TOP 10 TAX PLANNING IDEAS USING ACCOUNTING METHODS,

INCLUDING THE "TANGIBLES" REGULATIONS CHANGES

Wayne Hamilton, Moderator
Wal-Mart Stores, Inc.

Les Schneider, Speaker
Ivins, Phillips & Barker

Idea # 1 – Increase Your Adjusted Basis in Depreciable Property that is Disposed of by Reason of the Prior Use of FSC, ETI or IC DISC Export Trade Regimes

I. Background

1. When depreciable property is disposed of, the adjusted basis of the property that is disposed of is taken into account based on the depreciation that was allowed or allowable.

2. In *CBS Corp. v. United States,* 105 Fed. Cl. 74 (2012), the court held that where depreciation was allocated in part to tax exempt foreign trade income pursuant to the FSC provisions while they were in effect, the depreciation taken by the taxpayer in those years was considered allocable in part to tax-exempt income under the FSC regime, for purposes of the application of IRC § 265(a)(1).

3. As a result, the court held that the depreciation so allocated was not allowed or allowable within the meaning of IRC § 1016(a)(2)and did not reduce the adjusted basis of the depreciable property when the property was disposed of.

II. Scope of Idea

1. The *CBS* decision involved leased assets, whereas for most taxpayers, depreciation would be allocated to export trade income through its allocation to cost of goods sold.

2. Thus, IRC § 265(a)(1) is not directly applicable because cost of goods sold is not normally regarded as a "deduction."

3. However, a good argument could be made that the same result in *CBS* should apply to depreciation allocated to cost of goods sold pursuant to the "tax benefit" rule.

III. Implementation of the Idea

1. Claiming a lesser reduction in the adjusted basis of depreciable property when the property is disposed of is not a change in method of accounting because it results in a permanent difference in a taxpayer's income.

2. Accordingly, the IRS's advance consent to change is not required.

3. On the other hand, IRC § 481(a) is not applicable, so that the adjustment to basis for dispositions of property that have occurred in a prior year may only be claimed for open years by way of amended returns.

4. However, a taxpayer may take advantage of this idea prospectively in the case of future dispositions of depreciable property that were depreciated during taxable years when one of the export trade regimes was in effect (or is still in effect, in the case of an IC DISC), by simply increasing the adjusted basis of the property when it is disposed of.

5. Moreover, the idea may be used in conjunction with the next idea on this list, which is to claim a deduction for a partial disposition of property under the new repair regulations.

Idea #2 – Claim a Deduction for the Disposition of a Component of a Unit of Property in an Improvement Transaction

I. Background

1. When a taxpayer replaces an entire unit of property in a repair transaction, the cost of the new unit of property must be capitalized and the adjusted basis of the replaced unit of property is deducted when the property is disposed of or is permanently retired from use.

2. However, when a *component* of a unit of property is replaced in a repair transaction, the cost of the old component continues to be depreciated as part of the original unit of property, regardless of whether the cost of the replacement component is capitalized (as an improvement) or is deducted (in the case of a repair).

3. For example, if a taxpayer replaced the entire roof on a building prior to the taxable year in which the building was fully depreciated, and the cost of the replacement roof was capitalized as an improvement, the taxpayer would be required to depreciate the cost of the new roof over its new MACRS depreciation period and continue to depreciate the cost of the old roof over its remaining MACRS depreciation period.

II. Implementation of the Idea

1. In the proposed repair regulations, the IRS granted taxpayers the right for the first time to claim a deduction for the adjusted basis in the component of a unit of property that is replaced and disposed of.

2. Thus, in the foregoing example, the taxpayer could deduct the remaining adjusted basis in the old roof that was replaced by a new roof.

3. However, to obtain this favorable treatment under the prior proposed repair regulations, a taxpayer was required the elect General Asset Account ("GAA") treatment and such an election involved considerable complexity.

4. In particular, the prior proposed regulations imposed this result in the case of buildings by requiring every single component of a building to be treated as a unit of property for disposition purposes.

5. The new proposed regulations achieve this same result through a much simpler mechanism – a partial disposition election.

6. Under the new proposed regulations, a taxpayer may elect, on a property-by-property basis, to recognize a loss on the disposition of a component of a unit of property in the taxable year in which the component is disposed of.

7. In addition, at the taxpayer's option, the taxpayer may elect to make a partial disposition election for dispositions of components in taxable years prior to the issuance of the final repair regulations and claim that deduction through a section 481(a) adjustment in the year of change.

III. Effect of the Election

1. If a taxpayer makes a partial disposition election for a particular replacement transaction, that election has the effect of treating the replacement component as a capitalized restoration of the unit of property.

2. Since the cost of the replacement component is likely to be more costly than the remaining adjusted basis in the original component which is replaced, treating the replacement transaction as a deductible repair is preferable to deducting the adjusted basis of the old component that is replaced and capitalizing the cost of the new replacement component.

3. Accordingly, a taxpayer should make a partial disposition election for the replacement of a component of a unit of property only in those transactions where the taxpayer is sure that the replacement component would be capitalized as an improvement to the unit of property, without regard to whether the taxpayer made a partial disposition election.

4. In this regard, Treas. Reg. § 1.263(a)-1(k)(6) provides that where a taxpayer replaces one or more components of a unit of property that comprise a major component or substantial structural part of the unit of property, the cost of the replacement components must be capitalized as a restoration of the unit of property.

5. While the regulations contain some examples, there is no numerical threshold that automatically determines whether the replacement component is considered a major component or a substantial structural part of the unit of property.

6. Accordingly, taxpayers need to approach the partial disposition election with caution and limit its use to those replacement transactions that are certain to be capitalized as improvements. For example, if a taxpayer makes a book conformity election (another idea discussed below), a taxpayer could make a partial disposition election for any replacement transactions that are capitalized in the taxpayer's financial statements, since those replacement transaction must be capitalized for tax purposes as well.

7. Even where a taxpayer guesses wrong and fails to make a partial disposition election for the replacement of a component that the taxpayer deducts, but the deduction is later disallowed on audit, the taxpayer will still be able to make the partial disposition election as the later time of audit, but only through filing a prospective change in method of accounting request.

8. In computing the section 481(a) adjustment for a partial disposition election, or in computing the amount of a disposition loss upon a partial disposition in the future, it should be noted that the short-cut methods of computing the amount of depreciable basis that is allocable to the component that is disposed of will overstate the amount of remaining basis in the component.

9. The reason for this conclusion is that the ratio of the cost of a component as a percentage of the cost of the entire unit of property is greater than what it was in the year the component the unit of property was originally. That is the result of the fact that the cost of an entire unit of property is most likely substantially less than the cost of that same unit of property arrived at by aggregating the replacement cost of each component within the unit of property. For example, a new automobile might cost $50,000, whereas the aggregate cost of the replacement cost of each separate component of the automobile probably adds up to significantly more than $50,000. Since the regulations permit a taxpayer to estimate the adjusted basis of a component based on the current ratio of replacement cost of the component to replacement cost of the entire unit of property discounted back to the year the property was placed in service, this approach will uniformly yield a greater adjusted basis being allocated to the component that is disposed of than was the case when the unit of property was originally acquired.

10. Thus, taxpayers recognizing a loss on the disposition of a component of a unit of property are getting an extra benefit, so long as the replacement component would otherwise be capitalized as an improvement to the unit of property.

Idea #3 – Adopt a De Minimis Policy or Conform an Existing Policy to the Final Repair Regulations

I. Background

1. Many taxpayers maintain an accounting policy whereby all expenditures for the acquisition or production of fixed assets with a cost below a certain threshold are expensed, notwithstanding that the expenditures would otherwise constitute capital expenditures.

2. Many taxpayers have followed that same practice for tax purposes.

3. In the past, that practice has had a checkered history.

4. For example, in *Cincinnati, New Orleans & Texas Pacific Railway v. United States*, 424 F.2d 563 (Ct. Cl. 1970); and *Alcare Home Health Services, Inc. v. Commissioner*, T.C. memo. 2001-149, a taxpayer was permitted to employ a de minimis method for tax purposes.

5. In contrast, when one of the TEI Chapters wrote in to the IRS National Office soliciting advice on the procedures for changing the level of a de minimis method, the National Office replied that there was not authority for the use of such method.

6. The final repair regulations officially sanction the use of a de minimis method for tax purposes.

7. The final repair regulations eliminate this controversy by permitting taxpayers to make a de minimis election up to a cost threshold of $5,000 per unit.

II. Scope of Election

1. In order to adopt the de minimis method for tax purposes, the taxpayer must have such a method in place in its financial statements.

2. In addition, the taxpayer must have a written de minimis policy in effect at the *beginning* of the taxable year for which the method is to be employed.

3. A taxpayer can deduct up to $5,000 per item, or per invoice, if that is the way the taxpayer's de minimis method operates.

4. If a taxpayer currently has a de minimis method in use, but the cost threshold is lower than $5,000, the taxpayer should consider raising the cost threshhold to $5,000 (at the beginning of the taxable year for which the new threshold would be effective) for both financial reporting and tax purposes.

5. If a taxpayer currently has a de minimis method in use, but the cost threshold is greater than $5,000, I would recommend reducing the threshold to $5,000, unless the taxpayer obtains ironclad assurance from the IRS exam team that the higher level is ok to continue.

6. I have been involved in several IRS audits in which the exam team contended that the taxpayer's cost threshold was too high and required the taxpayer to capitalize costs in excess of some lower threshold. In that situation, taxpayers typically lack records to compute depreciation because the items were deducted for financial reporting purposes.

7. The final regulations permit the de minimis method to be applied to materials and supplies for the first time. While the language in the regulations is mandatory, the application of the de minimis method to materials and supplies is permissive in effect, because a taxpayer must expense the materials and supplies for financial reporting purposes in order to be subject to the requirement for tax purposes.

8. Taxpayers should consider whether GAAP will allow them to apply the de minimis method to materials and supplies for financial reporting purposes.

9. Of particular note, if a taxpayer has any incidental materials and supplies that the taxpayer has been expensing upon purchase under Treas. Reg. § 1.162-3, it is much safer to shift that deduction to the de minimis method by amending the de minimis policy to include incidental materials and supplies below the cost threshold.

III. Implementation of the Idea

1. The final regulations indicate that the de minimis method is an annual election, not a change in method of accounting.

2. Accordingly, the method may be elected each taxable year by filing a statement with the tax return and by maintaining a written de minimis policy and using the de minimis method in the taxpayer's financial statements.

3. The cost threshold may be modified from year to year without filing an accounting method change request.

4. However, all changes to the policy must be in effect at the beginning of the year of change and must be incorporated in the written policy by the beginning of the year of change.

5. However, by virtue of not being classified as a method of accounting, there is no audit protection for a taxpayer's prior use of the de minimis method.

Idea #4 -- Make a Book Conformity Election

I. Background

1. Many taxpayers follow the same procedures for distinguishing between deductible repair expenses from capital improvement expenditures for tax and financial reporting purposes.

2. Since taxpayers tend to be fairly conservative in claiming repair deductions in their financial statement, particularly publicly-owned corporations, this approach typically has the effect of treating even more expenditures as capital improvements for tax purposes than is required under the tax law.

3. Moreover, in terms of exposure on audit, IRS examination teams tend to identify capitalization issues where a taxpayer deducts an expenditure for tax purposes that was capitalized for financial reporting purposes (i.e., Schedule M adjustment). It is less common for the IRS to capitalize an expenditure that a taxpayer deducts as a repair for financial reporting purposes.

4. Accordingly, IRS spokespersons have suggested that if a taxpayer makes a book capitalization election for a particular taxable year, the IRS is less likely to be concerned with the taxpayer's detailed tax policies in distinguishing deductible repairs from capital improvement costs.

II. Scope of Election

1. Treas. Reg. §1.263(a)-3(n) provides that a taxpayer may elect to capitalize for tax purposes all repair expenditures that are capitalized in the taxpayer's books and records (i.e., for financial reporting purposes).

2. The election is an "all or nothing" election, and must be applied to all repair expenditures, except for rotable spare parts accounted for on the optional method.

3. The election is available annually and applies for the entire taxable year for which the election is made.

4. Technically, the election is a one-way street; all repair expenses capitalized for book purposes must be capitalized for tax purposes, but the taxpayer cannot rely on its book treatment of its deductible repair expenses as justification for its deduction of repair expenses for tax purposes.

5. However, some Treasury personnel believe that by making the election, a taxpayer's repair deductions will not be challenged on audit.

6. It is understood that this book conformity election was also included in the final regulations to ameliorate the concerns of some accounting firms that a taxpayer failing to properly deduct repair expenditures in the year incurred might somehow lose its adjusted basis in the property in respect of which repairs were erroneously capitalized.

7. Some taxpayers have characterized this issue as the "ghost asset" problem. However, the ghost asset problem is really a "red herring."

8. This issue was resolved in Rev. Proc. 96-31, where the IRS concluded that a change from depreciating to deducting a repair expenditure is a change in method of accounting and is not permanently lost as a result of the "allowed or allowable" concept. Accordingly, the IRS will not disallow basis under the allowed or allowable concept without treating the adjustment as a method change, thereby giving the taxpayer back its lost basis through IRC § 481(a).

III. Implementation of Idea

1. The election is made by filing a statement with the taxpayer's tax return for the taxable year for which the election would be effective.

2. This election is not an accounting method and must be filed each year that the election is in effect.

3. Since the book conformity election is not made with the method change filing under Rev. Proc. 2014-16, a question is posed as to how to handle the Rev. Proc. 2014-16 filing, if a taxpayer is planning to make the book conformity election for the first taxable year to which the Rev. Proc. 2014-16 method change would also apply.

4. For example, does a taxpayer need to make all of the detailed method changes in Rev. Proc. 2014-16 and disclose details concerning the taxpayer's repair practices, if the taxpayer also makes a book conformity election?

5. Will making the book conformity election result in audit protection for the years prior to the year of election?

6. In any taxable year in which a taxpayer doesn't claim any Schedule M adjustments for repair transactions, is there a downside to making the book conformity election?

Idea #5 – UNICAP for Fixed Assets

I. Background

1. Since 1986, the cost of producing property for use in a trade or business or as a lessor of the property must be determined based on the application of the uniform capitalization ("UNICAP") rules.

2. Under the UNICAP rules, more comprehensive costing procedures apply than would ordinarily be the case under the GAAP rules.

3. Even if a taxpayer does not produce fixed assets itself, but contracts with a third party to produce the property, the UNICAP rules apply to the property produced by the third party to the extent that the taxpayer (as the customer) performs a supervisory role in insuring the proper production or installation of the property.

4. In contrast, the UNICAP rules do not apply to routine purchases of fixed assets that come out of the producer's inventory.

5. While most taxpayers have not given much thought to the issue, the UNICAP rules apply not only to the cost of property originally constructed by the taxpayer, but also to capitalized improvements to existing property.

II. Scope of Issue

1. The prior proposed regulations and accompanying Rev. Proc. 2012-19 made the application of UNICAP to original construction and to capitalized improvements a mandatory change under the repair regulations.

2. Thus, if a taxpayer was not using UNICAP either for original construction of fixed assets or for the construction of improvements to fixed assets, or both, a Form 3115 to comply with the repair regulations was not considered complete and would not constitute a valid filing under the regulations unless the taxpayer also included in that filing an adjustment to cover the change to the UNICAP method for the construction of fixed assets and fixed asset improvements.

3. An additional complexity under the proposed regulations was that depending on how a taxpayer was proposing to compute the UNICAP adjustment for fixed assets, the adjustment might not be eligible to be implemented pursuant to the automatic consent procedures, but instead a separate advance consent method change request might be required.

4. For example, if the taxpayer calculated some type of "top-side" UNICAP adjustment for fixed assets, there was concern that the IRS might not allow that type of adjustment to be made as part of an automatic method change request.

III. Implementation of Idea

1. Rev. Proc. 2014-16 eliminates the mandatory connection between a repairs method change request and a UNICAP change for fixed assets.

2. Accordingly, despite the fact that taxpayers are still required to use UNICAP for fixed asset construction, including the construction of improvements to fixed assets, a taxpayer is not *required* to correct its UNICAP calculations as part of the automatic method change procedures in order to comply with the repair regulations.

3. However, a taxpayer may voluntarily choose to include the UNICAP method change in the same filing with the repairs method change.

4. Moreover, to facilitate the use of the automatic method change procedures, the IRS amended Rev. Proc. 2011-14 to permit the use of the automatic procedures for a change in UNICAP costing for fixed assets despite the fact that the taxpayer is not planning to use one of the conventional costing methods in the UNICAP regulations.

5. These modifications still leave open the question of what taxpayers should do if they are not using UNICAP to determine the cost of fixed assets constructed by the taxpayer or for the costs of constructing capitalized improvements to fixed assets.

6. Obviously, one alternative is to do nothing and risk audit exposure.

7. However, since the genie is out of the bottle and the IRS is aware that many taxpayers haven't been using UNICAP for all fixed asset construction, this approach has great risks, regardless of the fact that the taxpayer may still be able to comply with all of the other aspects of the repair regulations.

8. The other alternative is to propose some type of burden rate adjustment that steps up the cost of fixed assets or improvements constructed by the taxpayer to reflect the application of UNICAP.

9. Two considerations that affect the magnitude of the UNICAP adjustment are whether the UNICAP change is being applied just to improvements or to original construction and whether the taxpayer itself performs the construction or contracts the construction out to a contractor.

Idea #6 –Techniques for Temporarily Increasing a Taxpayer's Taxable Income or E&P

I. Background

1. Most taxpayers are focused on making accounting method elections that reduce taxable income or the E&P of a CFC.

2. However, there are special situations where it is in a taxpayer's interest to increase taxable income or E&P for a particular taxable year, particularly where the taxpayer's choices for increasing taxable income are temporary in effect and do not bind the taxpayer to report increased taxable income (or E&P) for the indefinite future.

3. Examples of these special situations include a taxpayer facing expiring NOLs, expiring credit carryovers, leakage of foreign tax credits due to foreign source income but a U.S. source loss, and AMT issues.

4. In the foregoing types of situations, a taxpayer may want to increase taxable income (or E&P) for a particular taxable year, but not be locked into a particular tax election for the future.

5. In some cases, a taxpayer has the time and luxury of planning into such situations by being able to file accounting method change requests that will temporarily increase taxable income or E&P.

6. In contrast, it is often the case that the need to create taxable income (or E&P) arises after the taxable year has ended, but before the taxpayer has filed its tax return for the taxable year.

7. In those cases, it is useful to have a handy list of elections, techniques and procedures that a taxpayer may follow, even at the last minute, in order to create additional taxable income (or E&P).

II. Possible Elections to Temporarily Increase Taxable Income or E&P

1. Book capitalization election in the repair regulations – By making this election, a taxpayer may be able to capitalize for tax purposes expenditures that would otherwise be a deductible repair expense for tax purposes, provided the repair expense is capitalized in the taxpayer's books and records.

2. Declining to make a de minimis election for a particular taxable year or limiting the scope of the election, so that it excludes materials and supplies – By declining to make this election or limiting the scope of the election, a taxpayer may increase its capitalization for a particular taxable year or years.

3. Elect to capitalize employee compensation and overhead costs incurred to facilitate the acquisition of real or personal property used in a trade or business – By making this election, a taxpayer would reduce current expense and increase its basis in the personal or real property that is acquired.

4. Elect to claim a disposition loss on the replacement of a component even though the replacement transaction would otherwise be currently deductible as a repair. By making this choice, a taxpayer forces a larger amount to be capitalized in exchange for deducting a smaller amount as a current loss.

5. Elect to defer prepaid expenses under the *INDOPCO* regulations – By electing to defer the deduction of prepaid expenses, a taxpayer would defer the deduction over the period benefitted by the prepaid expense.

6. Elect to capitalize employee compensation and overhead costs associated with the acquisition of the stock or assets of a trade or business – By electing to capitalize these costs, the deduction of these costs might be deferred into the indefinite future because the capitalized costs would be included in stock basis or in the basis of assets under a section 1060 allocation.

7. Change from current expense to deferred expense treatment for Section 174 R&E, including internal use software – By making these changes, a taxpayer may defer section 174 expenses into future taxable years.

8. Make a section 59(e) election for R&E – By making this election a taxpayer could defer a section 174 deduction for up to 10 years.

9. Elect slower depreciation methods for assets placed in service in a particular taxable year – Choosing this approach defers the recovery of basis over the MACRS depreciation period.

10. Elect to capitalize carrying costs under section 266 – By making this election, taxes and interest and other costs of carrying property may be deferred in connection with the holding of real and personal property for future development. Section 266 was not repealed with the enactment of UNICAP.

III. Implementation of Idea

1. In virtually every one of the foregoing ideas, the election or choice may be made up until the time for filing the taxpayer's tax return for the year for which the election or choice would be effective.

2. In virtually every one of the foregoing ideas, the election may be applied selectively on an asset-by-asset or expense-by-expense basis.

3. In virtually every one of the foregoing ideas, the taxpayer may switch back to its original method in the next or any future year without needing to file an accounting method change request.

4. In some, but not all cases, the election produces a one-year deferral of an expense and so the effect is not long-lasting.

Idea #7 – Bonus Accruals

I. Background

1. In the case of employee bonuses, the timing of the employer's deduction depends on when the "all-events" test is satisfied.

2. A number of principles have developed with respect to the treatment of employee bonuses.

3. If the bonus is determined based on a formula that is fixed prior to year end, it is not necessary for the bonus to be actually computed prior to year end; it is simply necessary for the amount of the bonus to be determinable based on fixed factors.

4. Where the bonus is based on the discretion of the compensation committee or board of directors, the amount of the bonus must be fixed by the end of the year and, according to the IRS, the amount of the bonus must be communicated to the individual employee.

5. If the bonus is forfeitable if the employee leaves the employ of the employer prior to the payment of the bonus, then the bonus is not deductible until the year of payment.

6. However, in an important new Field Attorney Advice, 20134301F released by LB&I recently, the IRS reached a number of disturbing conclusions.

7. Notwithstanding that a taxpayer's employee bonus plan is in form non-discretionary (i.e, the plan contains a fixed formula for deciding the amount of employee bonuses), if the bonus plan also contains a reservation of rights on behalf of the employer to unilaterally modify or cancel the employee bonuses, the bonuses are not deductible until the bonuses are actually paid to the employees.

8. If an employee bonus plan contains numerical targets that are satisfied, but the employee bonus plan nevertheless requires the employer's board of directors (or compensation committee) to approve the payment of the bonuses, the bonuses are not deductible until the taxable year in which the bonuses are approved by the board of directors (or compensation committee).

9. If an employee bonus plan contains subjective criteria in order for employees to earn their bonuses, such as a performance score that is subjective based on a superior's

appraisal of the employee's work, the bonuses are not deductible until the determination takes place as to whether the employee satisfies the subjective criteria for earning the bonus and the bonus decision is communicated to the individual employee.

10. While the holdings in the FAA are confined to employee bonus plans, it is not unusual for other types of benefit plans, such as medical reimbursement plans, to have these types of contingencies.

II. Avoiding the Adverse Holding

1. The employer could amend the bonus plan to provide that any forfeitures by individual employees are reallocated to the remainder of plan participants. The IRS has ruled that the foregoing approach entitles the employer to deduct the total bonus plan liability in the year in which the bonuses are earned. Rev. Rul. 2011-29, 2011-49 I.R.B. 824, and *Washington Post Co. v. United States,* 405 F.2d 1279 (Ct. Cl. 1969),

2. If a portion of an employer's liability to pay employee bonuses is fixed as a guaranteed minimum and the balance of the bonus pool is made discretionary, the fixed portion of the bonus pool may be deducted in the taxable year of accrual. However, to qualify under this rule, the fixed portion of the bonus pool must in fact be fixed under the terms of the employee bonus plan.

III. Implementation of Idea

1. Implementing either of the above changes in plan terms constitutes a change in underlying facts and circumstances. Accordingly, no method change request need be filed.

2. However, if a taxpayer files an accounting method change to correct its erroneous method prior to modifying the plan terms, the taxpayer could obtain a four-year spread of the resulting section 481(a) adjustment and then change the terms of the bonus plan to be able to continue to claim a the deduction of the bonus.

Idea #8 – Warranties and Customer Loyalty Payments

I. Background

Warranties

1. Prior to 2004, when a company sold a product that was accompanied by a warranty at no extra charge, the entire sales price of the product was includible in income at the time of the sale of the product.

2. Likewise, prior to 2004, if a company sold an extended warranty at an extra charge, along with the sale of the product, the company was required to include the consideration allocable to the warranty in income in the year of sale of the warranty.

3. Neither Treas. Reg. § 1.451-5, nor Rev. Proc. 71-21, was applicable to permit the revenue associated with the warranties to be deferred as an advance payment. *Standard Television, Inc. v. Commissione*r, 64 TC 238 (1975).

Customer Loyalty Programs

1. A number of companies in the retail, transportation and hospitality industries maintain customer loyalty programs wherein a customer is awarded loyalty points for purchasing goods or services from the taxpayer and in exchange therefor the customer is entitled to redeem the award points for free goods or services from either the taxpayer or someone else.

2. For GAAP purposes, the traditional way to account for such transactions is to recognize as revenue the entire amount of the sales price of the merchandise or services the sale of which generates the award points and deduct an offsetting reserve for the estimated cost of redeeming the award points issued to the customer.

3. For tax purposes, many taxpayers in the foregoing situation have deducted the estimated cost of redeeming customer award points pursuant to the provisions in Treas. Reg. § 1.451-4.

4. However, in *Capital One Financial Corp v. Commissioner,* 133 T.C. 136 (2009), *aff'd* 659 F.3d 316 (4th Cir. 2011), the Fourth Circuit affirmed the Tax Court and held that Treas. Reg. § 1.451-4 required that trading stamps or premium coupons, including award points under customer loyalty programs, be issued in

connection with "sales of merchandise" and, therefore, where the award points were issued as part of a credit card transaction, the "issued with sales of merchandise" requirement was not satisfied.

5. This case did not adversely affect the use of Treas. Reg. § 1.451-4 where the points were issued by the merchant from which the customer purchased the merchandise. However, the IRS has challenged credit card and service arrangements.

6. For those taxpayers adversely affected by *Capital One*, some taxpayers have attempted to rely on the all-events test and the recurring item exception to claim deductions prior to the taxable year in which the award points are redeemed, citing *Gold Coast Hotel & Casino v. United States,* 158 F.3d 484 (9th Cir. 1998).

7. The IRS has been resisting these positions and is even questioning whether Treas. Reg. § 1.451-4 is still valid for award points issued with sales of merchandise because of the enactment of section 461(h) of the Code.

8. The Treasury has placed the tax treatment of customer loyalty programs on the Treasury/IRS Priority Guidance Plan for 2013/2014.

II. Opportunity

Warranties

1. In contrast to Rev. Proc. 71-21, Rev. Proc. 2004-34 permits advance payments for warranties to be deferred for one taxable year.

2. In addition, Rev. Proc. 2004-34 modifies the definition of advance payments, so that it depends exclusively on whether any revenue is deferred for GAAP purposes.

3. As a result, if a taxpayer were willing to defer for GAAP purposes a portion of the sales price of a product that is sold with a warranty embedded in the sale of the product at no additional charge, the taxpayer could defer a portion of the sales revenue associated with the sale of the product.

4. For example, if a taxpayer sold a product for $100 and determined that the estimated value of the warranty embedded in the product was $2, the taxpayer could report $98 of revenue in the year of sale of the product and defer the other $2 of revenue over the term of the warranty (but limited to one taxable year).

5. Typically, for GAAP purposes, taxpayer will establish a reserve for warranty work, which is shown as a reduction in sales revenue in the taxpayer's income statement. That treatment does not satisfy the financial conformity requirement in Rev. Proc. 2004-34 in order to justify deferral of that amount of the consideration received as prepaid income.

6. In contrast, if the taxpayer were willing to reclassify that warranty reserve as a direct reduction in sales revenue on the taxpayer's income statement, the taxpayer could defer a like amount of income for up to one year under Rev. Proc. 2004-34.

Customer Affinity Programs

1. In economic reality, the cost of redeeming customer loyalty points under a reward program is a reduction in sales revenue recognized on the sale of the product or service on which the reward points are earned and the redemption liability is incurred.

2. However, as in the case of warranties, the way that taxpayers typically treat the redemption obligation under a customer affinity program is through a reserve for warranty expense in their financial statements.

3. Since that reserve is not a direct reduction in sales revenue, that treatment does not satisfy the financial conformity requirement in Rev. Proc. 2004-34 and the taxpayer cannot defer any revenue as an advance payment for tax purposes..

4 In contrast, if a taxpayer were willing to reclassify its customer loyalty liability from a reduction in gross income to a direct reduction in sales revenue, the financial conformity requirement in Rev. Proc. 2004-34 would be satisfied and the taxpayer could defer a portion of its sales revenue for tax purposes equal to the reduction in such revenue reported for GAAP purposes.

5. Both of the foregoing GAAP treatments of customer warranties and customer affinity programs move in the direction that the FASB is heading with its forthcoming pronouncements on multiple deliverables.

III. Implementation of Idea

1. The adoption of a deferral method of accounting under Rev. Proc. 2004-34 is a change in method of accounting.

2. This type of method change is eligible for the automatic consent procedures in Rev. Proc. 2011-14.

Idea #9 – Increase the Amount of Costs Treated as Deductible (and Creditable) R&E Costs

I. Background

1. Section 174 provides a taxpayer with a deduction for costs qualifying as R&E under section 174, whereas section 41 provides a taxpayer with a credit for R&E costs.

2. However, in order to qualify for the research credit under section 41, the expenditure must first qualify as a research expense under section 174.

3. The regulations under section 174 define what activities constitute research for purposes of section 174. See Treas. Reg. § 1.174-2(a).

4. Treas. Reg. § 1.174-2(b) provides that an expenditure for the acquisition or creation of depreciable property does not qualify as research for purposes of section 174.

5. For example, the full cost of a research building or lab equipment, including the component materials, would not qualify as research for purposes of section 174.

6. Likewise, inventory held for sale to customers does not qualify as research under section 174.

7. There has been considerable uncertainty concerning the scope of the foregoing two restrictions on the definition of research under section 174. See *T.G. Missouri Corp. v. Commissioner*, 133 T.C. 278 (2009); *Trinity Industries, Inc. v. United States,* 691 F. Supp. 688 (D.C. Tex. 2010).

8. The IRS recently issued proposed regulations that addressed some of these issues and the proposed regulations provide highly favorable rules for taxpayers.

II. Scope of Proposed Regulations

1. In dealing with pilot models and prototypes, the proposed regulations provide that if the development of the pilot model or prototype entails research activities, the subsequent use of the pilot model or prototype in the taxpayer's trade or business or the subsequent sale of the pilot model or prototype does not prevent the cost of the pilot model or prototype from being treated as R&E for purposes of section 174.

2. However, an allocation may be required where a taxpayer incurs costs to ready the property for use or sale after the research activities are completed and the usefulness of the property is established.

3. The proposed regulations also include a controversial "shrink-back" rule that permits research expenses with respect to a component of a unit of property to qualify under section 174, even where the production of the larger unit of property does not entail research and there is no uncertainty as to its successful operation.

4. The controversial part of this rule is that it might imply in some situations where integration of the component into the larger unit of property is required in order to insure that the larger unit of property functions properly that such integration costs and the costs of the larger unit of property do not qualify as section 174 costs.

5. Treasury representatives insist that the latter implication was not intended by the proposed regulations.

III. Implementation of Idea

1. While the proposed regulations are not final yet and are prospective in effect, the IRS will not disturb a taxpayer that is following the proposed regulations for years prior to the issuance of the regulations.

2. Accordingly, the issue is posed how taxpayers should take advantage of the new proposed regulations if they are not already following them.

3. There has long been uncertainty how a taxpayer that has treated an activity as an inventoriable cost or a cost of a fixed asset and has determined that such activity should have been treated as section 174 R&E may correct such treatment.

4. When the treatment of changes in an expenditure from a capital expenditure or an inventory cost to a section 174 cost was first addressed within the IRS National Office, the issue was assigned to the Passthroughs and Special Industries Branch ("PS&I) and that branch relied on a 1957 revenue ruling for the proposition that a reclassification of a cost to section 174 treatment constituted a correction of an error that is implemented by filing an amended return.

5. As a result, such a reclassification could only be made for open years, but the change in treatment did not require the filing of an accounting method change request.

6. After several years, responsibility for monitoring such changes was reassigned within the IRS National Office to the Income Tax & Accounting Branch

("ITA"), at which point such reclassifications were handled as accounting method changes. As a result, a section 481(a) adjustment was permitted in connection with such method changes.

7. Nevertheless, a few years thereafter, responsibility for R&E changes was transferred back to the PS&I Branch and, as a result, accounting method changes and section 481(a) adjustments are no longer permitted. Instead, amended returns must be filed for open years. That is the current status of the matter.

8. The issue has now been placed on the Treasury/IRS Priority Guidance Plan

9. The Treasury and IRS are trying resolve what the proper treatment should be for section 174 cost reclassifications and there are apparently three possibilities under consideration.

> a. One possibility is to treat reclassification of a cost as a correction of an error and permit filing of amended returns for open years to reclassify section 174 costs as current deductions.
>
> > i. The advantage of this treatment is that is permits taxpayers to effectuate the reclassification retroactively for open years.
> >
> > ii. Another advantage is that the IRS's consent to reclassify the cost is not required.
> >
> > iii. The disadvantage of this treatment is that a taxpayer cannot implement the reclassification for closed years.
>
> b. A second possibility being considered is to treat the reclassification as a change in method of accounting and permit a section 481(a) adjustment.
>
> > i. The advantage of this treatment is that the taxpayer is able to recoup deductions that should have been claimed in barred years.
> >
> > ii. The disadvantage of this treatment is that it can only be implemented prospectively and requires the IRS's consent.
> >
> > iii. In my view, this is the legally correct approach.
>
> c. The third possibility is to treat the reclassification as a change in method of accounting, but require a cut-off transition rule.

i. This is the worst of all the alternatives.

ii. The reclassification may only be made prospectively, the IRS's consent is required, but the taxpayer is unable to recoup deductions from barred years.

d. In light of the uncertain outcome of the Treasury Business Plan project, taxpayers are advised to act promptly and utilize the amended return approach while it is still permissible.

Idea #10 – Planning Around the New Final Regulations on Sales-Based Royalties and Sales-Based Vendor Allowances

I. Background – Sales-Based Royalties

1. For a number of years, controversy had existed over whether a producer of property that was required to pay royalties in exchange for the right to use production know-how is required to treat the royalties as an inventoriable cost, where the royalties are measured on the basis of the producer's sales of the products. See *Plastic Engineering & Technical Services, Inc. v. Commissioner*, T.C. Memo. 2001-324; *Robinson Knife Mfg. v. Commissioner,* 600 F.3d 121 (2d Cir. 2010).

2. The argument in favor of inventory treatment is that the royalties are not selling expenses, but deferred production costs that are incurred to be able to produce the goods being sold by the taxpayer.

3. The counter-argument is that because the royalties do not accrue until the product is sold, the expense should be allocated to cost of goods sold regardless of the taxpayer's inventory costing or identification method.

4. The Court of Appeals in *Robinson Knife* ultimately agreed with the latter of the two arguments.

5. Ultimately the Treasury also agreed with this approach, although the rationale was not identical to that of the court.

6. Accordingly, the Treasury issued final regulations recently in which the Treasury took the position that sales-based royalties are allocable exclusively to cost of goods sold, regardless of the taxpayer's inventory method.

Background – Sales-Based Vendor Allowances

1. The precedents in this area were much more uniform; they hold that a taxpayer's inventory flow assumption (i.e., FIFO, LIFO, etc.) determine the extent to which vendor allowances are allocated as a reduction in the taxpayer's ending inventory or is included in gross income. Rev. Rul. 2001-8, 2001-1 C.B. 726.

2. Thus, the fact that inventory must physically be sold in order to become entitled to receive a vendor allowance does not mean that such allowance is automatically included in income if, under the taxpayer's cost flow assumption, the inventory to which

the vendor allowance relates is deemed to still be present in the taxpayer's ending inventory.

3. Nevertheless, because of the treatment of sales-based royalties, the Treasury insisted on conforming treatment for sales-based vendor allowances.

4. As a result, recently issues final regulations provide that sales-based vendor allowances must be allocated to cost of goods sold as gross income.

II. Issues and Opportunities – Sales-Based Vendor Allowances

1. Taxpayers may have other overhead costs that are incurred at the point of sale of goods or thereafter.

2. However, it is the IRS's position that the holding in the final regulations with respect to sales-based royalties in no way determines the inventory treatment of other costs, despite their similarity to sales-based roylaties.

3. Thus, taxpayers with post-production costs, large storage costs and excise taxes that accrued after the completion of the production process should avoid adopting the simplified production method.

4. Taxpayers in such position could avoid the adverse effects of the simplified production method, while still electing such method, if the taxpayer modifies its section 471 costs to allocate costs incurred late in the production process or after the end of the production process to goods produced just for tax purposes.

5. Such a method change requires the IRS's advance consent; the request is not eligible for the automatic consent procedures in Rev. Proc. 2011-14.

Sales-Based Vendor Allowances

1. To avoid the adverse effects of the new regulations, the participants in the typical sales-based vendor allowance described as a chargeback need to modify the program.

2. Instead of paying the supplier the gross purchase price and then earning a rebate on the resale of the merchandise, the arrangement needs to be revised to provide that the supplier sells the merchandise at the net sales price and then grants a rebate if the customer resells the merchandise in a qualifying resale.

3. Under that revised approach, both the supplier and the customer benefit.

4. The supplier recognizes the net sales price as gross income and waits to record additional revenue only if the customer fails to resell the merchandise in a non-qualifying resale.

5. From the customer's perspective, the customer would record the purchase at the net purchase price and if the customer failed to resell the merchandise in a qualifying resale would increase its basis in its inventory by the additional purchase price.

6. Thus, the adverse result of the new regulations would be avoided.