Tax Accounting

BY JAMES E. SALLES

This month's column addresses four recent administrative announcements dealing with tax accounting issues. The IRS has:

1. Updated the procedure governing "automatic consent" to accounting method changes, limiting some changes when the same taxpayer uses different methods, Rev. Proc. 99-49, 1999-52 I.R.B. 1;
2. Confirmed that expenditures to secure and maintain ISO 9000 are currently deductible as ordinary costs of conducting business, Rev. Rul. 2000-4, 2000-4 I.R.B. 1;
3. Asserted that stock warrants granted to a major customer should be capitalized as leading to long-term benefits from the continuing relationship, F.S.A. 1999-1166; and
4. Reaffirmed its position that automatic expensing of very small expenditures is not permitted, I.L.M. 199952010 (Sept. 29, 1999).

NEW AUTOMATIC CONSENT PROCEDURE

Code Section 446(e) requires the Commissioner's consent to a change in accounting methods. Under recently liberalized rules, taxpayers can generally submit Form 3115 requesting consent at any time during the taxable year for which the change is sought to be made.[1] The normal procedures for requesting accounting method changes appear in Revenue Procedure 97-27, 1997-1 C.B. 680.

The IRS has long permitted taxpayers to make certain specific types of accounting method changes under special automatic consent procedures. In 1997, the IRS began consolidating the relevant rules, formerly found in a hodgepodge of administrative pronouncements, into one annual revenue procedure. General terms are given in the body of the procedure and descriptions of the specific changes covered and special rules applicable to each appear in an appendix. In general, taxpayers can make changes subject to the automatic consent procedures until the return filing date.

Modified Procedure

The IRS issued a new procedure in this accounting procedure series in December, 1999 Revenue Procedure 99-49, 1999-52 I.R.B. 1, which supersedes Revenue Procedure 98-60, 1998-51 I.R.B. 16. Among other minor changes, Revenue Procedure 99-49 for the first time incorporates rules for making mark-to-market elections under Code Section 475 and for revoking elections to currently include market discount on debt instruments under Code Section 1278(b).

New Restriction Added

One of the most common situations in which an automatic change is permitted has been that in which the taxpayer wants to change from the cash method or a hybrid method to an accrual method. Revenue Procedure 99-49 continues to permit such a change, with or without an election to apply the "recurring item exception" in determining economic performance. The revenue procedure requires that all trades or businesses of the same taxpayer adopt the same overall accrual method for the change in method to be approved for one entity.

Taxpayers are generally permitted to maintain different accounting methods for different trades or businesses that keep separate books and records. Treas. Reg. § 1.446-1(d). The IRS was probably concerned about potential abuses. See Treas. Reg. § 1.446-1(d)(3), which states that businesses conducted by the same taxpayer will not be considered separate if "by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between [them] so that income of the taxpayer is not clearly reflected."

Changes prohibited by this rule appear to be still possible; however, the taxpayer would have to submit the

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proposed change for individualized consideration under the general method change procedures because the change would fall outside the scope of Revenue Procedure 99-49.

ISO 9000 EXPENDITURES

In early January 2000, the IRS issued the latest in a series of revenue rulings in its continuing efforts to impose order on capitalization doctrine in the aftermath of the Supreme Court's decision in *INDOPCO v. Commissioner*, 503 U.S. 79 (1992). Revenue Ruling 2000-4, 2000-4 I.R.B. 1, holds that ISO 9000 compliance expenditures are ordinary expenses and are currently deductible.

ISO 9000 refers to a series of quality standards developed by the International Standards Organization. Organizations that aspire to ISO 9000 certification may have to expend substantial sums to bring their processes into compliance and then obtain a certificate of compliance from an outside auditor. Certification generally lasts from two to four years. Obtaining and maintaining ISO 9000 certification is not legally required, but is a prerequisite for dealing with many organizations in the United States and abroad and is of substantial help in marketing an organization's products and services.

INPOPCO Analysis

The IRS performed what is now becoming a fairly familiar INDOPCO analysis as to ISO 9000 certification. ISO certification is not a "separate and distinct asset," so the issue was resolved on the basis of general considerations of "future benefit" and "clear reflection." The revenue ruling concluded that the expenditures were principally intended to benefit current sales and that the future benefit was "incidental." Consequently, these expenditures were not required to be capitalized. The only exception was for expenditures directly related to the creation or acquisition of a specific separate and distinct asset with expected future utility, such as a quality manual.

New Life for Briarcliff Candy

The IRS relied on several cases holding that expenditures incurred in maintenance and expansion of an existing business are deductible. Interestingly, one case the ruling cited was *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), which allowed current deductions for expenditures the taxpayer incurred trying to open new distribution channels. Some commentators had doubted whether *Briarcliff* remained good law, given its reliance on the absence of a separate and distinct asset, 475 F.2d at 786, and a disparaging footnote in *INDOPCO*, 503 U.S. at 83 n.3.

Sun Microsystems, Inc.

Revenue Ruling 2000-4 cited *Sun Microsystems, Inc. v. Commissioner*, 66 T.C.M. (CCH) 997 (1993). In that case the Tax Court held, contrary to the IRS's position, that warrants granted as product discounts to a large customer did not have to be capitalized based on amorphous considerations of "market development." The ruling characterized the critical factor in Sun as being the nature of the customer relationship. Any expected long-term benefits from development of a customer relationship were "softer" and more speculative than the immediate benefit from the sales to which the warrants were tied.

Field Service Advice 199939035 was issued on August 9, 1999. This field service advice signaled the IRS's recognition that routine expenditures incurred to maintain and even "grow," in modern parlance, an existing business's customer base need not be capitalized on the basis of some speculative future benefit. The reinforcement of the same principle in a published ruling is welcome.

WHEN CUSTOMERS RECEIVE STOCK OPTIONS

An increasingly common practice, especially in the field of high technology, is for a supplier to issue stock warrants or options to its customers in connection with volume purchase contracts. Such arrangements have been before the Tax Court several times. The value of the warrants is treated as a sales discount, reflected as a reduction to gross sales by the supplier-issuer in *Sun Microsystems, Inc. v. Commissioner*, 66 T.C.M. (CCH) 997 (1993). The buyer treats the discount as a reduction in purchase price in *Computervision International Corp. v. Commissioner*, 71 T.C.M. (CCH) 2450, 2465–67 (1996).

The Tax Court addressed related timing issues in *Convergent Technologies v. Commissioner*, 70 T.C.M. (CCH) 87, 94–95 (1995). Here the Tax Court held that the value of the option is taken into account at issue if it has "readily ascertainable market value." Otherwise the taxable event occurs when the option is exercised. This is in keeping with the traditional treatment of options issued for compensation,[2] and in other contexts.[3] Non-publicly traded options rarely have readily ascertainable market value unless perhaps the options are deeply "in the money"[4] or other extraordinary circumstances exist.

A "New" Old Field Service Advice

A recently released field service advice may complicate this neat analysis as to customer options and warrants. In Field Service Advice 1999-1166, Tax Analysts Document 1999-2606, the IRS chief counsel's office concluded that warrants issued to a supplier in these circumstances represented a capital expenditure. The field service advice itself is undated, and although it purports to apply *INDOPCO v. Commmissioner*, 503 U.S. 79 (1992), the FSA relies upon (and incorporates as an appendix) an earlier FSA that was issued in 1991 or 1992, while *INDOPCO* was before the Supreme Court. Both FSAs are heavily redacted. These factors make it difficult to weigh the significance of Field Service Advice 1999166 as an indicator of current IRS National Office attitudes.

Grounds for Disagreement

The cost of the warrants has to be associated with the sales, which may take place over time, of the volume of goods covered by the option agreement in this type of warrant or option arrangement. This is achieved by treating the warrants as a reduction in sales price. The grounds for requiring further capitalization are unclear. The issuer obtains no other contractual right. *INDOPCO* indicates that there need not be a "separate and identifiable asset," like a contract, to trigger capitalization if there is a future benefit; however, no future benefit appears to exist here outside of that provided by ordinary expenditures incurred to build up a business.

The earlier field service advice cites the fact that the warrants enabled the issuer to "obtain its first large customer" and "the potential for future business" fostered by the stake granted the customer in the supplier's success. The first ground is unconvincing. A "workforce in place" can be a capital asset. See, e.g., Ithaca Indus., Inc. v. Comm'r, 17 F.3d 684, 686 (4th Cir.), *cert. denied*, 513 U.S. 821 (1994). Nevertheless, this treatment does not make routine training costs capital expenditures under Revenue Ruling 96-62, 1996-2 C.B. 9. Likewise, customer relationships acquired in the aggregate as part of an ongoing business can form part of goodwill or another capital asset, but this does not make every expenditure directed toward building up a customer base capital. See F.S.A. 199939035, discussed in the January 2000 column.

The Warrant as a Discount

The second ground cited by the field service advice in support of capitalization appears equally irrelevant. The warrants appear to be simply a volume discount. There seems to be no authority suggesting capitalizing volume discounts, no matter how helpful they may be in establishing or maintaining customer relationships. The fact that the discount is allowed in the form of a warrant should make no difference in treatment. This battle was fought long ago in *Commissioner v. LoBue*, 351 U.S. 243 (1956). There the Supreme Court rejected the taxpayer's argument that options should be treated differently from other forms of compensation because they served the secondary purpose of conveying to the taxpayer a "proprietary interest" in the business. Id. at 247.

Long-term employees are likely more prone than customers of high technology to keep the stock after exercise. The stock presumably continues to serve the intended purpose of bonding the employees' interest to the interest of issuer and spurring performance; however, employers are not required to capitalize otherwise deductible compensation expense as a result.

Implications

The Tax Court, at least, seems not to be particularly hospitable to arguments along the lines outlined in Field Service Advice 19991166. The field service advice does not discuss, and may even antedate, the decision in *Sun*, which expressly rejected various IRS arguments in favor of capitalization, including a somewhat amorphous argument based on the "new look" that INDOPCO allegedly bestowed on traditional capitalization rules. 66 T.C.M. (CCH) at 1005.

The IRS recently cited the *Sun* holding with evident approval in a published ruling. Rev. Rul. 2000-4, 2000-4 I.R.B. 1, discussed above. Field Service Advice 19991166 thus may or may not fully reflect the National Office's current position. Taxpayers engaging in these types of arrangements with major suppliers should draft carefully, however, so as not to provide an auditing agent with any unnecessary hooks on which to hang an INDOPCO argument down the road.

MATERIALITY DOES NOT MEAN SIZE

Another administrative tidbit in the form of an IRS legal memorandum confirms that the IRS has not backed off its position that whether an item is material, for purposes of determining whether there has been a change in accounting method, has nothing to do with its magnitude. The IRS believes there is no such thing as a de minimis exception to the rule requiring capitalization of expenditures that provide a future benefit. I.L.M. 199952010 (Sept. 29, 1999).

Regulations

As explained in last month's discussion of *Pelton & Gunther*, Treasury Regulations Section 1.446-1 defines a change in accounting method as "a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan" under Treasury Regulations Section 1.446-1(e)(2)(ii)(a). Material is in turn defined, not in terms of magnitude, as accountants and others familiar with the financial accounting concept of the same name tend to assume, but as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Id.

Court Decisions

In *Pelton & Gunther*, the court took issue with the IRS's definition of item, holding that a law firm's deductions for costs advanced to its clients, and the income it reported if it later recovered those costs, were different items. Therefore, when the IRS disallowed the deductions but permitted the taxpayer to exclude the recoveries from income, the change did not deal with the "timing" of a single item and there was no change in accounting method.

Courts have occasionally had the temerity to disagree with the IRS's definition of materiality, notably the Court of Claims in *Cincinnati, New Orleans, and Texas Pacific Railway Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970). The taxpayer, which had consistently expensed all expenditures of less than $100, increased the threshold to $500, following regulatory accounting prescribed by the Interstate Commerce Commission. The court held that the taxpayer's method clearly reflected income, because the differences between its accounting results and those that would have followed from a rigorous application of capitalization principles to these small expenditures were "so minute as to become unfathomable." Id. at 572. The court held that increasing the threshold from $100 to $500 was not an unauthorized change in method because the regulations required the Commissioner's consent only if the change was "a substantial or material one."

The Ruling

The taxpayer involved in the IRS legal memorandum[5] consistently expensed amounts expended for machinery, equipment, furniture, and fixtures below a threshold of $1,000. In 1991, possibly emboldened by the Court of Claims's holding in *Cincinnati, New Orleans,* the taxpayer applied for consent to a proposed change in the threshold to $2,000. For unexplained reasons, the ruling request seems to have languished in the National Office for eight years, and was then denied. The notice of denial to the taxpayer further advised:

> The taxpayer's current method of not capitalizing assets valued at a certain amount or less is not an acceptable method of accounting. All property used in a trade or business (except land or inventory) that has a useful life of more than one year must be capitalized and depreciated. Taxpayers are not permitted to treat such items as current expenses because the particular item has a certain minimum value or less.

Thus, 30 years after *Cincinnati, New Orleans,* the IRS continues to adhere to its position that there is no expenditure too small to be capitalized.

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1. Treas. Reg. § 1.446-1(e)(3)(i). Before 1998, the request had to be submitted within the first 180 days of the taxable year.

2. E.g., Comm'r v. LoBue, 351 U.S. 243, 249 (1956). Similar timing rules now govern under Code Section 83.

3. See, e.g., Simmonds Precision Prods. v. Comm'r, 75 T.C. 103 (1980).

4. See Comm'r v. Smith, 324 U.S. 177, 181 (1945); cf. Reg. § 1.83-7(b) (to have readily ascertainable market value under Code Section 83, the fair market value of the "option privilege" must be determinable, and presumably it would be if the terms were such that the option were virtually certain of exercise); Rev. Rul. 82-150, 1982-2 C.B. 110 ("deep in the money" option equivalent to ownership for foreign personal holding company purposes).

5. Letters granting or denying requests for consent to proposed changes in accounting method are normally not subject to public release. What was actually released as an IRS legal memorandum (I.L.M.) was the National Office's transmittal of a copy of the rejection letter to the district, with a redacted copy of the ruling letter attached.

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