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Accounting Methods After the Tax Reform Act of 1986

Howard J. Busbee

ACCOUNTING METHODS
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by

Howard J. Busbee
Coopers & Lybrand, Atlanta, Georgia

I. Introduction

A. The new law repeals or modifies various accounting methods and periods in an effort to generate substantial tax revenue over four years.

B. The most important changes are:

1. Stricter capitalization rules for inventories, self-constructed assets and long-term contracts.
2. The repeal of the bad debt reserve method.
3. A reduction of benefits under the completed contract method.
4. Requiring a number of companies to change from the cash to accrual method.
5. Limitations on the use of the installment method.
6. Many special accounting methods become subject to the alternative minimum tax.

II. Accounting for Changes

A. Section 481 Adjustment

1. When an accounting method is changed, the new accounting method must be used from the first day of the year of change. This may cause items of income or expense to be duplicated or omitted from the computation of taxable income.
2. Section 481 of the Internal Revenue Code of 1954, as amended ("Code") prevents omission or duplication of income or expense items by requiring such items to be taken into account as an adjustment to income.
3. The Code Section 481 adjustment is computed as of the last day of the taxable year immediately preceding the year of change and represents the cumulative differences between the present and

proposed accounting method at that point in time.

B. Spread Period

1. The Code Section 481 adjustment resulting from a change in accounting method under the Tax Reform Act of 1986 will generally be included in income ratably over the lesser of four years or the number of years the specific method was used prior to the year of change.
2. Adjustments prior to the Tax Reform Act of 1986 are subject to a maximum six-year spread period.
3. Exceptions to the general four-year spread period exist where --

   a. a company is changing from an erroneous accounting method (classified as either Category A or Category B methods; see Appendices D and E),
   b. a company is voluntarily changing its method of accounting,
   c. a company is involuntarily changing its method of accounting, or
   d. a substantial portion of the Code Section 481 adjustment is attributable to any of the three years immediately preceding the year of change.

III. Limitations on Use of Cash Method of Accounting

A. Use of the cash method of accounting is prohibited for --

1. Corporations (except S corporations and professional service corporations) and partnerships with corporations as partners, if those businesses have average annual gross receipts over a three-year period of more than $5 million.

   a. personal service corporations include those corporations that perform services in the field of health, law, accounting, engineering, architecture, consulting, actuarial science and the performing arts.
   b. to qualify as a personal service corporation, 95% of the stock must be owned by shareholders who provide services in the required fields.
   c. certain farming businesses may continue to use the cash method of accounting.

2. Tax Shelters, as defined in Code Section 461(i).

B. Financial statement conformity is not required for those businesses still entitled to use the cash method of accounting.

C. The required cash to accrual method conversion will result in a Code Section 481 adjustment which may be spread over a period not greater than four years.

D. Companies required to change to the accrual method of accounting must do so in the first taxable year beginning after December 31, 1986.

E. Planning -- S corporation election may preserve the cash method (as well as secure lower individual tax rates and avoid corporate minimum tax).

IV. Taxable Years of Certain Entities

A. All partnerships, S corporations, personal service corporations and trusts are required to use the taxable year of the majority interest owners.

B. May use different taxable year if business purpose is established.

1. A natural business year will constitute a business purpose.
2. Automatic three-month or less income deferral is no longer a valid business purpose.

C. Partner or shareholder takes its share of any excess income for any short taxable year resulting from a required change in taxable year into account ratably over the first four taxable years after the change, including the taxable year in which the short taxable year ends (an election is available which would allow inclusion of all short taxable year income in current year's income).

D. Effective for taxable years beginning after December 31, 1986.

V. Installment Sales

A. Installment sale reporting is no longer available for --

1. Revolving credit plans, and

2. Publicly traded stock or securities

   a. effective for <u>sales</u> after December 31, 1986 for publicly traded property and for <u>taxable years</u> beginning after December 31, 1986 for revolving credit plans.
   b. adjustment for deferred income at December 31, 1986 may be spread over four years for revolving credit plans and five years for stock or securities.

B. Reduced installment sale benefits

   1. Proportionate disallowance rule

      a. benefits of installment sale reporting are reduced for sales of personal or real property by dealers and on casual sales of real property (if the selling price exceeds $150,000) used in trade or business or held for rental income.
      b. generally, benefits are reduced by treating a portion owed on applicable installment obligations as if paid by year-end.
      c. The amount of deemed payment (referred to as "allocable installment indebtedness" or AII) is determined using a formula. Appendix F shows the formula and an application of the formula.

   2. Effective dates

      a. dealers in real property -- sales after February 28, 1986; proportionate disallowance starts with the first taxable year ending after December 31, 1986; limited spread available to allocate increase in tax.
      b. dealers in personal property -- sales after February 28, 1986; proportionate disallowance starts with the first taxable year ending after December 31, 1986; limited spread available to allocate increase in tax.
      c. all others -- sales after August 16, 1986; proportionate disallowance starts with the first taxable year ending after December 31, 1986; no spread is available.

VI. <u>Capitalization Rules for Inventory, Construction and Development Costs</u>

   A. Establishment of uniform capitalization rules (patterned after present extended-period long-term contract rules) which would require capitalization of certain previously deductible period expenses.

1. Construction period interest and taxes must be capitalized and added to the depreciable basis of the property if the property --

   a. is real property or property with a class life of twenty years or more, or
   b. has an estimated construction period exceeding two years, or a construction period of one year and a cost exceeding $1 million.
   c. effective for cost and interest paid after December 31, 1986 with respect to assets where construction began after February 28, 1986.

2. Inventories of manufacturers

   a. modification of full-absorption method

      i. under present law, a manufacturer must capitalize as inventoriable costs both direct and indirect production costs. Indirect costs are divided into three categories for this purpose:

         a. category 1 costs must be included in inventory costs
         b. category 2 costs may be deducted currently
         c. category 3 costs must normally be included in inventory only if they are included for financial statement purposes

      ii. the new law requires stricter capitalization rules, as follows:

         a. additional category 2 costs must be capitalized
         b. most category 3 costs must be capitalized regardless of their financial statement treatment
         c. manufacturers using the LIFO method must recompute their inventory for all years LIFO was used (or preceding three years if not able to recompute for all years) to conform to the modified full-absorption method

   b. manufacturers are required to treat the change in the law as a voluntary change in accounting method for the first taxable year beginning after December 31, 1986.

c. For examples and further explanation, see Appendices A, B and C.

3. Inventories of wholesalers and retailers

   a. in addition to the capitalization of transportation costs incurred in acquiring possession of goods, wholesalers and retailers with average annual gross receipts over $10 million for the preceding three years must capitalize additional costs, including

      i. off-site storage and warehousing costs
      ii. purchasing costs
      iii. handling, processing, repackaging, assembly and similar costs, loading and unloading labor costs, and
      iv. the portion of general and administrative costs allocable to these functions

   b. cost identification for the purposes of these new capitalization rules can be done through the use of a burden rate, or an optional simplified method to be developed by the Treasury Department.

   c. the inventory change is regarded as a voluntary change in accounting method, and the resulting Code Section 481 adjustment is to be included in income over a period not exceeding four years.

   d. effective for taxable years beginning after December 31, 1986.

4. Self-constructed property (noninventory property and self-use property) would be subject to uniform capitalization rules.

VII. Long-Term Contracts

A. Effective for contracts entered into after February 28, 1986, companies (except certain small contractors) must use one of two special methods to account for their long-term contracts.

   1. Modified percentage of completion method

      a. income inclusion is based on the percentage of work completed during a given year, determined using an architect's or engineer's report.

b. the amount included in income during the current taxable year will be determined by multiplying the total contract price by a ratio of contract costs incurred during the year over total estimated contract costs.
c. at contract completion, if the actual total contract costs do not equal the estimated total contract costs (as used to compute income inclusion in each year), interest will be paid on any income inclusion deficiencies or income inclusion overages. The rate paid by the IRS will be 1% less than the rate charged to taxpayers.

2. "40-60" method

a. forty percent of the contract is accounted for under the modified percentage of completion method.
b. Sixty percent of the contract is accounted for under some other permissable method (including the cash, accrual or completed contract method).
c. the interest "lookback" rule applies to forty percent of the contract accounted for under the modified percentage of completion method.

B. Exception: the present completed contract method may be used by small contractors who --

1. expect to complete the construction contract within two years, and
2. have three-year average annual gross receipts of $10 million or less.

VIII. Bad Debt Reserves

A. Except for banks with gross assets of $5 million or less and thrift institutions, the reserve method for bad debts is repealed.

B. Effect of repeal

1. the specific charge-off method will be required to be used for tax purposes.
2. bad debt deductions will be limited to actual loan losses, but wholly worthless debt need not be charged-off against bad debt reserve for financial statement purposes to be deductible.
3. existing bad debt reserves must be taken into income

over four years (regardless of the length of reserve method use) --

   a. ratably, or
   b. for banks, in the following percentages over four years, respectively -- 10%, 20%, 30% and 40%.

4. Effective for taxable years beginning after December 31, 1986.

IX. Simplified Dollar-Value LIFO

A. Under present law, small businesses with three year average annual gross receipts of $2 million or less may elect to use a single LIFO inventory pool with yearly indexes computed for each inventory item using its own data.

B. Under the new law, small businesses with three-year average annual gross receipts of $5 million or less may elect to use a separate pool for each major category of inventory items using a single published government price index for valuing each pool.

   1. if elected, the new simplified LIFO method must be used for all LIFO inventories.
   2. the initial election does not require the consent of the Treasury Secretary, but may only be revoked with such consent.
   3. the taxpayer must change from the new simplified LIFO method to another method the first year it fails to meet the $5 million average annual gross receipts test.

C. Effective for taxable years beginning after December 31, 1986.

X. Miscellaneous Provisions

A. Accrued vacation pay

   1. the special election to accrue a deduction for vacation pay expected to be paid within a 12-month period after the end of the year has been amended so that taxpayers can only accrue for an 8 1/2-month period.
   2. the time for making the election beginning with the year that includes July 18, 1984 has been extended to a date six months after the enactment of the law.

3. any suspense account created as a result of making the election can be recovered over a period not exceeding six years, rather than being recovered only as the work force shrinks or the company liquidates.

B. Qualified discount coupons

1. the new law repeals the present law provision allowing accrual method taxpayers that issue discount coupons a current deduction for coupons that are actually redeemed within six months after the close of the tax year.
2. any resulting adjustment is spread over four years.

C. Unbilled public utility income

1. accrual method utilities are required to recognize income from utility services not later than the taxable year in which services are provided, regardless of the date of billing.
2. effective for taxable years beginning after December 31, 1986.

D. Contributions in aid of construction

1. the new law repeals the current law provision allowing contributions in aid of construction to be treated as a nontaxable contribution to capital.
2. effective for contributions received after December 31, 1986.

E. Discharge of indebtedness of solvent taxpayers

1. the present law election allowing solvent taxpayers a basis reduction in depreciable property rather than forcing recognition of income for discharges of indebtedness on qualified business indebtedness is repealed.
2. effective for discharges after December 31, 1986.

CHANGE IN TREATMENT OF INVENTORIABLE COSTS (Tax Year Ending December 31, 1987)

Facts: Company A, a manufacturer, has previously used an inventory method that requires less indirect production costs to be capitalized than will be required under the new law. Under its prior full absorption method, Company A will report inventory in the amount of $3,650,000 as of December 31, 1986. Under the new law's capitalization rules, Company A's December 31, 1986 inventory would be $4,100,000. Therefore, the adjustment* required to change to the new capitalization rules would be $450,000 ($4,100,000-$3,650,000) and represents an increase in income.

Computation of 1987 Income

Sales		$8,000,000
Inventory at beginning of year (additional capitalized costs of $450,000 included)	$4,100,000	
Product costs computed under new method	5,850,000	
	$9,950,000	
Inventory at end of year (additional capitalized cost of $500,000, included)	3,350,000	
Cost of goods sold		6,600,000
Gross profit		$1,400,000
Less deductions		850,000
Taxable income before adjustments		$ 550,000
"Agreed-to-adjustment"* to be taken over the adjustment period of 4 years (¼ x $450,000)		112,500
Taxable income for 1987		$ 662,500**

*Computed under §481(a)

**The change in treatment of inventory costs would increase 1987 taxable income by $162,500 ($112,500 adjustment, plus $500,000 additional costs deferred in ending inventory, less $450,000 additional costs included in beginning inventory).

Comparison of Treatment of Manufacturing Inventory Under Present Law and Under the Tax Reform Act of 1986

	Present Method	New Law*
Direct Material and Labor	Inventoriable	Inventoriable
Indirect Production Costs		
Category One Costs		
Repair, maintenance, utilities and rent	Inventoriable	Inventoriable
Indirect labor and supervisory wages	Inventoriable	Inventoriable
Indirect material and supplies	Inventoriable	Inventoriable
Tools and equipment	Inventoriable	Inventoriable
Quality control and inspection	Inventoriable	Inventoriable
Category Two Costs		
Marketing, advertising, distribution and selling	Expensed	Expensed
Interest	Expensed	Expensed
Research and experimental	Expensed	Expensed
Section 165 losses and income taxes on sales	Expensed	Expensed
Excess depletion	Expensed	Inventoriable
Excess depreciation	Expensed	Inventoriable
Past service cost of pension plans	Expensed	Expensed
Non-production general and administrative	Expensed	Expensed
Non-production officers' salaries	Expensed	Expensed
Category Three Costs**		
Taxes other than state and local income taxes	Optional	Inventoriable
Financial statement depreciation/depletion	Optional	Inventoriable
Strikes	Optional	Expensed
Rework labor, scrap and spoilage	Optional	Inventoriable
Factory administrative and employee benefits	Optional	Inventoriable
Production officers' salaries and insurance	Optional	Inventoriable
Bid costs		
• Awarded contracts	Optional***	Inventoriable
• Unawarded contracts	Optional***	Expensed
Intangible drilling cost	Optional***	Expensed
Mine and natural deposits development cost	Optional***	Expensed

* Effective for taxable years beginning after December 31, 1986.

** Presently inventoried or expensed depending on financial statement treatment.

*** Category Three Cost not listed in full absorption Regulations.

Illustration of Types of Activities Manufacturers Would Ordinarily Allocate to Inventory*

Types of Costs Ordinarily Allocated

- The administration and coordination of manufacturing or construction projects (wherever performed in the business organization)
- Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees whose labor cost is allocable to manufacturing operations
- Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery and return of materials and equipment to or from factories or jobsites, and expediting and follow-up
- Material handling and warehousing operations
- Accounting and data services operations related to contract activities, including cost accounting, accounts payable, disbursements, billing, accounts receivable and payroll
- Data processing
- Security services
- Legal departments that provide legal services to manufacturing operations

Types of Costs Not Ordinarily Allocated

- Functions responsible for overall management or for setting overall policy (such as the board of directors including their immediate staff) and the chief executive, financial, accounting and legal officers (including their immediate staffs), provided that no substantial part of the costs of such departments or functions directly benefits manufacturing operations
- General business planning
- Financial accounting (including the accounting services required to prepare consolidated reports, but not including any accounting for particular manufacturing operations)
- General financial planning (including general budgeting) and financial management (including bank relations and cash management)
- General economic analysis and forecasting
- Internal audit
- Shareholder, public and industrial relations
- Tax department
- Other departments or functions that are not responsible for day-to-day operations but are instead responsible for setting policy and establishing procedures to be used by all of the taxpayer's activities or trades or businesses (see §1.451-3(d)(9)(viii) for examples)

* Section 1.451-3(d)(9) of the Regulations

Category A Accounting Methods

Description	Comment
• Deducting a reserve for price changes or estimated depreciation from the value of inventory.	Prohibited by §1.471-2(f)(1)
• Taking work-in-process or other parts of inventory at a nominal price or less than its proper value.	Prohibited by §1.471-2(f)(2)
• Omitting portions of the inventory stock on hand.	Prohibited by §1.471-2(f)(3)
• Using a constant price or nominal value for so-called normal quantities of materials or goods in inventory.	Prohibited by §1.471-2(f)(4)
• Including inventory in transit, shipped either to or from the company, in inventory when title is not vested in the company.	Prohibited by §1.471-2(f)(5)
• Treating only variable indirect production costs as inventoriable costs, while treating fixed indirect production costs as period costs (direct cost method).	Prohibited by §1.471-2(f)(6)
• Treating all or substantially all indirect production costs as period costs that are currently deductible (prime cost method).	Prohibited by §1.471-(2)(f)(7)
• Inventory write-downs that do not comply with §1.471-2(c).	For example, goods are written down without being sold or offered for sale.
• Inventory write-downs that do not comply with §1.471-4(b).	No open market or inactive market.
• Write-down of what is regarded as "excess" inventory to a net realizable value although such inventory has not been scrapped, sold or offered for sale at the reduced price.	***Thor Power Tool Co. v. Comm.***, 439 U.S. 522 (1979) and §1.471-4(b).
• In the absence of a specific statutory or regulatory exception, the use of the cash method for the sale of merchandise when such merchandise is an income-producing factor.	Prohibited by §1.446-1(c)(2).
• Use of a long-term contract method of accounting for income from contracts that clearly do not involve building, installation, construction, or manufacturing.	See Rev. Rul. 82-32 regarding industrial and commercial painting services. However, see Rev. Rul. 82-134 which holds that the use of the completed contract method by an engineering and construction management firm is a Category B method.
• Use by a manufacturer of an inventory method not conforming to the requirements of Regs. §1.471-11.	Full absorption inventory method.
• Use of a method of accounting other than that prescribed by Code §447 by a farming corporation subject to that Section.	Section 447 requires certain farming corporations to use the accrual method and to capitalize certain preproduction period expenses.
• In a tax year beginning after September 18, 1979, use of a method under Regs. §1.163-4(a) which provides for the deduction of interest as original issue discount with respect to obligations with a term of one-year or less.	
• Use of the LIFO inventory method when there has been a terminating event (as described in Rev. Proc. 79-23 or any other applicable revenue ruling or revenue procedure) that occurred in a year not barred by the statute of limitations as of the date of the filing of the application for change in accounting method.	Terminating events include such items as writing inventory down below cost for tax purposes or issuance of primary financial statements computing income using a non-LIFO inventory method.

Category B Accounting Methods

Up until June 9, 1986, the IRS had identified the following 11 accounting methods as Category B Methods.

Revenue Ruling

Rev. Rul. 81-173 — An accrual-method public utility may not deduct as a state franchise tax amounts attributable to unbilled sales that are neither included in, nor required to be included in, gross sales for purposes of computing and reporting the state franchise tax.

Rev. Rul. 81-176 — An accrual-basis nursing home must report the actual amount of readily calculable year-end adjustments with respect to income earned or services rendered during the taxable year to Medicaid patients in the taxable year the services are performed.

Rev. Rul. 81-208 — Crating and shipping expenses of a contractor utilizing the completed contract method of accounting are not currently deductible as "other distribution expenses," but are "indirect costs," and must be allocated to the long-term contracts to which they are attributable.

Rev. Rul. 81-243 — The treatment prescribed for the deferred and uncollected premiums at issue in the ***Standard Life and Accident*** decision does not apply to the deferred and uncollected premiums in group-term life insurance, which are not properly accruable.

Rev. Rul. 82-134 — A company, which by contract furnished engineering services and construction management services to clients, is not entitled to use the completed contract method of accounting.

Rev. Rul. 82-192 — A company that manufactures an item and purchases an identical item that is manufactured in accordance with the company's detailed design specifications is not deemed the manufacturer of the purchased item and may not include the manufactured and purchased item in one last-in, first-out (LIFO) NBU inventory pool. Rev. Rul. 77-107 distinguished.

Rev. Rul. 83-106 — A gambling casino that uses the accrual method must include in income the amount of gambling revenue derived from customers who gamble on credit for the taxable year the gambling obligation arises and the gambling occurs.

Rev. Rul. 84-27 — A company that uses the completed contract method of accounting and wishes to change from reporting income when each contract is substantially completed to reporting income when each contract is finally completed in order to comply with the regulations must apply for the Commissioner's consent to a change in method of accounting.

Rev. Rul. 84-31 — The deficiency taking amount in a "take or pay" gas purchase contract must be included in the producer's gross income for its tax year ended June 30, the tax year in which the amount of the deficiency taking became fixed and determinable.

Rev. Rul. 84-41 — An automobile dealer must record the cost of new automobiles in inventory, reduced by the amount of manufacturer's rebate that represents a trade discount.

Rev. Rul. 86-35 — A financial institution using the accrual method of accounting for all items of income and expense, except for interest income from commercial loans and mortgage loans, is not using a permissible method of accounting.

$$AII = \frac{\text{Average quarterly indebtedness}}{\text{Face amount of all obligations + adjusted basis* of all other assets}} \times \text{Face amount of allocable installment obligations}$$

*The company may elect to compute adjusted basis, for purposes of the formula, using straight-line depreciation over a longer life.

Amounts treated as payments on applicable installment obligations in prior years under this formula will not be again treated as payments because of subsequent applications of the formula.

The amount determined as a deemed payment under the above formula is multiplied by the gross profit ratio on the sale to determine the portion of the deemed payment includible as taxable gain.

Average quarterly indebtedness is defined very broadly — it includes all accounts payable and accrued expenses, as well as the usual forms of indebtedness. This amount is computed at the end of each quarter. Sellers other than dealers in personal or real property use year-end indebtedness rather than average quarterly indebtedness.

Example: In 1987, Company X sold real property used in its trade or business on the installment method. X is not a dealer in real property. The selling price was $900,000; no payments were received during 1987. The aggregate adjusted basis of X's year-end assets, other than this installment obligation, is $3,100,000. X's indebtedness is $2,000,000. Under the new law, X treats $450,000 as a payment during 1987, determined as follows:

$$\frac{\$2{,}000{,}000}{\$900{,}000 + \$3{,}100{,}000} \times \$900{,}000 = \$450{,}000$$

X applies its gross profit ratio for this sale to determine what portion of the $450,000 deemed payment is taxable gain.