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FT. WORTH, TEXAS CHAPTER MEETING

Tax Executives Institute

Current Developments in Tax Accounting and Accounting Methods

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I. New Revenue Procedures 2015-13 and 2015-14

A. Background

1. Prior to the issuance of these two new revenue procedures, the rules for filing a request to change a method of accounting were divided into two different revenue procedures, one for advance consent requests and one for automatic changes.

2. The latest versions were Rev. Proc. 97-27, covering advance consent requests, and Rev. Proc. 2014-11, covering automatic changes.

3. The disparity in the time of issuance of the two different pronouncements resulted in the need to constantly update the older

pronouncement to conform to any different procedural rules adopted in the later pronouncement.

4. The IRS has fixed this problem by issuing one revenue procedure containing all of the procedural rules for both type of accounting method change requests (Rev. Proc. 2015-13) and a separate revenue procedure listing all of the types of accounting method changes that qualify for an automatic method change (Rev. Proc. 2015-14).

5. While Rev. Proc. 2015-14 does not contain any significant new categories of automatic changes, there are dramatic changes in the procedural rules for both types of method changes.

B. Significant Changes in Procedural Rules

1. 90-Day Window

a. In the past, if a taxpayer was under IRS examination, the taxpayer could not file a method change request until the examination ended.

b. However, if the taxpayer was under examination for 12 consecutive months as of the beginning of a taxable year, the taxpayer could file either an advance consent or automatic consent method change request during the first 90 days of the taxable year of change, provided the method being changed was not an issue under consideration by the IRS in that examination.

c. The 90-Day window (now called the three month window) has been moved by Rev. Proc. 2015-13 from the first 90 days of a taxable year to the three-month period between the 15th day of the seventh month and the 15th day of the 10 month of the taxable year (i.e., for a calendar-year taxpayer, the three-month window period runs from July 15 to October 15). Likewise, the requirement that the taxpayer be under examination for 12 consecutive months as of the beginning of the taxable year is moved to the 12-month period immediately preceding the beginning of the new three-month window.

d. This change in the timing of the window was made based on the premise that the need to make a method change from an improper method (where the window would be needed) is usually discovered during the period when the tax return is being prepared for filing, so that the window period would now overlap the likely time of discovery of the improper method.

e. What problems might this change in the window cause?

i. To avoid financial statement disclosure of an improper method, a taxpayer might want to file the method change request near the beginning of the taxable year, before the financial statements for the preceding year are issued. The timing of the new 90-day window prevents this tactic.

ii. The discovery of the erroneous method might occur very late in the window period and a taxpayer might not be ready to request a correction of such method by the close of the new window period. The taxpayer would then need to wait almost a whole year before being able to file the accounting method change request and obtain audit protection.

2. Filing Under Exam Outside of a Window

a. Under the prior revenue procedures, a taxpayer under examination without a window needed the exam team's permission to file a method change request.

b. If permission was granted, as it frequently was, all of the regular filing rules applied.

c. Under Rev. Proc. 2015-13, exam team permission is no longer needed in such circumstances.

d. However, the taxpayer doesn't receive audit protection until the current audit ends without an adjustment.

e. Accordingly, if a taxpayer wants to avoid wasting its time on filing a method change request, it is advisable to still clear the filing in advance with the exam team in order to avoid having the exam team be surprised by the disclosures in the method change filing, prompting the exam team to propose the method change as an audit adjustment.

f. Moreover, there is now a significant new detriment to filing a method change request outside of a window; under these circumstances, the taxpayer obtains only a two-year spread of any positive section 481(a) adjustment, rather than a four-year spread.

3. Filing with a Pending Issue

a. In the past, it was very unclear in what circumstances a taxpayer could file a method change request to change a method of accounting that was under consideration by the exam team.

b. Under Rev. Proc. 2015-13, all such filings are permitted, subject to the restrictions noted in the preceding section.

4. Where to file advance copy of method change request

a. Under Rev. Proc. 2011-14, advance copies of automatic method changes were usually sent to the IRS National Office; however, copies of repairs method change requests were sent to Ogden, Utah.

b. Under Rev. Proc. 2015-14, copies of all automatic consent method change requests go to Ogden, Utah, which scans them into the computer system and then forwards them to the National Office for potential review.

II. Repair Regulation Issues

A. Procedural Issues

1. Make sure you have a written accounting policy with a de minimis election in place as of the beginning of the taxable year.

a. Simply electing book conformity does not inform the IRS as to what the taxpayer's book policies are and whether there are risks of non-compliance.

b. If you didn't file a Form 3115 for 2014, this increases the risk of an audit. The statements from personnel at Treasury that are no longer there when the audit issue arises will be little comfort to the taxpayer.

i. Consider filing a Form 3115 for 2015

ii. It's not too late.

c. Filing a Form 3115 will provide audit protection for the past.

i. The previously-announced "stand-down" is ending with the deadline for filing a Form 3115 following the filing of the 2014 tax return looming in the near future.

ii. Thus, the lack of a Form 3115 will enable the IRS to go after back years, both those that are open under the statute of limitations and those that are closed through the application of section 481(a).

B. Follow the new accounting method going forward

1. Too many accounting firms and companies focused on the section 481(a) adjustment and the treatment of prior transactions.

2. Make sure you have a policy in place to implement the new regulations on a go forward basis.

C. De Minimis Rule

1. Under the final regulations, a taxpayer that has an applicable financial statement may deduct up to $5,000 per invoice, or $5,000 per each item on the invoice, to the extent the item is deducted in the taxpayer's financial statements.

a. Having a written accounting policy with a threshold larger than $5,000 would not preclude the use of the de minimis method, but the threshold for tax purposes would be limited to $5,000.

b. However, if a taxpayer follows this approach it may be difficult to track the items above $5,000 and account for them properly for tax purposes.

c. Discuss what to do in that case.

2. If the taxpayer does not have an applicable financial statement, the deduction ceiling is limited to $500 per invoice or per item on the invoice. What is the item?

3. Flexibility to have different limits for different types of assets.

4. If the expenditure for any property is deducted under the de minimis rule, such property is not treated as capital gain property (under either section 1221 or section 1231) upon a later sale or other disposition of the property.

5. De minimis doesn't trump other capitalization rules. If item part of large repair or improvement may still have to capitalize.

6. A number of points should be noted about the new de minimis rule.

    a. Treatment of "additional costs," including labor, overhead and other costs of facilitating the acquisition of property subject to the de minimis rule.

        i. "Additional costs" related to the acquisition of property subject to the de minimis rule are generally deductible, provided they are not included in the same invoice with the property itself.

        ii. However, any "additional costs" included on the same invoice as the expenditure for the property count in determining whether the expenditure falls under the de minimis threshold.

        iii. Labor, overhead and other facilitative costs only qualify for special treatment as "additional costs" if they relate to the acquisition of property; they do not qualify for special treatment in the case of a repair that does not involve the acquisition of property.

    b. The final regulations require a taxpayer to apply the de minimis method to any qualifying materials and supplies.

        i. However, rotable, temporary and standby emergency spare parts are not eligible for the de minimis method if elect to capitalize or use optional method.

ii. It will be interesting to see whether taxpayers are permitted to include materials and supplies under their de minimis method for GAAP reporting purposes in order to be able to deduct the cost of materials and supplies at the time of their purchase.

iii. Thus, the requirement that the de minimis method apply to materials and supplies may be illusory because, presumably, if the materials and supplies are excluded from the taxpayer's de minimis method for GAAP reporting, they must also be excluded from the taxpayer's de minimis method for tax purposes.

c. The final regulations permit the choice of measuring the de minimis threshold on either an item or an invoice basis.

i. While the item method may provide a greater amount of overall deductions, it may not be practical if the taxpayer does not employ that approach currently.

ii. In either case, this choice should be made based on the way the de minimis method is applied in the taxpayer's applicable financial statements.

iii. An allocation rule for "additional costs" is provided if a taxpayer seeks to measure the cost threshold at the individual item level, rather than at the invoice level.

7. Procedural Issues

a. A taxpayer makes the election by filing a statement with its tax return indicating that it is making a de minimis safe harbor election.

b. This election is not a method of accounting, but is instead a year-by-year election.

c. This means that a taxpayer could change its threshold amount in its financial statements for a particular year and apply the new threshold for tax purposes without applying for a change in method of accounting.

d. The downside of this flexibility is that the taxpayer does not obtain audit protection for taxable years prior to the year of the election by making this election for a particular taxable year.

e. So what happens if taxpayer previously used a higher threshold? What to do.

f. Another downside is that an election statement must be filed every year with the tax return.

D. Special Book Conformity Election

1. Election to capitalize

2. Discuss pros and cons of election

3. What is the status of your method if you made the election for 2014 and choose not to make it in 2015 or a later year?

E. Treatment of Dispositions of Components of Depreciable Property and Depreciation Grouping Rules

1. Assuming you did not file a retrospective partial disposition method change request, you can still claim losses on partial dispositions on a go-forward basis.

2. This is a case by case choice and is not a binding accounting method.

3. Discuss when it is prudent to claim losses on partial dispositions

a. It is always better to decline the loss if the replacement expenditure would be deducted as a repair.

b. Claiming the partial disposition loss triggers the requirement to capitalize the replacement property, so don't claim the partial disposition loss unless you are sure the replacement expenditure would otherwise be capitalized.

4. Discuss the effect of the *CBS* case, 105 Fed. Cl. 74 (2012), on partial dispositions.

5. Calculating the adjusted basis of the component that is disposed of.

   a. The regulations give taxpayers several options for calculating the adjusted basis of the component that is disposed of.

      i. One option would be to determine the fraction that the replacement cost of the component represents relative to the total replacement cost of the entire unit of property, and then apply that ratio to the original cost of the entire unit of property.

      ii. Another permitted approach would be to index the current replacement cost of the component back to the year the entire unit of property was placed in service using the CPI.

      iii. Alternatively, a taxpayer could perform an historic engineering study to determine the original cost of the component.

F. Lessee Improvements

1. In many cases, such as rental real estate, shopping centers, etc., a lessee makes an improvement that is chargeable to the lessor.

2. If the improvement is significant to the leased property, the lessee would have capitalized the improvement if it was charged to the lessee.

3. However, from the point of view of the lessor, in the past, lessors followed the same approach as the lessee, regardless of whether the improvement would have been material to the lessor's unit of property, i.e., the entire property.

4. Under new regs., lessor can follow its own unit of property definitions.

5. However, lessor must take into account the disposition rules.

6. When a tenant moves out, if old tenant improvements are deducted, new improvements must be capitalized regardless of materiality.

7. Moreover, section 168(i)(8)(b) requires deduction of basis of old improvement if entire old tenant improvement is abandoned.

8. Accordingly, lessor must determine whether part of prior improvement is preserved, so that it is treated as a partial disposition of a unit of property and lessor is able to elect not to recognize the loss on prior disposition.

9. That way, the lessor has a chance of expensing the new tenant improvement.

G. UNICAP for Fixed Assets

1. Background

2. How to make it work for fixed assets.

   a. Discuss choices and options

3. Applicability of section 481(a)

4. How was this issue handled in repairs method change requests?

   i. Most taxpayers ignored this issue.

III. Section 174 Method Changes

A. Background

1. The rules on what constitutes research expenses are quite nebulous.

2. As a result, various accounting firms have undertaken research credit studies for clients with the hope that expenditures previously capitalized or allocated to inventory might be identified as qualifying research expenses for purposes of the research credit.

3. In order to file a refund claims for additional research credits, the taxable years for which the claims are filed must be open under the statute of limitations.

4. However, the research expenditures might also generate additional deductions from taxable income under section 174.

5. This gives rise to the question whether a change in treatment of a particular cost from either a capital expenditure or inventory cost to a section 174 expense is a change in method of accounting that requires the filing of a Form 3115 or a correction of an error that is claimed by filing an amended return.

B. Prior Treatment

1. 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.

2. As a result, such a reclassification may only be made for open years.

3. 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.

4. A few years ago, responsibility for such changes was transferred back to PS&I 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.

5. However, this type of change was added to Rev. Proc. 2015-14, but must be made with a cutoff transition rule.

6. This has led most taxpayers to conclude that this is the only option.

7. However, the National Office still honors amended returns for open years.

8. This issue is also important because many of the new international tax reform proposals on patent boxes depend heavily on the amount of section 174 R&E a taxpayer has incurred in prior years, so it is important to make sure that even if an expense was deducted, it

should be classified as R&E to expand the base for the calculation of income that is taxed at a lower rate under a patent box.

i. There is a pretty good argument that an expense misclassified as something else instead of R&E, but deducted nonetheless, may be retroactively reclassified as R&E through the filing of an amended return.

ii. This would not be an accounting method change because it doesn't affect the timing of deductions.

iii. However, if the R&E was mistakenly classified as a capital expenditure or as an inventoriable cost, then the method change issues addressed above come into play.

C. Treasury/IRS Priority Guidance Plan

1. For the past few years, there was an item on the Guidance Plan to address this section 174 issue.

2. While the project was dropped from the most recent Guidance Plan, the Treasury and IRS are still trying resolve what the proper treatment should be for section 174 cost reclassifications.

3. There are apparently three possibilities.

a. 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.

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. Treat 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.

iv. However, at present there is no procedural vehicle for adopting this approach.

v. Thus, taxpayers wanting to use this approach must wait for hopefully a favorable outcome from the guidance project

c. Treat as a change in method of accounting, but require a cut-off transition rule.

i. This is the worst of all alternatives.

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

iii. This approach was adopted in Rev. Proc. 2011-14 and is still available up through the 2014 tax return.

iv. After 2014, the IRS has eliminated this option in Rev. Proc. 2015-13, so that an advance consent method change request would presumably need to be filed, unless the taxpayer is willing to follow the amended return approach.

IV. Accrual of Income and Accrual of Deductions and the All-Events Test for Service Providers and Service Recipients

A. General Tax Principles

1. From the viewpoint of a service provider, revenue accrues at the earlier of: (1) when an amount is due; (2) when an amount is

received; or (3) performance occurs. *Schlude v. Commissioner*, 372 U.S. 128 (1963); Rev. Rul. 2003-10, 2003-1 C.B. 288.

2. Except in instances where the performance called for by the contract is severable, performance does not occur until performance is completed. *Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2; Rev. Rul. 79-195, 1979-1 C.B. 177.

3. However, amounts received in advance of the performance of services may be eligible for a one-year deferral under Rev. Proc. 2004-34.

4. Accordingly, there is the possibility that revenue may be deferred in contrast to taxpayers' present methods.

   a. Such deferral would surely be available if no amounts were due and payable until the completion of the service.

   b. However, even if there were interim billings, if the taxpayer could persuade its accountants to defer the advance payment in the financial statements, deferral would be possible for tax purposes even where the interim billings were collected.

   c. For most publicly-held companies, such deferral is unlikely to be permitted for financial reporting purposes.

5. However, this issue cuts both ways. From the viewpoint of the recipient of the services, expenses accrue upon the earlier of:

   a. When the amount is due and payable; or

   b. When the all-events test, including economic performance, is satisfied. Section 461(h) and Rev. Rul. 2007-3, 2007-4 I.R.B. 350.

   c. In the case of an obligation to receive services, economic performance occurs as the services are received.

   d. Where an event other than payment is required to satisfy economic performance, payment may precede economic performance by up to 3 ½ months for purposes of satisfying the economic performance requirement.

e. In addition, an amount may be deducted in the taxable year preceding economic performance where economic performance occurs within 8 ½ months of the succeeding taxable year and the matching requirement is satisfied.

f. An expense may satisfy the all-events test and the economic performance requirement, but that doesn't necessarily mean the expense is currently deductible because the expense might be a prepaid expense that doesn't satisfy the 12-month rule in the INDOPCO regulations.

6. However, in *Caltex Oil Venture v. Commissioner*, 138 T.C. 18 (2012), the Tax Court ruled that in the case of an obligation to pay for a non-severable service, economic performance for purposes of the 3 ½ month rule (and presumably the 8 ½ month rule in the case of the recurring item exception) was not satisfied until the services were completed and the services had to be completed within the relevant 3 ½ or 8 ½ month period.

7. In an attempt to provide relief to taxpayers from this decision, in Rev. Proc. 2015-39, the IRS announced a safe harbor that applies in the case of severable, repetitive types of services. In that case, economic performance may be treated as occurring ratably over the term of the contract (referred to as a "ratable service contract").

1, Illustrations of ratable service contracts are maintenance contracts, janitorial service contracts, etc.

2. In contrast, contracts for result oriented services are not eligible for this treatment.

8. However, where does this leave non-severable service contracts? Surely, it cannot be the case that if a client makes periodic payments to its auditor for services rendered prior to the completion of an audit or a client is billed monthly by its attorney for worked performed on litigation that is not complete, the IRS position would be that the taxpayer cannot deduct the expenses because the services are not completed.

9. Should the flip side of Rev. Proc. 2015-39 be limited to situations where the amount billed or paid bears no relationship to the amount of services performed in respect of which the services are being billed?

10. It remains to be seen how the IRS will interpret the rules in these situations.

B. Application of principles to various types of service arrangements viewed from both the income and deduction perspective

1. A contract to provide auditing services

2. A litigation agreement

3. A research contract

4. A maintenance contract

5. An extended warranty or contingent services arrangement

6. A service contract with deferred contingent revenue

7. Ordinary employee services where employees work on unfinished projects.

C. The IRS recently sponsored a program at the ABA Tax Accounting conference wherein the IRS was promoting the importance of parity between the application of severability principles from the perspective of the contractor and the customer.

V. Customer Loyalty Programs

A. Background

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 prizes and/or free goods 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.

B. Tax Status

1. Most 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.

2. 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.

3. 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 or services.

4. 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).

C. In *Giant Eagle, Inc. v. Commissioner*, T.C. Memo. 2014-146, the Tax Court addressed the issue of deductibility both in the context of the "all-events test" and in the context of Treas. Reg. § 1.451-4.

1. However, the overriding factual distinction between this case and most others is that the customer in this case was required to purchase additional merchandise from the taxpayer in order to use his or her reward points to earn a discount on the purchase price of gasoline that the customer needed to purchase.

2. Because of this factual distinction, the Tax Court held that the purchase of additional gasoline was a condition precedent that trumped the likelihood that customers would redeem their reward points. Thus, the court ruled that the all-events test was not satisfied until the reward points were redeemed by the customer.

3. The court noted that even if a particular customer had sufficient reward points to reduce the price of gasoline to zero, the taxpayer still needed to establish the purchase price of the gasoline each day in order for a customer to be able to redeem the reward points.

4. Likewise with respect to Treas. Reg. § 1.451-4, the Tax Court held that this section was not available because the reward points functioned like discount coupons, instead of as premium coupon.

5. The court did suggest that if the reward points redeemed were sufficient to reduce the purchase price of the gasoline to zero, that type of redemption might qualify under Treas. Reg. § 1.451-4, but noted that in this particular case, the taxpayer failed to offer into evidence statistics of that type of redemption transaction.

D. The Treasury has placed the tax treatment of customer loyalty programs on the Treasury/IRS Priority Guidance Plan for 2015/2016.

1. In addition to all of the issues addressed above, one issue that remains unexplored is the revenue side of the transaction.

2. For example, with the recent trend in GAAP to recognize revenue separately for multiple deliverables or for separate elements of a sales transaction, one might argue that the portion of the original sales price of the merchandise on which award points are issued should be deferred until the points are redeemed by the customer.

3. If this approach were followed for tax purposes, it would avoid the issues with the application of Treas. Reg. § 1.451-4 and the all-events test.

4. However, the shortcoming of following this approach for tax purposes is that the deferral of revenue would be limited to two taxable years for prepayments from the sale of goods and one taxable year for prepayments from the sale of services.

5. It remains to be seen what direction this priority guidance project takes.

6. In the meantime, issues will continue to be raised by the IRS both under Treas. Reg. § 1.451-4 and under the all-events test and economic performance requirement.

VI. Deductibility of Employee Bonuses

A. An important new Field Attorney Advice, 20134301F was released by LB&I in 2013.

B. This FAA addresses a number of important issues faced by taxpayers with employee bonus plans.

C. Principal holdings

1. Impact of Employer Reservation of Right to Modify or Cancel Bonuses

a. 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.

b. This same conclusion would also apply where a bonus plan contains formulary criteria that must be satisfied in order for a bonus to be paid, but the plan reserves discretion to the board of directors (or compensation committee) to deviate from the fixed formula and reduce the amount of the bonuses.

c. The FAA cites a large number of state contract law cases holding that employees may not sue their employer for breach of contract, if the employer terminates employee bonuses prior to their payment pursuant to a clause in the employee bonus plan reserving in the employer the right to terminate the bonuses.

d. The FAA likewise notes that the doctrine of promissory estoppel is not applicable where the bonus plan expressly reserves in the employer the right to terminate the payment of the bonuses.

2. Impact of Requirement that Board of Directors (or Compensation Committee) Approve Bonuses

a. 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).

b. The FAA holds that in those circumstances, the employer's legal liability to pay the employee bonuses does not become fixed until the board of directors (or compensation committee) approves the bonuses.

c. Thus, if the board of directors (or compensation committee) approval does not occur until after the end of the year to which the bonuses relate, the bonuses are not deductible in the year to which they relate.

3. Bonus Plans with Subjective Criteria for Earning the Bonus

a. 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.

b. Thus, if this determination does not take place until after the end of the year to which the bonus relates, the bonus is not deductible in the year to which it relates.

c. While the FAA does not expressly address this point, we have encountered situations where an employer's bonus plan contains a fixed formula that might appear to meet the all-events test without action by the board of directors (or compensation committee).

d. However, in practice, the formula leaves considerable discretion to the employer to determine whether the bonus criteria are satisfied.

e. These types of plans must be analyzed on a case-by-case basis to determine whether board of directors (or compensation committee) action is required before year end in order to deduct the bonus in the taxable year of accrual.

f. Finally, many bonus plans contain a requirement for formal certification by an employer that employee performance criteria have been met.

g. This is typical of bonus plans designed to satisfy the requirements of section 162(m).

h. In our view, post-year end certification that criteria for a bonus are satisfied does not, in and of itself, turn a formulary plan into a discretionary plan that precludes deductions until the certification is issued.

i. However, as in the case of bonus plans without a certification feature, if the bonus criteria suggest subjective discretion on the part of the employer as to whether the bonus will be granted, that might prevent deduction of the bonus in the year to which the bonus relates, where the certification does not occur until the year of payment of the bonus.

D. Other conclusions in the FAA

1. Reliance on Group Liability

a. Rev. Rul. 2011-29, 2011-49 I.R.B. 824, and *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), hold that an employer's liability to pay an aggregate amount of bonuses to a group of employees may overcome the fact that an individual employee's bonus is forfeitable and permit a deduction of the aggregate amount of the bonuses.

b. However, this doctrine is applicable only if the employer's liability to the group of employees is fixed by the end of the taxable year of accrual.

c. If the employer's group liability is contingent on board of directors (or compensation committee) approval to the same extent as the employer's liability to each individual employee, the group liability concept does not support the deduction of the bonuses prior to board of directors (or compensation committee) approval.

2. Deduction of a Guaranteed Minimum Amount of Liability

   a. If a portion of an employer's liability to pay employee bonuses is fixed and the balance is discretionary, the fixed portion of the bonuses may be deducted in the taxable year of accrual.

   b. However, to qualify under this rule, the fixed portion of the bonus must in fact be fixed under the terms of the employee bonus plan.

   c. If board of directors (or compensation committee) action is required even for the guaranteed minimum portion of the bonus (either individually or in the aggregate) or if the guaranteed minimum portion of the bonus could be cancelled by the board of directors (or compensation committee), no portion of the bonuses would be deductible in the taxable year to which the bonuses relate.

3. Impact of Past Practice in Fixing Liability to Pay Employee Bonuses

   a. The IRS is unlikely to accept the argument that a taxpayer's legal obligation to pay bonuses under the terms of an employee bonus plan that is discretionary according to the terms of the plan is converted into a fixed obligation based on the taxpayer's past practice in paying employee bonuses under that plan.

4. Nature of Underlying Obligation to Pay Employee Bonuses

   a. The FAA seemingly accepts the notion that if, as part of a pre-existing employee bonus plan, a taxpayer's board of directors fixes the employee bonuses prior to the end of the taxable year of accrual (assuming no reservation of a right to cancel the bonuses), the bonuses would be deductible in the taxable year to which the bonuses relate.

   b. However, this conclusion is subject to some uncertainty based on the analysis in a recent Second Circuit decision, *New York*

Life Insurance Co. v. United States, 724 F.3d 256 (2d Cir. 2013).

c. This case is not cited in the FAA, but the FAA cites several of the same cases that the court in *New York Life* relied on for its holding.

d. In that case, the Second Circuit held that a gratuitous decision by a taxpayer's board of directors prior to the end of the taxable year to pay a dividend to policy holders in the following year (in a context where the dividend is the type of dividend that would be deductible) was not sufficient to satisfy the all-events test in the year the board of directors' resolution was adopted, even though the board's decision was binding and irrevocable.

e. The court cited several older employee benefit cases in which it was held that a board of directors' resolution to pay a discretionary bonus to employees was not deductible until the bonuses were paid to the employees, where the taxpayer was under no binding legal obligation to pay the bonuses at the time the board of directors' resolution was adopted.

f. This case suggests that a discretionary bonus is not made mandatory (and therefore fixed under the all-events test) by a board of directors' resolution to pay the bonuses.

g. The holding in the case thus seems more extreme than the positions expressed in the FAA, since the FAA seems to accept that an irrevocable board of directors resolution is sufficient to fix the liability to pay a bonus.

h. Query whether this same argument could be made in the case of a board of directors' resolution to pay a bonus to employees that is adopted after the employees complete the performance of the work that is being rewarded by the employer, if there was no pre-existing duty imposed on the employer to pay the bonus.

i. A result contrary to the *New York Life* decision was rendered in the *Massachusetts Mutual Life Ins. Co. v. United States*, 782 F.3d 1354 (Fed. Cir. 2015), supporting the proposition that a board of directors resolution promising the payment of a dividend satisfied the all-events test.

VII. Retrospective Costs and Section 199

A. What is a retrospective cost?

1. A cost that relates to work in a prior year, but that does not accrue for tax purposes until a later year. For example, a bonus paid more than 2-1/2 months after the end of the year in which the bonus was earned.

2. PLR 200946037 and pension costs

a. Wholly apart from the proper treatment of retrospective costs, this PLR deals with whether pension expense is a retrospective cost.

b. The IRS says no. Pension expense is deemed allocable to the production effort that occurs in the same taxable year that the pension expense is deductible.

3. Other employee benefits

4. Other post-production costs

B. How do retrospective costs affect section 199?

1. Where a taxpayer deducts an expense in a taxable year subsequent to the taxable year in which the expense accrues in an economic sense, a question exists whether that cost reduces QPAI in the taxable year in which the cost is deducted, if the taxable year in which the cost is economically incurred predates the effective date of section 199.

2. For example, assume that a taxpayer makes a contribution to a defined benefit pension plan in 2013 and thus deducts the pension contribution in 2013.

3. However, further assume that the employee service credits on which the pension contribution is based were incurred in 2003. In that case, the issue is posed whether the pension contribution reduces QPAI in 2013.

C. Explain IRS Position in LMSB Directive 04-0209-004, dated March 4, 2009

1. In this pronouncement, the IRS permits the allocation of costs to pre-effective date DPGR, provided the costs are factually allocable to pre-effective date effort and the costs are subject to the section 861 allocation rules.

2. Since cost of goods sold is an "above-the-line" deduction and is not subject to allocation under section 861, the IRS position is that retrospective costs may not be allocated to pre-effective date DPGR using section 861.

D. 2015 Proposed Regulations

1. In proposed regulations issued in 2015, the IRS would bar the allocation of retrospective costs that are allocable to cost of goods sold to DPGR earned in a prior taxable year.

2. However, such a retrospective allocation would still be permitted for costs that are period costs and not included in cost of goods sold.

3. Thus, for example, one could argue that employee fringe benefits allocable to service costs of administrative and sales personnel that are not part of mixed service costs allocated to inventoriable costs are still eligible for a retrospective allocation to pre-section 199 taxable years.

VIII. New FASB on Revenue Recognition

A. FASB recently issued new pronouncement on the recognition of revenue for GAAP purposes.

B. In general, this pronouncement divides revenue recognition into separate elements of deliverables and requires revenue recognition as each deliverable is delivered to customer.

C. Technically, this pronouncement has no legal effect on revenue recognition for tax purposes, but in practical terms it may have two effects.

1. First, to the extent that a taxpayer is deferring the recognition of revenue from advance payments under Rev. Proc. 2004-34 or Treas.

Reg. § 1,451-5, a change in the timing of revenue recognition for GAAP purposes may change the time for reporting such advance payment recognition for tax purposes.

2. Second, if the time for revenue recognition changes for GAAP purposes, this may be an indication that the taxpayer's revenue recognition *may* be incorrect for tax purposes.

D. Change in Timing of Advance Payments

1. If taxpayer is deferring advance payments under Rev. Proc. 2004-34 and the length of the deferral is affected by a GAAP change due to the new FASB pronouncement, Section 15.11 provides a simplified procedure for obtaining IRS consent to make a comparable change for tax purposes.

2. If taxpayer is deferring advance payments under Treas. Reg. § 1.451-5 and the length of the deferral is affected by a GAAP change due to the new FASB pronouncement, the taxpayer must file an advance consent method change request to change period of deferral for tax purposes.

E. Change in Timing of Revenue Recognition

1. First, a taxpayer needs to decide whether because of the new FASB, the taxpayer's tax method of revenue recognition is improper or whether new GAAP method may be used for tax purposes.

   a. For administrative reasons, most taxpayers prefer to report revenue for tax purposes at the same time that the revenue is reported for financial reporting purposes.

2. If a taxpayer concludes that its tax method is improper or new GAAP method may be used for tax purposes, the taxpayer must file an accounting method change request in order to change its tax treatment to conform to the new GAAP method.

3. If the taxpayer cannot or does not want to change its tax method and the new FASB creates a book/tax difference, the taxpayer needs to be mindful of the requirement for a Schedule M adjustment.

4. Tax departments need to be alert to such GAAP changes as sometimes the GAAP accounting function in a company does not notify the tax department of such changes.

F. The FASB recently postponed the effective date of this pronouncement from 2017 to 2018, but early adoption for 2017 is permitted.

IX. Sales-Based Royalties and Similar Costs such as Excise Taxes Imposed at Time of Sale.

A. Background of issue

1. As noted above, the simplified production method has a built in bias that overallocates additional section 263 A costs to ending inventory.

2. This problem is particularly acute in the case of costs that do not accrue until the point of sale of the goods, such as sales-based royalties.

3. In the case of these types of costs, if a taxpayer used a facts and circumstances allocation method, the taxpayer could simply match the costs that do not accrue until the point of sale of goods with the goods that are sold and treat 100% of such costs as includible in cost of goods sold.

4. In recognition of this result under the facts and circumstances, but wishing to avoid the complexity of a facts and circumstances allocation method, as described in a preceding section, some taxpayers using the simplified production method treated sales-based royalties as if they were selling expenses and excluded such costs from the numerator of the absorption ratio under their simplified production method.

5. This issue came to a head in *Robinson Knife Co. v. Commissioner*, T.C. Memo. 2009-9, where the Tax Court held that a taxpayer using the simplified production method must treat sales-based production royalties as an additional section 263A cost and include such cost in the numerator of the absorption ratio under the simplified production method, notwithstanding that the costs physically relate to goods that are sold.

6. However, in 600 F.3d 121 (2d Cir. 2010), the Second Circuit reversed the Tax Court and held that sales-based royalties could be excluded from inventory under the simplified production method.

B. Final regulations

1. Notwithstanding that the IRS disagreed with the holding in *Robinson Knife*, the Treasury issued regulations that implement the Second Circuit decision in *Robinson Knife*.

2. However, one issue not addressed in *Robinson Knife* is the effect of the holding on taxpayers using the LIFO inventory method.

3. If, as the IRS indicates, it disagrees with the conclusion in *Robinson Knife* that sales-based royalties are not production costs, then for a taxpayer using the LIFO method with inventory layers that relate to the taxable years in which goods were produced on which sales-based royalties accrued, presumably such royalties must be capitalized into the cost of the old LIFO layers under the theory that the royalties are retrospective additional costs of creating those inventory layers.

4. In an effort to avoid this problem, the Treasury decided to adopt the approach in the regulations that sales-based royalties must be allocated to the cost of goods sold in the taxable year the royalties accrue, regardless of the taxpayer's inventory method.

5. While this solves the problem for LIFO taxpayers, it created an inconsistency with other retrospective costs that accrue subsequent to the taxable year in which the costs are incurred in an economic sense, particularly where the taxpayer uses the LIFO inventory method.

6. This problem is considered in the next section, dealing with sales-based vendor allowances.

C. Effect on other retrospective costs

1. There are a number of other types of costs that accrue (under the all-events test including the economic performance requirement) either at the time of sale of the goods or after the goods are sold.

2. These costs might include:

a. Pension costs that are funded in a later taxable year than the taxable year in which employees performed services on which the pension costs are based.

b. Other employee benefit costs, such as retiree medical and employee benefits funded after the 2 ½ month rule expires under section 404(a)(5).

c. Other costs subject to deferral pursuant to section 461(h).

d. Excise taxes imposed at a time when goods are sold to which the taxes relate, such as excise taxes imposed on tobacco products or beer, wine or distilled spirits. While these taxes are technically imposed when the products are removed from a bonded warehouse, the goods are typically not removed from a bonded warehouse until almost immediately prior to the sale of the products. See *City Line Candy & Tobacco Corporation v. Commissioner*, 141 T.C. 13 (2014).

e. Renewable Identification Numbers for clean fuel standards.

3. In all of these cases, an issue has existed as to how such costs are treated under U NICAP.

a. One possibility is to treat such costs as retrospective production costs that are allocable to the goods produced in the taxable year when the costs were economically incurred, but were not yet deductible.

i. In that case, except where the taxpayer uses the LIFO method, it is unlikely that any goods would physically remain in inventory to which the retrospective costs relate, resulting in a current deduction of such costs.

ii. However, if the taxpayer uses the simplified production method or simplified resale method, the same type of issue as in *Robinson Knife* arises.

b. Another possibility is to treat such costs as allocable to the goods produced in the taxable year in which the costs accrue for tax purposes, even if the costs do not physically relate to such goods.

i. This approach would subject such costs to the Government's original argument in *Robinson Knife*.

ii. Moreover, such approach would apply even if the taxpayer used a facts and circumstances allocation method.

c. The third possibility is to treat such costs as deductible in the taxable year in which they satisfy the all-events test and the economic performance requirement.

i. This would be the same approach as is adopted for sales-based royalties in the recently-issued regulations.

4. IRS position

a. This depends on the particular cost.

b. In the case of routine, repetitive costs, such as employee benefit costs that are not deductible until paid and costs deferred by application of section 461(h), the IRS position is that such costs are allocable to goods produced in the same taxable year that the costs are deductible.

c. In contrast, in instances where the costs are directly traceable to particular goods, such as excise taxes imposed on goods as they are removed from a bonded warehouse, the IRS permits the costs to be matched with the goods to which the costs factually relate, if the taxpayer uses the facts and circumstances allocation method.

d. In contrast, if the taxpayer uses one of the simplified allocation methods, the IRS insists that the costs be allocated to all goods produced in the same taxable year that the costs are deductible.

X. Future of LIFO