Tax Accounting

BY JAMES E. SALLES

In this month's column,

1. A new law may liberalize the "nonaccrual experience method," but narrows its application;
2. The Third Circuit affirms the Tax Court's holding that a teacher was in constructive receipt of pension benefits;
3. New revenue procedures provide special methods of accounting for vehicle tires and auto dealers' "capital cost recovery" payments; and
4. The IRS will not propose adjustments in a broad category of capitalization cases pending issue of proposed regulations in the area.

CHANGES TO THE NONACCRUAL EXPERIENCE METHOD

The Job Creation and Worker Protection Act of 2002,[1] signed into law by President Bush in March, is best known for providing special temporary depreciation bonuses and extended periods for carryback of losses and credits. However, buried some pages back is a provision that rewrites Code Section 448(d)(5), which allows use of the nonaccrual experience method for service receivables.

Code Section 448, which dates from the Tax Reform Act of 1986, generally requires C corporations, and partnerships including C corporations, to use accrual accounting if their gross receipts exceed $5 million. "Qualified personal service corporations" providing particular types of services are exempt. Code Section 448(d)(5) formerly permitted a service provider that used accrual accounting, either voluntarily or because it failed to meet the definition of a qualified personal service corporation, to elect not to report as income most "amounts which (on the basis of experience) will not be collected." Except for small banks,[2] the 1986 Act had generally repealed reserves for bad debts.[3] However, the nonaccrual experience method provided eligible taxpayers with roughly equivalent relief, although under tighter rules.

Application Narrowed

The Job Creation Act amended Code Section 448(d)(5) to confine use of the nonaccrual experience method to taxpayers that either do not meet the $5 million revenue threshold or are qualified personal service corporations, and are therefore exempt from the accrual requirement. Taxpayers that are *required* to use accrual accounting will therefore generally no longer be allowed to use the nonaccrual experience method. Moreover, taxpayers that are not subject to Code Section 448 because they are not C corporations, such as partnerships or S corporations, will not be able to use the nonaccrual experience method unless they could do so if they were C corporations.

Alternative Formulas Permitted

On the other hand, the rewritten version of Code Section 448(d)(5) may herald a more liberal approach to applying the nonaccrual experience method for those taxpayers that remain eligible to use it. There are two basic ways of applying the nonaccrual experience method: Taxpayers may track the amounts not reported as income either on receivable-by-receivable basis (the "separate receivable system")[4] or on an aggregate basis (the "periodic system").[5] In either case, however, the percentage of receivables that are not reported as income must be computed according to an experience-based formula set forth in the regulations.

There was a key change in this formula when the original temporary regulations issued in 1987 were amended in 1988. The 1987 regulations had computed the allowable percentage on the basis of the proportion of bad debts to outstanding receivables at the end of each year during the testing period.[6] This was similar to the "*Black Motor* formula"[7] commonly used in computing bad-debt reserves and the "experience method" applicable to small banks.[8] By contrast, the 1988 regulations determine the percentage on the basis of the ratio of bad debts to *all receivables earned* during the testing period.[9]

The taxpayer in *Hospital Corporation of America v. Commissioner*[10] argued that the 1988 regulations were invalid because they departed from the traditional methods for determining bad-debt reserves and did not necessarily reflect the probability of collecting the accounts receivable that were actually outstanding at year-end. This could happen, for example, if the year-end receivables contained a disproportionate amount of questionable accounts, which would seem likely. For example, the regulations' formula allowed the taxpayer in *Hospital Corporation* to exclude only about 3 to 5 percent of its year-end receivables from income, whereas about 20 percent of those accounts later became uncollectible.[11] However, the Tax Court held that the 1988 regulations were not so unreasonable as to be invalid.

The new version of Section 448(d)(5) requires that regulations be issued that permit "using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected." The section further provides that "a taxpayer may adopt, or request consent of the Secretary to change to, a computation or formula that clearly reflects the taxpayer's experience. A request . . . shall be approved if such computation or formula clearly reflects the taxpayer's experience."[12]

The legislative history makes it clear that the critical con-

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sideration is whether the formulas clearly reflect "the amount of [the taxpayer's] *year-end receivables* that will not be collected,"[13] and adds that "it is anticipated" that the forthcoming regulations will provide appropriate safe harbors. The unusual provision requiring that the IRS approve taxpayers' requests to change methods is evidently intended to ensure that taxpayers will be allowed to change from the 1988 regulations' formula, since the IRS normally enjoys near-absolute discretion in acting on taxpayers' applications to change from one permissible method to another.[14] Of course much will depend on the new regulations and how the safe harbors are drafted.

CONSTRUCTIVE RECEIPT

An earlier column discussed the Tax Court's decision in *Visco v. Commissioner.*[15] The taxpayer in *Visco* was a teacher who refused to accept checks for back pay, apparently because she mistakenly felt that doing so would prejudice her right in an ongoing dispute with the school district. The checks were later deposited into a bank escrow account for her benefit. The Tax Court held that she could not "turn her back" on the resulting income. The Third Circuit has now affirmed the Tax Court.[16] Like the Tax Court, the appellate court reasoned that the teacher had both the right to the income and the power to receive it. She was entitled to the payments under a state court order, and could have cashed the checks at the time of receipt or later have instructed the bank to pay over the escrow proceeds.

REV. PROC. 2002-27: VEHICLE TIRES

Over the past two years or so, the IRS has provided an unprecedented amount of administrative guidance on assorted tax accounting issues, major and minor. Revenue Procedures have been particularly in vogue. The latest spate of guidance began in April, when the IRS issued Revenue Procedure 2002-27, prescribing a special method of accounting for the cost of tires acquired along with the associated vehicles.

Tires are generally accounted for separately from the associated vehicle.[17] As with other expenditures for tangible goods, whether the tires' cost has to be capitalized depends on whether they have a useful life that extends "substantially beyond the taxable year."[18] Taxpayers have frequently taken the position, with some success,[19] that they should be entitled to a current deduction because the tires have useful lives of less than one year.

On the other hand, as Revenue Procedure 2002-27 notes, modern tires are generally much longer lasting than those in use at the time of the early cases and rulings, so that the current expensing treatment may be vulnerable to challenge. If the cost does have to be capitalized, the depreciation recovery period will depend on the business in which the associated vehicle is used, but will generally be much longer than the actual useful life of the tire.[20] Under a strict interpretation of present law, therefore, the choice lies between a current deduction and an unreasonably long recovery period.

Revenue Procedure 2002-27 seeks to alleviate this problem and head off potential disputes by prescribing an elective method of accounting known as the "original tire capitalization method." The method requires taxpayers to treat the cost of original tires as part of the cost of the associated vehicle, but permits current deduction of the costs of any replacement tires that are later acquired while the vehicle remains in use.[21]

Taxpayers are generally granted automatic consent for the necessary changes in accounting method in the first or second taxable year ending on or after December 31, 2001.[22] If the IRS has already raised the issue, taxpayers may still make the change for 2001 or 2002, but without the usual "audit protection" for earlier years.[23] The procedure also provides a one-time settlement offer under which taxpayers may agree to resolve outstanding controversies by making the change in the earliest consecutive open year.[24] Except when a Tax Court trial is imminent, taxpayers generally have until September 3 to request application of the settlement. Changes are made on a "cut-off" basis, meaning that the new method is used for vehicles acquired during or after the year of the change.

REV. PROC. 2002-36: VEHICLE LEASES

Another accounting issue that has been the cause of some recent controversy has been the treatment of so-called "capital cost reduction payments" (CCRs) that are made at the beginning of a lease term. CCRs are commonly encountered in vehicle leases. The customer may make an up-front payment to the dealer, in cash or in the form of a vehicle trade-in, or the manufacturer may provide a rebate or incentive payment at the inception of the lease. In either case, the effect is to reduce the payments that would later be due under the lease. The dealer then sells the vehicle to a finance company subject to the lease, sometimes, but not necessarily, along with the CCR itself.

Three-Way Transactions

Long before the Supreme Court applied the same principle to services in *Schlude v. Commissioner*,[25] advance rentals were held to be income upon receipt, even if the lessor reported on an accrual method.[26] In a simple two-party transaction involving only the customer and the dealer, the dealer simply has prepaid rental income. Commonly, however, the dealer sells the vehicle subject to the lease to a third party (finance company), frequently though not necessarily an affiliate of the manufacturer, at a price which takes into account the reduced payments to be expected under the lease. The question of how to treat these transactions has been a recurring one in various forms of private guidance.[27]

The IRS has generally taken the position that the transaction should be treated as if the dealer sold the vehicle to the finance company at a market price and then made a separate payment to the finance company in the amount of the CCR. The result will usually be a wash so far as the dealer is concerned. If the dealer receives the CCR as agent for the finance company, it will have neither income nor deduction. Assuming the CCR is income to the dealer in the first place, however, it should have a corresponding deductible payment to the finance company to assume its liability under the lease.

Under this model, however, the *buyer* then has advance rental income on the lease on which it is now the lessor. For example, if the buyer actually pays $20,000 for a car that (disregarding the lease) is worth $25,000, it would be treated as buying the car for $25,000 and then receiving a deemed payment of $5,000 advance rent under the lease. The buyer would have to report the $5,000 in the year of purchase, although it would be entitled to depreciate the "extra" purchase price over the car's cost recovery period.

This analysis is consistent with the rules that apply when a publisher that has advance receipts for subscriptions sells its business. The seller has to recognize any subscription income that was previously deferred under Code Section 455, but gets an offsetting deduction for a deemed payment to the buyer to assume liability for future performance. The buyer treats the deemed payment as an advance receipt of subscription income, which may be eligible for deferral in appropriate circumstances.[28]

Revenue Procedure 2002-36

Third-party buyers, like the finance company on the facts discussed above, complained that under the IRS's treatment they were forced to recognize income even though they generally got no cash. They argued that from their perspective, they had merely bought a vehicle at a bargain price because it was subject to a below-market lease. Their case aroused some sympathy among the new Treasury team. Last year, officials were quoted as saying that the government was seeking a solution that was "easily administrable and imposes the lowest compliance costs."[29]

Revenue Procedure 2002-36 represents the IRS's attempt at such a solution. The procedure sets forth an elective safe harbor that covers most common types of vehicle leases, noting that further modifications were possible "as necessary to respond to changes in leasing market conditions." The safe harbor "CCR method" permits the vehicle buyer to elect to exclude the CCR from income in exchange for not including it in the vehicle basis. The buyer's basis in the vehicle will be the net amount paid the dealer. The IRS will no longer challenge buyers that are already using the CCR method. Other taxpayers are granted automatic consent to change to the CCR method in the first or second taxable year ending on or after December 31, 2001. If they do so their previous method will no longer be challenged.

CAPITALIZATION CONTROVERSIES

In January, the Service issued an advance notice of proposed rulemaking (the ANPR),[30] allowing taxpayers a "sneak preview" of the forthcoming proposed regulations on the capitalization of intangible costs. The ANPR includes several simplifying and taxpayer-favorable rules. For example, a "12-month rule" would allow expensing of most outlays that generate a future benefit that extends less than 12 months beyond the close of the taxable year. The ANPR also suggests that the regulations will provide that routine internal costs (such as employee salaries and overhead) will generally not have to be capitalized into the basis of intangible assets.

As an earlier column[31] noted, however, the ANPR's impact on controversies that may arise in the meantime is somewhat unclear. A February divisional memorandum says that the ANPR "do[es] not provide any authority for concession of these issues," but also instructed agents not to raise fresh capitalization issues if the deduction would be allowable under the ANPR's proposed 12-month rule.[32] A few weeks later, the Office of Chief Counsel announced that it also would not pursue cases involving the capitalization of "fixed overhead"-type costs and *de minimis* costs that would be eligible for expensing under the ANPR.[33] A new divisional memorandum now instructs field agents not to propose adjustments relating to these issues either.[34] Much audit and litigation activity in this area is therefore likely to be put on hold pending the promised proposed regulations.

1. Pub. L. No. 107-147, 116 Stat. 21 (Mar. 9, 2002).
2. See I.R.C. § 585.
3. Tax Reform Act of 1986, Pub. L. No. 99-514, § 805(b), repealing former I.R.C. § 166(f).
4. Reg. § 1.448-2T(e)(3).
5. Notice 88-51, 1988-1 C.B. 535.
6. Reg. § 1.448-2T(e)(2)(i), T.D. 8143 [6-12-87].
7. See Black Motor Co. v. Commissioner, 41 B.T.A. 300, 302 (1940), *aff'd on other issues*, 125 F.2d 977 (6th Cir. 1942).
8. Reg. § 1.585-2(c)(1)(i).
9. Reg. § 1.448-2T(e)(2)(i).
10. 107 T.C. 116 (1996).
11. *Id.* at 137 n. 16.
12 Pub. L. No. 107-147, codified at I.R.C. § 448(d)(5).
13. Joint Committee Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCS-12-02, March 6, 2002) at 30-31 (emphasis added).
14. See generally J. Salles, "Of Merchandise, Accruals, and Administrative Grace," 95 Tax Notes 1778, 1791 (June 17, 2002).
15. 79 T.C.M. (CCH) 1613 (2000), discussed in J. Salles, "Tax Accounting," 1(8) *Corp. Bus. Tax'n Monthly* 29, 31 (May, 2000).
16. 281 F.3d 101 (3d Cir. 2002).
17. See, e.g., Zelco, Inc. v. Commissioner, 331 F.2d 418 (1st Cir. 1964); W.H. Tompkins Co. v. Commissioner, 47 B.T.A. 292 (1942).
18. Reg. §§ 1.263(a)-2(a); 1.446-1(c)(1)(ii).
19. See Tompkins, supra note 2; Interstate Truck Service, Inc. v. Commissioner, 17 T.C.M. (CCH) 1079 (1958); Rev. Rul. 59-249, 1959-2 C.B. 355, amplified by Rev. Rul. 68-134, 1968-1 C.B. 63.
20. See generally Rev. Proc. 87-56, 1987-2 C.B. 674.
21. Rev. Proc. 2002-27, § 5, 2002-17 I.R.B. 802, 803.
22. Rev. Proc. 2002-27, § 6.02, 2002-17 I.R.B. 802, 803.
23. Rev. Proc. 2002-27, § 6.03, 2002-17 I.R.B. 802, 804.
24. Rev. Proc. 2002-27, § 7, 2002-17 I.R.B. 802, 805.

25. 372 U.S. 128 (1963).

26. E.g., New Capital Hotel v. Commissioner, 261 F.2d 437 (6th Cir. 1958) (per curiam), *aff'g* 28 T.C. 706 (1957); Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938).

27. E.g., CCA 200123047 (Mar. 12, 2001); FSA 200103006 (Jan. 19, 2001); CCA 200048001 (May 11, 2000).

28. Rev. Rul. 71-450, 1971-2 C.B. 78; Rev. Rul. 68-112, 1968-1 C.B. 62; see also James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964) (amounts deferred under pre-§ 455 law).

29. See "Treasury Looks to Please Business on Corporate Tax Questions," 92 Tax Notes 884, 884-86 (Aug. 13, 2001).

30. REG-125638-01, RIN 1545-BA00.

31. J. Salles, "Tax Accounting," 3(8) *Corp. Bus. Tax'n Monthly* 33, 34-35 (May, 2002).

32. Memorandum dated February 26, 2002, from Commissioners Larry R. Langdon of the Large and Mid-Size Business (LMSB) Division and Joseph G. Kehoe of the Small Business/Self-Employed (SB/SE) Division to LMSB and SB/SE Employees, Tax Analysts Doc. No. 2002-4959.

33. Chief Counsel Notice CC-2002-021 (March 15, 2002).

34. Memorandum dated April 26, 2002, from Commissioners Larry R. Langdon of the Large and Mid-Size Business (LMSB) Division and Joseph G. Kehoe of the Small Business/Self-Employed (SB/SE) Division to LMSB and SB/SE Employees, Tax Analysts Doc. No. 2002-11231.
