactured "items.

2. The Court concluded that the large bargain element assigned to inventory (the discount) resulted in those inventories having materially different cost characteristics than the subsequently produced or acquired inventories. These differences lead the Court to the conclusion that separate "item" treatment was appropriate for the exact same physical goods.

3. The Court also held that the change in "item" definition was a change in method of accounting (rather than the correction of an error) and that a §481(a) adjustment to require recognition of the income was appropriate.

4. The Court also reasoned that taxpayers should be required to recognize the gain inherent in the inventory discount at the time the gain is realized in order to clearly reflect income.

B. Taxpayers now must realize that _any_ bargain purchase is open to scrutiny without regard to how long ago or under what circumstance it may have occurred. The benefits of adopting LIFO will be at risk _currently_ despite the fact that the year of acquisition closed many years ago.

C. Implications:

   1. Change voluntarily -- May obtain a more favorable year of change (current or subsequent year); while recognizing that this change may not be reversed if an appeal of _Hamilton Industries_ overturns the Tax Court.

   2. Avoid Changing and Risk IRS examination?

EXHIBIT I

REV. PROC. 92-20
Year of Change and Spread Periods

	Adjust. + / -	Year of Change	481(a) Adjustment Period
Category A Methods Treated as Not under examination*	Positive	Current Year	Maximum of 3 Years
	Negative	Current Year	1 Year (Year of Change)
90-Day Window (Taxpayer under Examination)	Positive	Earliest Year Under Exam	Maximum of 3 Years
	Negative **	Current Year	1 Year (Year of Change)
Category B Methods Treated as Not Under Examination*	Positive	Current Year	Maximum of 6 Years
	Negative	Current Year	Maximum of 6 Years
90-Day Window (Taxpayer under Examination)	Positive	Current Year	1 Year (Year of Change)
	Negative **	Current Year	Maximum of 6 Years
Changes Within the LIFO Method Treated as Not under Examination*	Positive	Current Year	Not applicable, except as otherwise published
	Negative	Current Year	Not applicable, except as otherwise published
90-Day Window (Taxpayer under Examination)	Positive	Earliest Year Under Exam	Maximum of 6 Years***
	Negative **	Current Year	Not applicable, except as otherwise published

EXHIBIT I

REV. PROC. 92-20
Year of Change and Spread Periods

* This includes taxpayers not under examination, as well as taxpayers filing under the 120-day window, the 30-day window, or the 90-day post-affiliation window, and taxpayers that receive the consent of the district director to file.

** The taxpayer is treated as not under examination because it is not appropriate (according to the IRS) to provide terms and conditions more favorable than if the taxpayer had not been contacted for examination.

*** Generally, a modified §481(a) adjustment is computed using only the prior ten taxable years.

Alternative Cost Limitation
Information Needed on Initial Request

- The developer's name, address, telephone number, and taxpayer identification number.

- The IRS Service Center where the federal income tax return is filed.

- A description of the project covered by the request which includes details of location of the property including the state, county, town, plat map number and, if appropriate, the subdivision name and lot numbers.

- A schedule which includes:

  - The cost or other basis of the entire tract(s) of land included in the project and a description of how the cost or other basis was determined.

  - A listing of lots by subdivision covered by the request.

  - The portion of the cost or other basis of the tract(s) of land allocable to each lot and a description of how the costs were allocated.

  - If the request is not for lots (e.g., a condo in a high rise development), the portion of the cost or other basis of the tract(s) of land allocable to each property and a description of how the costs were allocated.

- A second schedule which includes:

  - A description of each common improvement required to be made by contract or by law.

  - The person(s) to whom the developer is contractually obligated or legally required to provide the common improvements.

  - A description of the documents evidencing the contractual or legal obligation and a description of the obligation contained in the document.

  - The estimated cost of each of the common improvements and the manner in which the estimate was made.

  - The portion of the estimated cost of common improvements

allocable to each lot and a description of the manner in which the estimated cost was allocated.

- If lots are not involved, a description of the allocation and manner of allocation to each property.
- The estimated dates of when construction of the common improvements will begin and when it will be completed.

- The request must be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this request, including the accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling are true, correct and complete.

This declaration must be signed by an officer of the corporation, general partner of a partnership, or trustee of a trust.

Alternative Cost Limitation
Information Required on Annual Statement

- The developer's name, address, telephone number and taxpayer identification number.
- The IRS Service Center where the federal income tax return is filed.
- The internal revenue district in which the request to use the alternative cost method was filed.
- The date of expiration of the statute of limitations as consented to on Form 921 or Form 921A.
- A description of the project covered by the request which includes details of location of the property including the state, county, town, plat map number and, if appropriate, the subdivision name and lot numbers.
- A schedule with the following information:
    - o An updated estimate of the cost of each common improvement.
    - o The portion of the estimated cost of common improvements allocable to each lot (or other property) and a summary of the manner in which the estimated cost was allocated.
    - o The lots (or other properties) sold at the end of the immediately preceding taxable year.
    - o The common improvement costs incurred, within the meaning of section 461(h), as of the end of the immediately preceding taxable year.
    - o The common improvement costs included in the basis of (or otherwise taken into account with respect to) lots (or other properties) sold as of the end of the immediately preceding taxable year.
    - o The lots (or other properties) sold during the year.
    - o The common improvement costs incurred, within the meaning of section 461(h), during the taxable year.
    - o The common improvement costs included in the basis of (or otherwise taken into account with respect to) the lots (or other properties) sold during the taxable year.