2011

Accounting Methods

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Accounting Methods

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Agenda

Session	Time
Accounting Methods - General Concepts	5 mins
Accounting Methods – Timing of Deductions	35 mins
Accounting Methods – Income Deferral	15 mins
Questions	5 mins

Goals

- Understand what is an "accounting method"
- Understand formal procedures to implement a change in method (automatic versus non-automatic)
- Understand the following concepts: "All-Events Tests", Economic Performance and Recurring Item Exception
- Ability to identify and implement certain automatic accounting method changes (Rev. Proc. 2008-52, as modified by 2011-14)

Accounting Methods

- In general, an accounting method has two characteristics:
  - Timing
    - Most important characteristic of an accounting method
    - Determines year in which income or expense is reported
    - If change in practice does not affect timing , it is not an accounting method and, generally, IRS prior approval is not required to change the practice (Reg. 1.461-1(e)(2)(i)).
  - Consistency - allows for certainty and predictability
    - Varies depending upon whether an accounting method is proper or erroneous.

What is a Method?

- "Accounting Method" generally refers to the treatment of an item for the purpose of determining the timing of revenue or deduction
  - Three Considerations
    - Has a method been adopted?
    - Is there a more optimal method?
    - How does the taxpayer implement the change?
- Change in Method of Accounting includes:
  - Change in overall method (e.g., cash to accrual)
  - Change in method for any specific item(s)

What is a Method?

- U.S. taxpayer is considered to have adopted an accounting method if:
  - Proper method used in a single return; or
  - Erroneous method consistently used in at least two consecutive returns (Rev. Rul. 90-38).
  - Each "item"; within each trade or business (§446(d)); within each legal entity (§1.1502-17).
- Foreign taxpayer adopts a new method the first taxable year in which the method is "significant" for E&P purposes (Treas. Reg. §1.964-1).

NOTE: A correction of an error, change in fact or change in character is NOT a change in method.

Accounting Method Change Procedures

- Why file a request for change in method?
  - For favorable changes, could lose benefit of unauthorized change on exam
  - For unfavorable changes, risk of IRS-initiated change on exam with less favorable terms and conditions (Rev. Proc. 2002-18)
    - Change effected in the earliest open year
    - No spread of section 481(a) adjustment
    - Exam agent determines new method (likely the least favorable method for taxpayer if there are multiple permissible methods)

Accounting Method Change Procedures

- Schedule B to Form 1120 requires disclosure of whether the taxpayer has made a change in method of accounting for book and/or tax purposes (even if change was made without a Form 3115)

Accounting Method Change Procedures (cont.)

- How is a method change implemented?
  - Guidance for changing a method of accounting
    - Rev. Proc. 97-27 – non-automatic method changes
    - Rev. Proc. 2008-52 – automatic method changes
  - Four determinations required for voluntary changes
    - Automatic or Non-automatic
    - 481(a) adjustment vs. Cut-off
    - If 481(a) adjustment, positive vs. negative
    - Examination status

Note: Rev. Proc. 2011-14 makes substantial revisions and must be read in conjunction with Rev. Proc. 2008-52

Implementing a Method Change: Automatic vs. Non-Automatic

	Rev. Proc. 97-27 (Non-Automatic)	Rev. Proc. 2008-52 (Automatic)
Due date	Last day of taxable year	With original, timely filed tax return
IRS filing fee	$4,200 (plus $150 for each additional legal entity)	None
Where to file	File with IRS National Office*	Original with tax return; duplicate with IRS National Office*
481(a) spread for adjustment	Favorable: 1 Year Unfavorable 4 Years	
Taxpayer under exam	Obtain director consent unless filing during a window period: • First 90 days of taxable year if under continuous exam for at least 12 months • 120 days after an examination ends	

***Triplicate filing required for certain method changes**

How Do You Determine If a Method Change is Automatic?

- Rev. Proc. 2008-52 contains a list of automatic changes (but see Rev. Proc. 2011-14 for certain modifications to Rev. Proc. 2008-52).

- Check Rev. Proc. 2011-1 for a list of automatic method changes that require a Form 3115 but are made outside of the provisions of Rev. Proc. 2008-52.

Special Considerations for Automatic Method Changes

- Ensure qualification under Rev. Proc. 2008-52 (as modified by Rev. Proc. 2011-14)
- 5-year rule
- Due date of Form 3115
- Triplicate filing requirement

Special Considerations for Non-Automatic Method Changes

- Follow procedures under Rev. Proc. 97-27
  - Non-automatic method changes receive significantly more scrutiny by IRS National Office
- Due date of Form 3115 – timely filed before taxpayer's fiscal year end for the change year.
- Pending Accounting Method Changes
  - Rev. Proc. 2011-1, Sec. 9.17, provides flexibility to taxpayers
  - Rev. Proc. 2007-67 allows taxpayers to formally request modification of original year of change
  - DH recommendation – extend tax return, if possible, to allow time for receipt of IRS approval.

Taxpayers Under Audit

- Generally, taxpayers under examination cannot file an accounting method change without:
  - obtaining consent from the Director of Field Operations, or
  - filing within a window period.
- Also:
  - The method cannot be an issue under consideration or placed in suspense if filing in a window period.
  - If an exception applies, generally required to send copy to revenue agent, appellate conferee, and/or district counsel (as appropriate)

Under Examination – Rev. Proc. 2011-14

- Rev. Proc. 2011-14 released January 10, 2011
  - Amplifies, clarifies, and modifies Rev. Proc. 2008-52 and Rev. Proc. 97-27
- Changes to the definition of "Under Examination"
  - A taxpayer is considered "under exam" if:
    - Under review by the Joint Committee on Taxation ("JCT"), or
    - Participates in the IRS Compliance Assurance Process ("CAP") program
  - Unclear when examination begins and ends for taxpayers under review at JCT or in CAP

Taxpayers Under Audit (cont.)

- Two window periods are available:
  - 120-day window - First 120 days following the date an examination ends, even if subsequent exam has begun.
  - 90-day window - First 90 days of taxable year for taxpayers under audit for at least 12 consecutive months as of the first day of the taxable year.
- Important to consider when filing a change where audit protection is desired (e.g., change creating a positive 481(a) adjustment).

Taxpayers Under Audit (cont.)

- Director of Field Operations Consent
  - May file outside of a window period if obtain Director of Field Operations consent
  - Send letter to the Director of Field Operations requesting consent on or before the Form 3115 is filed. If consent is received before filing, attach the consent to the Form 3115. If consent is received after, send consent to the IRS National Office
  - Director will consent if the method of accounting to be changed would ordinarily not be included as an item of adjustment in the year(s) for which the taxpayer is under exam (i.e., negative (taxpayer favorable) 481(a) adjustments)

New Rules for Method Changes – Rev. Proc. 2011-14

- Effective Dates for Rev. Proc. 2011-14
  - Automatic
    - Effective for applications filed on or after January 10, 2011, for a year of change ending on or after April 30, 2010
  - Non-automatic
    - Effective for applications filed on or after January 10, 2011, for a year of change ending on or after January 10, 2011

Accounting Method Change Procedures (cont.)

- Involuntary Method Changes
  - Initiated by IRS on exam
  - Usual terms and conditions (Rev. Proc. 2002-18)
    - Year of change – earliest open year
    - No spread of section 481(a) adjustment

The "All-Events Test" and an Introduction to Accounting Methods

(Rev. Proc. 2008-52, Appendix 19*)

* As modified by Rev. Proc. 2011-14

Timing of Deductions
The "All-Events Test"

- Taxable Year of Deduction:
  - I.R.C. Section 461 - General rule for taxable year of deduction
  - Treas. Reg. Section 1.461-1(a)(2)(i) states: "Under an accrual method of accounting, a liability is incurred and generally taken into account in the taxable year in which all events have occurred that establish:
    1. the fact of the liability (e.g., "Fixed" liability),
    2. the amount can be determined with reasonable accuracy, and
    3. <u>economic performance has occurred with respect to the liability</u>."

Please Note: Economic Performance was added in 1984

Timing of Income and Deductions – The "All-Events Test"

- Deduction (Prong One): The fact of the liability must be fixed
  - The operative facts are those that make it clear that the taxpayer has incurred an obligation to pay money, render services, deliver property, or take some other action; which, although not yet fulfilled, is nevertheless fixed.
  - Contingent liabilities - generally do not meet the all events test. Must determine whether the contingency is either :
    - Condition Precedent
    - Condition Subsequent

Timing of Income and Deductions – The "All-Events Test"

- Deduction (Prong Two): Determination of Amount
  - Treas. Reg. Section 1.461-1(a)(2)(ii) – If the entire amount of a liability is not known, you can deduct the amount that is determined with "reasonably" accuracy (but does not need to be exact).
  - Generally, determinations of liability based on industry wide experience or the experience of the taxpayer have been accepted by the courts as reasonable.

Timing of Income and Deductions – The "All-Events Test"

- Deduction (Prong Three): Economic Performance
  - I.R.C. Section 461(h) states: "... the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs."
  - General Rule: Where a taxpayer's obligation consists of promising to pay for services or property provided to the taxpayer or providing services or property to another, economic performance occurs only as these services are provided.
    - Economic Performance Documentation Best Practice:
      - Reduce the contract to writing to establish proof of compliance (NOTE: Mere execution of contract does not establish fact of liability – Rev. Rul. 2007-3).

Timing of Deductions
The "All-Events Test" (cont.)

- Also may need to satisfy other requirements for the liability to be deductible, including for example:
  - Not a capital item under sections 263(a) or 263A
  - Not deferred compensation under section 404, and
  - Not subject to section 267 (related party rules).
- Relevant authority
  - United States. v. Hughes Properties, Inc.
  - United States v. General Dynamics Corp. (481 U.S. 239 (1987))
  - Rev. Rul. 98-39

Economic Performance

- General rules for economic performance:
  - **Services or property provided to the taxpayer: as services or goods are provided (e.g., service contract for advertising)**
  - **Exception for goods or services provided to the taxpayer: Economic performance occurs at payment if services/goods are reasonably expected to be provided within 3 ½ months of payment**
  - Use of property: over period to be used, (e.g., licenses)
  - Services/property provided by company: as costs incurred to satisfy liability, (e.g., remediation)
  - **Payment (for certain specified liabilities)**

Economic Performance

- For certain liabilities, payment is economic performance (Reg. 1.461-(g)(2)-(7))
  - Worker's compensation claims, tort, breach of contract, or violation of law (g)(2)
  - Rebates and refunds (g)(3)
  - Awards, prizes and jackpots (g)(4)
  - Insurance, warranty and service contracts (g)(5)
  - Taxes and license fees (g)(6)
  - Other liabilities not classified elsewhere (g)(7)
- "Recurring Item Exception" may apply to items (g)(3)-(g)(6) per Reg. 1.461-5.

Prepaid Payment Liabilities

What taxpayers generally do:

- Follow book method and capitalize and amortize prepaid payment liabilities over the period to which such expenses relate

Optimal method:

- Deduct prepaid payment liabilities that are incurred with useful life of 12 months or less

How to recognize:

- Prepaids on balance sheet (e.g., insurance, warranties, software maintenance contracts, licenses, fees, permits, etc.)
- No deferred tax liability
- No book-tax difference

Note: Prepaid goods or services also may be deducted when incurred if reasonably expect to receive goods or services within 3 ½ months of payment (non-automatic method change).

Bad Debts

What taxpayers generally do:

- Deduct when uncollectible receivables are removed from the balance sheet

Optimal method:

- Deduct when bad debt is wholly worthless, or partially worthless and specifically reserved

How to recognize:

- Bad debt allowance on the balance sheet
- Deferred tax asset
- Book-tax difference based on change in account balance

Accrued Compensation

What taxpayers generally do:	• Deduct when paid
Optimal method:	• Deduct in the year the compensation liability is incurred to the extent paid within 2 ½ months after year end
How to recognize:	• Accrued compensation on balance sheet • Deferred tax asset • Book-tax difference based on change in account balance

Examples: bonus pay, vacation pay, severance, commissions

Accrued Service Liabilities

What taxpayers generally do:

- Deduct when paid

Optimal method:

- Deduct when services are provided

How to recognize:

- Accrued expenses on the balance sheet
- Deferred tax asset
- Book-tax difference based on change in account balance

Examples: Co-op advertising, professional fees (legal, accounting, consulting, etc.)

Recurring Item Exception

- I.R.C. Section 461(h)(3) – Recurring Item Exception
- Economic performance is deemed satisfied if recurring item exception applies. This exception applies if:
  - All events have occurred as of the end of the taxable year,
  - Amount can be determined with reasonable accuracy,
  - EP occurs within the shorter of when return is filed (including extensions) or within 8 ½ months after close of year;
  - Liability is recurring in nature, and
  - Either the amount is not material or results in better matching with income to which it relates.

Recurring Item Exception

- Recurring Item Exception Does Not Apply to (See Reg. 1.461-5(c)):
  - Interest
  - Workers compensation, tort, breach of contract, and violation of law
  - Other liabilities not classified elsewhere

Recurring Item Exception

- Classic Recurring Item Exception Items – payment liabilities
  - Rebates/returns*
  - Property tax deductions*
  - Payroll Taxes (FICA, FUTA, SUTA, Railroad Retirement Taxes)*

* The "more proper matching" principle is automatically treated as satisfied for those liabilities listed in Reg. §1-461-4(g)(3)-(6))

Recurring Item Exception

- Items often erroneously accounted for under the recurring item exception
  - IBNR medical claims (economic performance occurs as services are provided)
  - Items for which all-events test not met (e.g., reserves, miscellaneous accrued liabilities)

Self-Insured Medical IBNR Accruals

What taxpayers generally do:

- Deduct self-insured medical incurred but not yet reported ("IBNR") liability when paid

Optimal method:

- Deduct self-insured medical liabilities of active employees, retired employees and the medical portion of workers compensation in the year the services are provided*

How to implement:

- Automatic method change
- Unwind VEBA if applicable

How to recognize:

- Medical IBNR accrual on the balance sheet
- Deferred tax asset
- Book-tax difference based on change in account balance

* Rev. Proc. 2011-14 modifies the automatic change for IBNR medical expenses to explicitly include medical services provided to retirees and employees filing claims under a workers' compensation act or out of any tort, breach of contract, or violation of law.

Real and Personal Property Tax

What taxpayers generally do:

- Follow book method of accounting (ratable accrual)

Optimal method:

- Use "lien date" method with the recurring item exception, under which property taxes are accrued to the extent the liability is fixed by year end (the lien date has occurred), the amount is reasonably determinable, and is paid within 8 ½ months after year end, where preferable

How to recognize:

- Significant real and personal property tax liabilities in the following states: CA, AL, CT, ME, MD, NH, NJ, NV, VT, and WV or fiscal year taxpayer
- No book-tax difference/no deferred tax liability

Note: Rev. Proc. 2011-14 provides a new automatic change for taxpayers that want to change their method of accounting to revoke the ratable accrual election.

Payroll Tax Liabilities

What taxpayers generally do:

- Do not accrue payroll taxes on year-end accrued compensation (e.g., bonuses, vacation pay, severance) for financial statement purposes

Optimal method:

- Treat payroll tax liabilities as fixed and determinable in the same taxable year in which the related compensation is fixed and determinable, even though uncertainty may exist at the end of such year as to the amount of the final liability

How to recognize:

- Compensation accruals on the balance sheet
- No accrual of payroll taxes on certain year-end accrued compensation (e.g. bonus, vacation pay, severance) for financial statement purposes
- No book-tax difference/no deferred tax liability

Rebates and Returns

What taxpayers generally do:

- Deduct items such as volume rebates, customer incentives, and sales returns when paid

Optimal method:

- Apply the recurring item exception to the extent the liability is fixed and determinable at year end

How to implement:

- Automatic method change for rebates
- Non-automatic method change for returns

How to recognize:

- Accrued customer rebates/incentives, or accrued sales returns on the balance sheet
- Deferred tax asset
- Book-tax difference based on change in account balance

Income Deferral

Deferral Method for Certain Advance Payments

What taxpayers generally do:

- Recognize into taxable income amounts paid in advance for certain services, goods, and the use of intellectual property

Optimal method:

- Recognize into income only the amount applicable to the year of payment, deferring recognition of the remainder until the next taxable year

How to implement:

- Rev. Proc. 2004-34: Automatic method change #84*
- Treas. Reg. Section 1.451-5 – Non-automatic method change

How to recognize:

- Customer deposits and deferred revenue on balance sheet
- Deferred tax asset
- Book-tax difference

Deferral of Income – Long-Term Service Contracts

What taxpayers generally do:

- Recognize into taxable income amounts accrued on long-term service contracts following a percentage of completion method of accounting

Optimal method:

- Recognize into income only the amount required pursuant to the economic performance rules – i.e., completion of contract, payment is due, or payment is made

How to implement:

- Non-automatic method change

How to recognize:

- Accrued service contract receivables on balance sheet
- No deferred tax liability
- No book-tax difference

Advance Rentals

What taxpayers generally do:

- Recognize advance rental income based on the period to which it relates despite lack of payment

Optimal method:

- Recognize advance rental income in the year in which payment is received as provided by Treasury Reg. 1.61-8(b)

How to recognize:

- Rent receivables on balance sheet
- No deferred tax liability
- No book-tax difference

Nonaccrual-Experience Method (Sec. 448)

What taxpayers generally do:

- Include in income receivables earned through the performance of services in the year the receivable is generated, including the portion of such receivables that, based on the taxpayer's experience, will not be collected

Optimal method:

- Exclude from income the portion of the receivables that, based on the taxpayer's experience, will not be collected utilizing the nonaccrual-experience method. Five safe harbor methods available under Treasury Reg. 1.448-2(f)

How to recognize:

- Only applicable to taxpayers providing qualified services - health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting
- Discussion with client regarding collectability of receivables
- Bad debt reserve

Disputed Income

What taxpayers generally do:

- Recognize income although the right to receive the income is in dispute

Optimal method:

- Defer recognition of disputed income (and related COGS) under Rev. Rul. 2003-10

How to implement:

- Non-automatic method change

How to recognize:

- Contra-receivable on the balance sheet
- Deferred tax asset
- Book-tax difference based on change in contra receivable account (e.g., pricing reserve or bad debt allowance)

Multi-year Service Warranty Contracts

What taxpayers generally do:

- Recognize into income advance payments received on multi-year service warranty contracts

Optimal method:

- Recognize into income the advance payment received, increased by an imputed income amount, over the shorter of the life of the warranty or six years

How to recognize:

- Accrued warranty liability / deferred revenue on balance sheet
- Deferred tax asset
- Book-tax difference

Ratable Inclusion Method for Credit Card Annual Fees

What taxpayers generally do:

- Recognize into income credit card annual fees when amounts are posted to customer statements

Optimal method:

- Recognize into income the annual fees ratably over the period covered by the fees

How to recognize:

- Deferred revenue on balance sheet
- Deferred tax asset
- Book-tax difference

Credit Card Late Fees

What taxpayers generally do:

- Recognize into income credit card late fees when due and payable

Optimal method:

- Account for income from credit card late fees under a method that treats these fees as interest that creates or increases the amount of original issue discount ("OID") on the pool of credit card loans to which the fees relate

How to recognize:

- No balance sheet accounts
- Late fees in income statement
- No deferred tax liability
- No book-tax difference

Fixed Assets

Depreciation Methods and Deductibility of Repair and Remodeling Costs

(Rev. Proc. 2008-52, Appendix 3.06, 6.01, and 6.02)
(Rev. Proc. 2011-14)

Depreciation – Impermissible to Permissible

What taxpayers generally do:

- Assign the wrong class lives to assets or use the wrong methods/conventions, failing to take deductions as quickly as would otherwise be allowed. Fail to take bonus depreciation, even though not making a formal election out

Optimal method:

- Assign the correct class lives and use the correct methods/conventions, thereby recovering costs as quickly as possible.

How to recognize:

- Review fixed asset reports, paying close attention to assets with long lives
- Review Form 4562 for years in which bonus depreciation was available (no bonus depreciation during 2005, 2006, or 2007)

Repair and Remodeling Costs

What taxpayers generally do:

- Capitalize as depreciable assets amounts paid to refresh or renew their buildings or storefronts

Optimal method:

- Deduct amounts paid that do not substantially enhance or improve the asset being refreshed as repair and maintenance costs

How to recognize:

- Review fixed asset reports, paying close attention to assets with long lives that do not represent new construction

ACCOUNTING METHODS

QUESTIONS?