Tax Accounting

By James E. Salles

This month's column discusses *Metro Leasing and Development Corp.,*[1] which holds that federal income taxes did not accrue as a deduction under the accumulated earnings tax[2] while both unpaid and contested. The Ninth Circuit's holding affirms the Tax Court and conflicts with the Fifth Circuit's 1988 holding in *J.H. Rutter Rex Mfg. Co., Inc.*[3]

Federal income taxes are not allowed as a deduction in computing federal taxable income, but are deductible in computing corporate earnings and profits. They are also deducted in applying second-level taxes that apply to C corporations, including the accumulated earnings tax, personal holding company tax and foreign personal holding company tax. There is a surprising amount of authority on when federal income taxes (and interest on them) accrue as deductions, and the rules differ depending on the context. Understanding *Metro Leasing* requires some background on both the rules that generally apply to accrual of deductions and the circumstances in which they do not (or may not) apply.

The "All Events" Test

The traditional "all events" test for the accrual of deductions, which parallels a similar rule for income, requires that "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." The Deficit Reduction Act of 1984 added the requirement that "economic performance" occur by the end of the year, or, under some conditions, within a "reasonable time" thereafter.[4] The economic performance requirement was extended to most taxes from 1992. Taxes are economically performed upon payment.[5]

The "Relation-Back" Doctrine

The annual accounting principle requires that income and deduction items must be "reflected in terms of their posture" at the close of the tax year.[6] Whether or not a deduction is properly accrued is determined "in light of the events known or reasonably to be anticipated" by the taxpayer at that time.[7]

Despite the reference to amounts "determined with reasonable accuracy," taxpayers are responsible for making the best calculation possible based on all the information "known or knowable."[8] A well-established legal fiction holds that a liability that can theoretically be computed based upon facts available at year-end is determinable, even if an actual calculation is not practically possible. Thus, for example, an income tax[9] or an obligation under a formula lease[10] is "determined" when all the controlling factors are fixed as of the end of the year.[11]

Long-standing regulations provide that "if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year."[12] However, that prospective adjustment is only made when a "best estimate"

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proves inaccurate because of developments that were not reasonably foreseeable at year-end[13] or some other inherent uncertainty in the calculation. This is rarely going to be the case with respect to income taxes because, in theory, the liability can be precisely computed as of the last day of the year.

The above principles indicate that a "mere mistake" in calculation must be corrected by an adjustment to the original year, and not when the mistake is discovered. This "relation-back" principle has been consistently applied to deductible state taxes,[14] customs duties,[15] federal capital stock[16] and excess profits taxes,[17] liabilities for violating wartime price controls,[18] and other formula-based liabilities. One corporation that paid bonuses based on taxable income was allowed to "retroactively" adjust its compensation expense when it conceded adjustments on a tax audit that increased its liability.[19]

No deduction is allowable—and therefore, no deduction can relate back—if a tax is not paid within a reasonable time after the close of the tax year.

One important limitation on the scope of the "relation-back" doctrine is that it assumes that the amount properly accrued in the first place. An adjustment to a liability will not "relate back" if it is attributable to an independent event that occurred after the close of the year in question, such as new legislation,[20] or even an unforeseeable change in an agency's interpretation of the law.[21] The economic performance requirement further curtails application of the "relation-back" doctrine. No deduction is allowable—and therefore, no deduction can relate back—if a tax is not paid within a reasonable time after the close of the tax year.

Contested Liabilities

Early courts were confused about how to apply the "relation-back" doctrine when the amount of the liability was contested. However, in *Dixie Pine Products Co.*[22] and *Security Flour Mills Co.*,[23] the Supreme Court held that the taxpayers could not deduct unpaid state gasoline taxes and federal processing taxes while contesting their liability. Both cases relied upon the annual accounting principle and emphasized the need for "bright-line" rules.

Suppose the taxpayer pays the disputed amount and then seeks a refund. In *Consolidated Edison Co. of New York*,[24] the Supreme Court held that the payment of a contested liability would not support a deduction. The Court reasoned that denying the underlying liability effectively turned the "payment" into a nondeductible deposit. However, Congress countered with Code Sec. 461(f), which generally allows deducting a disputed amount upon payment if the contest is the only thing that would otherwise stand in the way.

These developments left it clear that, under general "all events" principles, a resolution of a dispute concerning an additional asserted liability or a refund of an amount already paid is an independent event. Therefore, any adjustment to the amount of the liability that results from resolution of the contest will not "relate back" to affect the amount of an earlier accrual. There can remain issues about whether there is actually a "contest," and if so, when it arose. A contest that first arises after year-end should not prevent accrual.[25] A latent contest generally only becomes evident, however,

when the additional liability is asserted. Contests, therefore, are generally "related back" to inception of the liability and will forestall accrual, unless there is a clear indication that they arose after the end of the year from some independent cause.[26]

Different Rules for "Earnings and Profits"

The early courts' vacillation about contested liabilities left a legacy in the form of two "common law" exceptions to the general "all events" rules. One of these exceptions applies to foreign taxes that are claimed as credits.[27] Subject to very narrow exceptions, U.S. tax liability is recomputed to reflect any adjustment to a foreign tax liability that has been claimed as a credit, regardless of whether the foreign adjustment was contested or not.[28]

The other exception applies in computing corporate earnings and profits (E&P). Earnings and profits determine the extent to which a corporate distribution is a dividend and matter for a number of other purposes as well. The law in this area grew out of early cases under the "excess profits taxes" intermittently levied before 1954. Somewhat simplified, "excess" profits were determined by comparison with a normal return on corporate capital, which was computed by reference to earnings and profits. The government frequently argued for an earlier deduction because it would decrease corporate capital and increase the potential excess profits tax liability. The IRS argued, and the courts agreed, that federal tax adjustments "related back" in computing earnings and profits on an accrual basis, whether there was a contest or not.[29] Leaving aside economic performance, that remains the rule to this day. The Ninth Circuit and the Tax Court extend the same "relation-back" treatment to interest on the contested liability,[30] although the IRS does not agree.

Both the persistence of a broader "relation-back" doctrine for E&P and the controversy concerning interest are likely now much less important. The regulations that provide that taxes are "economically performed" upon payment also apply in computing earnings and profits.[31] Unless the regulations' application is successfully challenged, extending "relation-back" treatment to contested liabilities is likely only to matter in rare cases in which a disputed tax is paid early in the year following that in which it would otherwise accrue, and possibly in cases where the contest is about the right to a tax refund that would *increase* E&P.[32]

Second-Level Corporate Taxes

The different treatment of contested tax liabilities under the regular tax and in computing E&P sets the stage for the controversy before the Ninth Circuit in *Metro Leasing*. Federal income taxes are also deductible in applying the accumulated earnings tax (AET) and the personal holding company (PHC) and foreign personal holding company (FPHC) tax regimes. The relevant regulations state that the deduction for federal taxes shall be allowed on an accrual basis, regardless of the taxpayer's method of accounting. They also add specifically that "an unpaid tax which is being contested is not considered accrued until the contest is resolved," as the Supreme Court held in *Dixie Pine*.[33]

Two rulings illustrate application of both the "relation-back" principle and the exception for contested liabilities to federal tax liabilities. Rev. Rul. 68-632[34] held that a deficiency to which the taxpayer agreed on audit "related back" under "all events" principles for purposes of the AET.

By contrast, Rev. Rul. 72-306[35] concluded that a deficiency did not "relate back" when the taxpayer disputed the adjustments after receiving a "30-day letter," even though it ultimately conceded liability.

The IRS clearly envisions two different variants of the "relation-back" doctrine. A narrower interpretation applies under the regular income tax and the second-level corporate taxes, and (leaving aside "economic performance") allows "relation back" of uncontested adjustments but defers deductions for contested liabilities under *Dixie Pine*. A broader version of the doctrine, applicable only in computing corporate E&P, relates back *all* adjustments, contested or not.

Rutter Rex and *Metro Leasing*

The IRS's application of the narrower "relation-back" rule has been generally supported by court decisions under both the accumulated earnings tax[36] and the personal holding company tax.[37] However, in *Rutter Rex*,[38] the Fifth Circuit, reversing the Tax Court, reduced the taxpayer's accumulated earnings to reflect a contested income tax deficiency determined in the same proceeding. The appellate opinion relied on the "earnings and profits" cases and attempted to distinguish the personal holding company tax authorities on the grounds that the Supreme Court has characterized the AET as a penalty rather than a conventional tax. The Fifth Circuit also construed the regulations' prohibition on accruing unpaid taxes "until the contest is resolved" as not prohibiting the deduction's "relating back" once the tax is paid.

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Metro Leasing gave the Tax Court its first chance to address the issue since being reversed in *Rutter Rex*. The taxpayer raised three computational issues under the AET, the second involving when it could deduct the income tax deficiency being determined in the same case. The Tax Court, in a unanimous reviewed opinion, disregarded *Rutter Rex* as resting on a strained interpretation of the regulations, and applied conventional "all events" principles to deny the deduction in the year that the tax liability arose. Judge Halpern, joined by three colleagues, wrote a separate detailed concurrence explaining that the additional tax would have "related back" had there been no contest, and acknowledging that the authorities on corporate earnings and profits extended this treatment even to contested taxes.[39] However, both the court's opinion and the concurrence made clear that the governing authority under the AET was the "all events" test and *Dixie Pine*, and not the old "earnings and profits" cases.

The Ninth Circuit has now upheld the Tax Court, and declined to follow the Fifth Circuit. The court reasoned that the statutory requirement was clear and the Supreme Court's calling the AET as a "penalty" was beside the point. The "all events" test simply denied any deduction so long as the tax remained unpaid. The court noted that the tax might have accrued under Code Sec. 461(f) when the taxpayer made an interim payment on account, but did not have to decide the issue because that year was not before the court.[40]

Metro Leasing highlights the fact that the second-level taxes can give taxpayers another

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[7] Tax Reform Act of 1986 (P.L. 99-514).

[8] *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998).

[9] Similarly, *see W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo. 1998-279, *infra*.

[10] *Id.*

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disclosure requirements described in Code Sec. 280G(b)(5)(B) and Reg. §1.280G-1, Q&A-7 are deemed to be satisfied, and the payments to Executive E are exempt from the definition of parachute payment.

Effect on Companies

Rev. Rul. 2004-87 provides some guidelines to help reduce uncertainty when determining whether certain payments to executives are parachute payments when the corporation is in bankruptcy. The ruling also demonstrates the bankruptcy court's impact on parachute agreements when it makes determinations in the interest of the corporation's shareholders.

Effective Date

Rev. Rul. 2004-87 applies to any payment that is contingent on a change in ownership or control if the change of ownership or control occurs on or after July 19, 2004. Notwithstanding the foregoing, where a corporation is a debtor in a case under the Bankruptcy Code, its securities traded on an over-the-counter market are not considered "readily tradeable" for purposes of Code Sec. 280G(b)(5)(A)(ii) with respect to a change in ownership or control that occurred before July 19, 2004.

[1] Rev. Rul. 2004-87, IRB 2004-32, 154.

[2] Deficit Reduction Act of 1984 (P.L. 98-369).

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tactical consideration to take into account in deciding whether to make a payment while a tax dispute is going on. *Rutter Rex* had somewhat confused the picture because it was the most recent appellate decision and departed sharply from the prevailing legal backdrop. After the Tax Court and Ninth Circuit opinions, however, taxpayers—at least outside the Fifth Circuit—will face an uphill battle in trying to get a "retroactive" deduction for a contested tax.

[1] *Metro Leasing and Development Corp.*, CA-9, 2004-2 USTC ¶50,308, 376 F3d 1015, *aff'g*, 119 TC 8, Dec. 54,809 (2002).

[2] Code Sec. 531, *et seq.*

[3] *J.H. Rutter Rex Mfg. Co., Inc.*, CA-5, 88-2 USTC ¶9499, 853 F2d 1275, *rev'g on this issue*, 53 TCM 1125, Dec. 43,979(M), TC Memo. 1987-296.

[4] Act Sec. 91 of the Deficit Reduction Act of 1984 (P.L. 98-369), codified at Code Sec. 461(h); Reg. §1.461-1(a)(2)(i).

[5] Reg. §1.461-4(g)(6), (k)(3) (effective date).

[6] *Consolidated Edison Co. of New York, Inc.*, SCt, 61-1 USTC ¶9462, 366 US 380, at 384.

[7] *United Control Corp.*, 38 TC 957, at 971, Dec. 25,678 (1962), *acq.*, 1966-1 CB 3.

[8] *E.g., Chicago, Burlington & Quincy Railroad Co.*, CtCls, 72-1 USTC ¶9253, 197 CtCls 264, 455 F2d 993, at 1018–19, *rev'd and rem'd on another issue*, SCt, 73-1 USTC ¶9478, 412 US 401.

[9] *Uncasville Mfg. Co.*, CA-2, 3 USTC ¶869, 55 F2d 893, at 895, *cert. denied*, SCt, 286 US 545 (1932).

[10] *Illinois Power Co.*, 87 TC 1417, Dec. 43,556 (1986).

[11] *Compare, e.g.*, Rev. Rul. 82-174, 1982-2 CB 99; GCM 38901 (Feb. 12, 1982) (deduction for windfall profits tax allowed in the amount paid when final liability depended in part on facts that the taxpayer could not know at the time).

[12] Reg. §1.461-1(a)(3).

[13] *E.g., Baltimore Transfer Co. of Baltimore City*, 8 TC 1, Dec. 15,534 (1947), *acq. on this issue*, 1947-2 CB 1.

[14] *See, e.g., Dravo Corp.*, CtCls, 65-2 USTC ¶9564, 172 CtCls 200, 348 F2d 542 (Pennsylvania capital stock tax); *Uncasville Mfg. Co., supra* note 9; *Gulf States Utilities Co.*, 16 TC 1381, at 1395–98, Dec. 18,363 (1951) (Louisiana income tax); *H.E. Harman Coal Corp.*, 16 TC 787, at 803–04, Dec. 18,236 (1951), *nonacq. on another issue*, 1951-2 CB 5, *aff'd and rev'd on other issues*, CA-4, 52-2 USTC ¶9487, 200 F2d 415 (Virginia income tax); *Standard Paving Co.*, 13 TC 425, at 447–48, Dec. 17,204 (1949), *aff'd on other issues*, CA-10, 51-2 USTC ¶9376, 190 F2d 330, *cert. denied*, SCt, 342 US 860 (1951) (Oklahoma income tax); *Oregon Pulp and Paper Co.*, 47 BTA 772, at 780, Dec. 12,835 (1942) (reviewed) (Oregon excise taxes); *Haverty Furniture Co.*, 20 BTA 644, Dec. 6277 (1930) (South Carolina income tax).

[15] *Keller-Dorian Corp.*, CA-2, 46-1 USTC ¶9200, 153 F2d 1006 (liability accrued in the year of importation if the correct amount was "ascertainable"); Rev. Rul. 75-562, 1975-2 CB 197.

[16] *E.g., Budd International Corp.*, 45 BTA 737, Dec. 12,174 (1941), *aff'd and rev'd and rem'd on other issues*, CA-3, 44-2 USTC ¶9425, 143 F2d 784, *cert. denied*, SCt, 323 US 502 (1945).

[17] *National Forge and Ordnance Co.*, CtCls, 58-1 USTC ¶9331, 158 FSupp 860 (*per curiam*) (federal excess profits taxes, which were deductible in computing "ordinary" taxable income).

[18] *Hershey Creamery Co.*, CtCls, 52-1 USTC ¶9132, 101 FSupp 877, at 884 (amount estimable because administrators consistently only required payment of an amount equal to the overcharge in such cases, and taxpayer did not contest its liability); *Marantz v. Yoke*, DC W. Va., 53-2 USTC ¶9502, 113 FSupp 536 (similar).

[19] *McKenzie Construction Co.*, DC Tex., 63-1 USTC ¶9335, 214 FSupp 738.

[20] *E.g., Cedar Rapids Engineering Co.*, DC Iowa, 49-2 USTC ¶9419, 86 FSupp 577; *Detroit Moulding Corp.*, DC Mich., 44-2 USTC ¶9456, 56 FSupp 754 (new election allowed taxpayers to "retroactively" change capital stock tax valuation; compare *Budd* above).

[21] *E.g., Baltimore Transfer Co., supra* note 13 (state board changed interpretation of unemployment tax); Rev. Rul. 75-562, 1975-2 CB 197 (customs duties).

[22] *Dixie Pine Products Co.*, SCt, 44-1 USTC ¶9127, 320 US 516.

[23] *Security Flour Mills Co.*, SCt, 44-1 USTC ¶9219; 321 US 281.

[24] *Consolidated Edison Co. of N.Y., Inc., supra* note 6.

[25] *E.g., Globe Products Corp.*, 72 TC 609, Dec. 36,158 (1979), *acq.*, 1980-2 CB 1 (taxpayer only became aware of facts indicating that a tax assessment was untimely in the following year); Rev. Rul. 67-127, 1967-1 CB 113 (real estate taxes properly accrued in year before protest was filed).

[26] *See, e.g., LX Cattle Co.*, CA-5, 80-2 USTC ¶9798, 629 F2d 1096 (additional taxes for 1968–1970 that were asserted and paid without protest in 1971, but which were challenged in a refund claim filed in 1973, did not "relate back" to 1968–1970 but accrued under Code Sec. 461(f) when they were paid in 1971).

[27] *Cuba Railroad Co.*, DC N.Y., 54-2 USTC ¶9498, 124 FSupp 182; Rev. Rul. 84-125, 1984-2 CB 125; Rev. Rul. 58-55, 1958-1 CB 266.

[28] *See generally* Code Sec. 905(c) and related regulations.

[29] *E.g., Stern Bros. & Co.*, 16 TC 295, Dec. 18,103 (1951).

[30] *G.O. Clark*, CA-9, 59-1 USTC ¶9430, 266 F2d 698, at 714–15; *S. Stark*, 29 TC 122, Dec. 22,636 (1957), *nonacq.*, 1961-2 CB 6.

[31] Reg. §1.461-1(a)(2) (last sentence).

[32] *See, e.g.*, Rev. Rul. 75-153, 1975-1 CB 106; Rev. Rul. 66-336, 1966-2 CB 110; Rev. Rul. 64-146, 1964-1 CB (pt. 1) 129, holding that carryback refunds accrue on the last day of the year of the loss or credit being carried back. Under the current IRS position, for regular tax purposes, a carryback refund will not accrue until allowed. *See* Rev. Rul. 2003-3, 2003-1 CB 252, discussed in James E. Salles, Tax Accounting, CORP. BUSINESS TAX'N MONTHLY, Mar. 2003, at 32.

[33] Reg. §§1.535-2(a)(1); 1.545-2(a)(1); 1.556-1(a)(1).

[34] Rev. Rul. 68-632, 1968-2 CB 253.

[35] Rev. Rul. 72-306, 1972-1 CB 165.

[36] *E.g., R.A. Goodall Est.*, CA-8, 68-1 USTC ¶9245, 391 F2d 775, *cert. denied*, SCt, 393 US 8; *Doug-Long, Inc.*, 73 TC 71, at 77–78, Dec. 36,384 (1979).

[37] *LX Cattle Co., supra* note 26; *Kluger Associates, Inc.*, CA-2, 80-1 USTC ¶9314, 617 F2d 323; *Hart Metal Products Corp.*, CA-7, 71-1 USTC ¶9186, 437 F2d 946, at 951–53; *Mariani Frozen Foods, Inc.*, 81 TC 448, at 490–95, Dec. 40,474 (1983), *aff'd on other issues sub nom., M.L. Gee Trust*, CA-9, 85-1 USTC ¶9428, 761 F2d 1410.

[38] *J.H. Rutter Rex Mfg Co., Inc., supra* note 3, at 1295–98.

[39] *Metro Leasing and Development Corp., supra* note 1, 119 TC, at 22, n. 1, and at 26, n. 5.

[40] *Metro Leasing and Development Corp., supra* note 1, 376 F3d, at 1027, and at n. 12.

Multistate Taxation

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New York

The Division of Taxation has the authority under N.Y. TAX LAW §211(4) to require the taxpayer to file its franchise tax report on a combined basis with its sister corporation, which is an intangible holding company, in order to properly reflect the taxpayer's tax liability. The division's position is that the sister corporation must be included in a combined report with the taxpayer when an agreement exists in the form of the license agreement between the taxpayer and sister corporation, as well by the assignment of the trademarks by the parent to the sister corporation and the license-back of those marks by the parent from the sister corporation.

These agreements cause the taxpayer's activity, business, income or capital within New York to become improperly or inaccurately reflected. The effect of these agreements, according to the division, is to divert taxable income out of New York in the form of excessive royalties paid by the taxpayer to the sister corporation. On appeal, the court agreed with the division, holding that the taxpayer failed to meet its burden of proving that the royalty rate paid to the sister corporation was at arm's length. Further, the division carried its burden of proving that the transfer and license-back transactions had no business purpose apart from tax avoidance, lacked economic substance other than the creation of tax benefits, and that the royalty payments made to the sister corporation were a contrived mechanism to limit the taxpayer's exposure to state franchise tax.[6]

The New York Department of Taxation and Finance (DOTF) issued new WITHHOLDING TAX FIELD AUDIT GUIDELINES with an effective date of September 17, 2004. The revised guidelines make significant changes to the state's enforcement approach to its nonresident withholding tax requirements. The most significant changes in the audit guidelines are two "rules of convenience" in the enforcement of nonresident withholding tax computations:

- The 14-day rule
- Deferred compensation, stock options and other income

The audit guidelines place a greater emphasis on employer compliance with the Form IT-2104.1, *New York State, New York City Yonkers Certificate of Nonresidence and Allocation of Withholding Tax*. Nonresident employees use that form to estimate the amount of time that will be worked in New York for a calendar year. The audit guidelines instruct NY auditors to question employers about their process for reviewing the reasonableness of information provided by employees on the IT-2104.1. No apparent review process might be in place, for instance. In that event, the form is merely entered into a payroll