Tax Accounting

BY JAMES E. SALLES

In this month's column:

- Accounting issues figure prominently in the IRS 2000 business plan;
- The Tax Court creates some confusion with a cryptic holding in *Exxon Mobil Corp. v. Commissioner*, 114 T.C. No. 20 (2000);
- The IRS concludes in a field service advice that mutual fund fees based on net asset value (NAV) are not determinable with reasonable accuracy while the NAV remains susceptible to market fluctuation, F.S.A. 200016002 (Jan. 13, 2000); and
- There are several new developments in the ongoing controversy over whether taxpayers must accrue merchandise receivables.

IRS BUSINESS PLAN

Accounting issues figure prominently in the IRS business plan for 2000, formally known as the Priority Guidance Plan, which was released in late March.

INDOPCO Regulations

Treasury and the IRS have responded to widespread requests for general guidance on capitalization issues and the implications of the Supreme Court's decision in *INDOPCO v. United States*, 503 U.S. 79 (1992). The business plan for 2000 promises specific guidance—probably in the form of revenue rulings—on whether and when to capitalize such items as cyclical maintenance costs, sales commissions, mutual fund launch costs, and bank loan origination costs. What all of these types of expenditures have in common is that they produce some sort of future benefit, but are repetitive and are routinely incurred by taxpayers in particular businesses.

The plan also includes proposed regulations under Code Sections 162 and 263 that are described only as relating to "deduction and capitalization of expenditures." Acting Assistant Secretary for Tax Policy Jonathan Talisman explained that the intent is to take an approach to capitalization issues that is "broader and deeper" than the approach taken under the regulation-by-ruling policy that has prevailed in the past. The proposed regulations are expected to address such issues as repairs and the "plan of rehabilitation" doctrine, and how to account for the cost of self-created intangible assets, and may even incorporate a *de minimis* rule,[1] which the IRS has steadfastly resisted until now.

Other Accounting Issues

Other accounting guidance scheduled for release includes the following:

- Final regulations on various topics under the uniform capitalization (UNICAP) provisions
- Final and proposed regulations under Code Section 460 (concerning long-term contracts)
- Additional guidance under Code Section 446 concerning notional principal contracts
- Finalization of the controversial proposed revenue procedure in Notice 98-31, 1998-1 C.B. 1165, setting forth how the IRS proposes to handle involuntary changes in accounting methods

EXXON MOBIL CORP. v. COMMISSIONER

In *Exxon Mobil Corp. v. Commissioner*, decided on May 3, 2000, the Tax Court clarified the application of the "all events" test, while obscuring the issue of what constitutes a change in accounting method. The issue was when Exxon could take a deduction for the costs of "dismantlement, removal, and restoration" (DRR costs) incurred through different joint ventures in Alaska's Prudhoe Bay field.

Background

A liability cannot be deducted or otherwise taken into account for tax purposes until "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."[2]

It was long disputed whether this all events test could be met when the taxpayer's obligation was to perform in

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kind rather than pay cash. The IRS argued that the all events test was not met until the taxpayer actually began incurring costs in performing its obligation. For example, in Revenue Ruling 80-182, 1980-2 C.B. 167, an offshore oil lease required the taxpayer to remove platforms and well fixtures on termination. The ruling stated that even if the taxpayer contracted with a third party to perform the necessary services, it could not deduct anything until removal actually began. Several courts, however, disagreeing with this reasoning, allowed mining companies to amortize their estimated cost of restoring strip-mined land over the period during which the mine was operated.[3] The economic performance rules overruled these cases,[4] but they remained good law for the years involved in the Exxon case (1979-82).

The All Events Test

Exxon's original return followed the IRS's position and made no attempt to accrue Exxon's DRR costs during the production period. On amended returns, however, Exxon treated its DRR liability as becoming "fixed" when it signed the leases, and added them to basis in computing percentage depletion and the investment tax credit. Alternatively, it argued for simply deducting the DRR costs outright as soon as the leases were signed.

In either case, Exxon had to begin by showing that its liability for DRR costs under the leases met the all events test. Exxon and its co-venturers leased the land under an Alaska form contract referred to as a DL-1 lease. Under the DL-1 leases the venturers were allowed to remove any equipment or facilities left over from its operations. The companies were not, however, generally obligated to remove facilities, although the leases also provided that the lessees "shall remove any and all . . . properties when . . . directed" by the state, and that no site could be abandoned until "final cleanup and revegetation, if required, [was] approved" by the state. In contrast, contemporary leases entered into with the federal government in connection with the Alaska Pipeline project (TAPS leases)—which the IRS apparently conceded met the all events test—expressly obliged the oil companies to "promptly remove all improvements and equipment" and "restore the land" to the satisfaction of federal officials.

Despite testimony from experts and state officials that state policy favored restoration of lands and predictions that the state would use the authority granted it by the leases to require a full cleanup of the property, the Tax Court held that the DL-1 leases did not create the necessary fixed liability as to "fieldwide" reclamation costs, because "expectations and predictions simply do not satisfy the all-events test of section 461. They do not rise to the level of fixed and definite legal obligations." The court held, however, that Alaska regulations did create an enforceable obligation to plug oil wells and clean up the immediate vicinity of well sites, and thus that portion of Exxon's DRR costs met the all events test.

Changes in Method

The remainder of the court's opinion dealt with how to treat the well cleanup costs that met the all events test. The court held that Exxon could not change from deducting to capitalizing the costs because that would be in change accounting method. Taxpayers ordinarily cannot change accounting methods without permission, or retroactively.[5] The court then dismissed Exxon's fallback argument for an immediate deduction on the grounds that, although it might not be a change in accounting method, the resulting mismatch of income and deductions would not clearly reflect income.

In contrast to its exhaustive treatment of the all events test, the court's discussion of the accounting issues was short, cryptic, and somewhat puzzling. Either changing to amortizing the DRR costs, or continuing to deduct them but at an earlier time, would involve a change in "the proper time for . . . the taking of a deduction."[6] Both, therefore, could equally be changes in accounting methods. In either case, Exxon would have an argument that it was simply correcting an "error" rather than changing methods, especially if it could show that it already treated similar costs the same way.[7] This might have been possible, since the IRS evidently conceded that the DRR costs imposed by the TAPS leases could be capitalized. As a result of the court's abbreviated opinion, it is hard to evaluate the strengths of the parties' positions, and it is hard to explain a holding that changing to amortizing the DRR costs would be a change in accounting method but simply deducting them earlier might not.

The court's treatment of Exxon's fallback argument is almost equally mysterious. "Clear reflection of income" is almost never cited as independent grounds for disallowing use of an accounting method explicitly permitted by the Code or regulations. Indeed, the Tax Court has gone so far as to say that the IRS "may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis." *Hallmark Cards v. Commissioner*, 90 T.C. 26, 31 (1988). Too big a deal should not be made of this semantic point. The Tax

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Court could have (correctly) come out in the same place by simply holding that general capitalization principles forbid an immediate deduction. But the court's summary holding and reliance on the "clear reflection" mantra simply add to the tangle that may have to be sorted out on appeal.

FIELD SERVICE ADVICE EXPLAINS "REASONABLE ACCURACY"

In Field Service Advice 200016002, the IRS National Office held that a taxpayer need not accrue 12b-1 fees from a mutual fund because they could not be determined with the necessary reasonable accuracy. The field service advice also provided an advance peek at the IRS's reaction to its partial loss in *Johnson v. Commissioner*, 184 F.3d 786 (8th Cir. 1999), the case involving auto dealers' vehicle service contracts that was discussed in this column in the November 1999 issue.

The All Events Test

The all events tests for income and deductions are essentially the same. An income item or expenditure is taken into account when "all the events have occurred which fix the right to receive such income," or "establish the fact of the liability," as the case may be, if the amount is determinable with "reasonable accuracy."[8] It was this "reasonable accuracy" requirement that was involved in Field Service Advice 200016002.

Named after the regulations under the Investment Company Act of 1940 that authorize them,[9] 12b-1 fees are fees paid by a mutual fund to its distributing broker to help finance the costs of marketing the mutual fund shares. Such fees are computed based on the NAV of the fund, and in this particular case, were computed and paid to the distributor monthly. The National Office held that the distributor earned its fees, and thus acquired a "fixed right to receive income," as it sold shares of the mutual fund. It did not have to recognize income immediately, however, because the NAV of the fund fluctuated daily and therefore the amount of the fees could not be determined with reasonable accuracy until the end of the month.

Matching Income and Deductions?

The National Office then addressed the commissions paid by the taxpayer on the same sales. Assuming without deciding that the commissions would be "ordinary and necessary" expenditures and hence currently deductible, it next considered whether the fee income not being currently reported should make any difference. This is where the *Johnson* case came in.

In *Johnson*, the taxpayer successfully argued that it could currently deduct certain otherwise capitalizable expenses because they were directly related to advance payments it had to report immediately as income, and "both income and deductions must be considered" in considering whether an accounting method clearly reflects income. 184 F.3d at 790. Here, the *Johnson* shoe was potentially on the other foot, since the taxpayer was currently deducting sales commissions but the associated fee income was not recognized until the following month. In unusually strong language, however, the field service advice scorned any notion of applying *Johnson*:

> We note that the 8th Circuit's discussion of this issue is devoid of analysis, cites no case law, and resulted in an unvarnished beneficial result for the taxpayer ("matter of fairness"; "It is not fair . . . ." *Id.*) We strongly disagree with the 8th Circuit's approach in allowing a deduction for the administrators' fee . . . [and] strongly recommend against pursuing a mismatch of income and expense/clear reflection of income argument as an alternative argument to either the income or deduction side of this case.

To the extent that a single administrative document can be taken as an indication of institutional attitude, the IRS does not seem inclined to take its loss in *Johnson* lying down.

NEW DEVELOPMENTS ON "MERCHANDISE" FRONT

Last month's column discussed recent court cases applying the rule that taxpayers selling merchandise must accrue purchases and sales, and recent congressional and regulatory initiatives to ease the rule following the widespread outcry about denying use of the installment method to accrual-basis taxpayers. The following new developments occurred on this front since that column went to press:

- The IRS has formally acquiesced in *Osteopathic Medical.*[10] A.O.D. 2000-05 (Apr. 27, 2000). The acquiescence was in result only. This normally indicates disagreement with a certain part of the court's reasoning. The IRS, however, concedes that in similar circumstances, "prescription drugs or similar items administered by healthcare providers" are not merchandise subject to inventory accounting. Providers may be required to keep track of their

stockpiles of medication as "supplies" under Treasury Regulations Section 1.162-3.

- The Tax Court followed *Osteopathic Medical* in another memorandum opinion featuring similar facts. Mid-Del Therapeutic Ctr., Inc. v. Commissioner, T.C.Memo. 2000-130.
- The IRS issued the promised regulatory guidance in the form of Revenue Procedure 2000-22, 2000-20 I.R.B. 1, which allows taxpayers with gross receipts of $1 million or less that meet a LIFO-style conformity requirement to continue to use the cash method.

Predictably, practitioners who had been critical of the IRS position at House Small Business Committee hearings in early April expressed disappointment at the retention of the $1 million threshold,[11] and the pressure for congressional action can be expected to continue.

1. "IRS, Treasury Release 2000 Business Plan," 86 *Tax Notes* 1819 (Mar. 27, 2000); see also, e.g., Letter from Charles W. Shewbridge, Tax Executives Institute, to Mr. Talisman and IRS Chief Counsel Stuart Brown, Mar. 6, 2000, Tax Analysts Doc. No. 2000-7609.
2. I.R.C. § 461(h)(4); Treas. Reg. § 1.461-1(a)(2).
3. Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951); Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).
4. See, e.g., Staff of Joint Comm. on Taxation, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84) 258 (Jt. Comm. Print 1984). The mining companies were given a special exception in Code Section 468A.
5. I.R.C. § 446(e); Rev. Proc. 97-27, § 2.04, 1997-1 C.B. 680, 682.
6. See Treas. Reg. § 1.446-1(e)(2)(ii)(a).
7. Cf. Standard Oil Co. (Indiana) v. Commissioner, 77 T.C. 349 (1984) (allowing taxpayer to extend its election to expense intangible drilling costs to eligible expenditures it had overlooked).
8. I.R.C. § 461(h)(4); Treas. Reg. §§ 1.451-1(a), 1.461-1(a)(2).
9. 17 C.F.R. § 270.12b-1.
10. Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner, 113 T.C. 376 (1999).
11. Massey, "Practitioners Disappointed With New Cash Basis Revenue Procedure," 57 *Daily Tax Highlights & Documents* 906 (Apr. 28, 2000).

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