Tax Accounting

By James E. Salles

This month's column features a sampling of recent guidance from the IRS:

- Temporary regulations rewrite the rules for the "nonaccrual experience method" under section 448(d)(5)[1];
- Final rules under section 457 that require beneficiaries of tax-exempt employers' option plans to currently include income[2];
- Proposed regulations that would defer income from inducement fees received to assume noneconomic residual interests in REMICs[3]; and
- A new revenue procedure liberalizing the rules for automatic consent to individual taxpayers' changes from fiscal to calendar years.[4]

Nonaccrual Experience Method

In early September, Treasury and the IRS issued temporary and proposed regulations[5] implementing the 2002 amendments to section 448(d)(5), which describes the "nonaccrual experience method" of accounting for service receivables. The temporary regulations supersede the earlier guidance in Notice 2003-12.[6]

Section 448 generally requires C corporations and partnerships with C corporation partners to use accrual accounting if their revenues exceed $5 million. An exception applies to "qualified personal service corporations" (QPSCs) that provide certain types of mostly professional services. Section 448(d)(5) permits some taxpayers to forgo accruing service receivables that "on the basis of . . . experience, will not be collected." Last year, Congress restricted use of this "nonaccrual experience method" to receivables for the types of services performed by QPSC's and to taxpayers falling below the $5 million revenue threshold.[7] As a result, the taxpayers that remain eligible to use the nonaccrual experience method are mostly not required to use accrual accounting at all, although limited exceptions exist.

Jim Salles is a member of Caplin & Drysdale in Washington, D.C.

On the other hand, the 2002 statutory amendments also settled in taxpayers' favor an issue concerning the mechanics of applying the method. 1988 regulations had required taxpayers to determine the excludable portion of receivables based on an analysis of all the receivables that accrued during a test period. Taxpayers contended that this practice grossly understated balance sheet receivables likely to go bad.[8] In section 448(d)(5)(C), Congress effectively directed the IRS to design safe harbors based upon taxpayers' experience with *year-end receivables,*[9] like the *Black Motor* formula commonly used to compute bad debt reserves before the Tax Reform Act of 1986.[10]

New Safe Harbor Methods

Notice 2003-12 provided an alternative method of deriving the excludable percentage that the IRS dubbed the "actual experience method." The "actual experience" method was, like the *Black Motor* formula, based upon an analysis of year-end receivables during a test period. However, instead of simply comparing bad debt expense to balance sheet amounts, taxpayers were required to trace the bad debts sustained to particular receivables on the balance sheets. Taxpayers could also continue to use the regulations' method, or else they could adopt any "alternative NAE method" so long as the alternative method would exclude no more income than the "actual experience method."

The new temporary regulations retain the Notice's safe harbors (the regulations' method and the "actual experience method") and provide two more alternatives for determining the percentage of receivables deemed uncollectible.

- The first safe harbor, the "six-year moving average method," is carried over from the 1988 regulations. The taxpayer divides bad debts, net of recoveries, sustained over a test period (generally six years) by the sum of the total receivables earned over the same period.[11]
- The second "safe harbor," the "actual experience method," dates from the Notice, and requires taxpayers to determine the excludable percentage based on an analysis of writeoffs to

date of the specific receivables on their last three balance sheets. Taxpayers newly electing the method can choose between reconstructing this data for the past three years (Option A) or beginning with the balance sheet at the beginning of the year preceding adoption (Option B).[12]

- The third "safe harbor," the "modified *Black Motor* method," is new. As under the traditional *Black Motor* method, taxpayers divide bad debts sustained over the test period by the total of balance sheet receivables to derive the "*Black Motor* moving average percentage." The regulations' refinement is to require taxpayers, after applying this percentage to outstanding receivables, to subtract current receivables already charged off during the year to arrive at the excludable amount. For example, if the "*Black Motor* moving average percentage" were 15 percent and year-end receivables $1,000,000, and $25,000 of receivables arising during the year had already been charged off, the taxpayer would exclude $125,000 (15 percent of $1,000,000 minus $25,000) of the $1,000,000 in outstanding receivables.[13]
- The final "safe harbor," called the "modified six-year moving average method," is another variation on the *Black Motor* method. Under this safe harbor, taxpayers eliminate receivables accrued and charged off during the same year in computing the percentage itself. Thus, the taxpayer starts with the gross amount charged off during a year, and then subtracts the portion that related to receivables that arose during the same year. The taxpayer divides the total of the resulting numbers for each year in the test period by the sum of the corresponding balance sheet amounts to determine the excludable percentage.[14]

Alternative Methods

As under the Notice, Taxpayers are also allowed to develop their own methods, provided that these methods do not exclude more receivables than under the "safe harbors." The custom method must be tested during the first year of use, and for each three years thereafter. Taxpayers may choose the safe harbor method to use for reference, but any later change in this comparison method is a change in method of accounting, even if the taxpayer does not change how it actually computes the exclusion percentage.[15]

Method Changes

Taxpayers can freely choose among available alternatives for implementing the nonaccrual experience method in the year in which section 448 first requires them to adopt accrual accounting. Taxpayers must obtain individualized permission to use shorter test periods than those generally prescribed for the various "safe harbor" methods.[16] Otherwise changes to and between variants of the nonaccrual experience method are generally eligible for automatic consent procedures.[17] The usual restrictions on such changes are waived for changes in the first and second taxable years ending after March 9, 2002.[18]

A separate rule grants automatic consent for taxpayers no longer eligible to use the nonaccrual experience method to change to the specific chargeoff method in their first taxable year ending after March 9, 2002.[19] In later years such taxpayers must also use the automatic consent procedures. There seems to be no specific provision that covers a taxpayer that remains eligible for the nonaccrual experience method but nevertheless wants to return to the specific chargeoff method.

Section 457 Regulations

Final regulations under section 457 were issued in July, 2003[20] reflecting various statutory changes since 1982, when the regulations were last rewritten. As discussed in an earlier column,[21] however, one of the most controversial aspects of the new regulations does not reflect any change in the statute, but a change in interpretation of existing language that had formerly been understood to exclude option plans from its ambit.

Section 457 imposes limits on tax-favored deferred compensation plans maintained by tax-exempt entities. Section 457(f) generally provides that beneficiaries of "ineligible plans" that do not conform to these limits are taxed when their rights to a deferred amount are no longer subject to a "substantial risk of forfeiture."[22] In contrast, beneficiaries of similar plans maintained by other types of taxpayers are generally taxed only when they receive deferred amounts so long as the plan remains unfunded.

The "ineligible plan" rules, however, do not apply to "that portion of any plan which consists of a transfer of property described in section 83."[23] Taxpayers have generally read this exclusion to mean that option plans are covered by section 83, rather than section 457. Under section 83, unless the option has "readily ascertainable market value," the transfer of property is deemed to occur, and the recipient has to include the associated income, when the option is exercised.[24] This reading allowed participants in tax-exempt employers' option plans to defer tax until that time.

Proposed regulations issued in June, 2002[25] rained on this parade in a paragraph specifically addressing coordination between section 457 and section 83. Despite considerable negative comment,[26] the final regulations retained the controversial language and added an example specifically dealing with options. Reg. § 1.457-11(d) limits the exclusion from application of section 457 to cases where the transfer of property under section 83 occurs, or has already occurred, when section 457 would otherwise require inclusion. The new interpretation means that participants are taxed on the options' value as soon as there is no longer any substantial risk of forfeiture, even if the options do not meet section 83's "readily ascertainable fair market value" standard. The new regulations are effective for options granted after May 8, 2002.[27]

REMIC Inducement Payments

Proposed Regulations § 1.446-6,[28] released in mid-July, would add another regulatory exception to the so-called "*Schlude* rule," under which advance payments are generally treated as gross income upon receipt. A "noneconomic residual interest" in a REMIC (real estate mortgage investment conduit) is one that is expected to produce tax liability in excess of cash flow.[29] Taxpayers are thus paid "inducement fees" to agree to assume them. The proposed regulations would require recipients to recognize the income from these fees "over the remaining expected life of the applicable REMIC in a manner that reasonably reflects . . . the after-tax costs and benefits of holding that noneconomic residual interest," with any remaining amount recognized upon disposition.[30] Two amortization methods are specifically allowed, with the IRS authorized to add more:

- Taxpayers may follow the same method used for financial reporting.
- Alternatively, taxpayers may report income "as if the inducement fee were unrecognized gain being included in gross income under Reg. § 1.860F-2(b)(4)(iii)," that is, generally as if it were market discount on a bond held by the taxpayer.[31]

The new rules would apply in taxable years ending after final regulations are issued.[32]

Individuals' Changes To Calendar Years

As promised in Notice 2002-75,[33] the IRS has issued a new procedure for granting automatic consent to individuals' changes from fiscal years to the calendar year. Revenue Procedure 2003-62,[34] which supersedes the long-standing Revenue Procedure 66-50,[35] is another step in the general overhaul of the procedural rules for taxable year changes following last year's issue of new regulations.[36] The new procedure removes the restriction to taxpayers receiving specified types of income. The main effect of this change is to make the procedure available to sole proprietors. Moreover, the previous ban on changes by individuals holding interests in pass-through entities has been replaced by restrictions similar to those imposed upon corporations' automatic changes under Revenue Procedure 2002-37.[37] Thus, such taxpayers will now be eligible for automatic consent so long as they do not receive too much income from entities reporting on a fiscal year basis.

1. Reg. § 1.448-2T, T.D. 9090, 68 Fed. Reg. 52,490-01 (Sept. 4, 2003).

2. Reg. § 1.457-11, T.D. 9075, 68 Fed. Reg. 41,230 (July 11, 2003).

3. Prop. Reg. § 1.446-6, REG-105885-99, 2003-23 I.R.B. 1103.

4. Rev. Proc. 2003-62, 2003-32 I.R.B. 299.

5. T.D. 9090, 68 Fed. Reg. 52,496-01 (Sept. 4, 2003); REG-141402-02, 68 Fed. Reg. 52,543-01 (Sept. 4, 2003).

6. 2003-6 I.R.B. 422, discussed in J. Salles, "Tax Accounting," 4(6) Corp. Bus. Tax'n Monthly 31 (Mar. 2003).

7. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 403(a), amending I.R.C. § 448(d)(5).

8. See Hospital Corporation of America v. Commissioner, 107 T.C. 116 (1996).

9. Joint Committee Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCS-12-02, Mar. 6, 2002) at 30-31 (emphasis added).

10. 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).

11. Reg. § 1.448-2T(e)(2).

12. Reg. § 1.448-2T(e)(3).

13. Reg. § 1.448-2T(e)(4).

14. Reg. § 1.448-2T(e)(5).

15. Reg. § 1.448-2T(e)(6).

16. Reg. § 1.448-2T(3)(2)(ii), (4)(ii), (5)(ii).

17. See Reg. § 1.448-2T(e)(6)(iii)(C), (g)(3).

18. Reg. § 1.448-2T(g)(3)(ii).

19. Reg. § 1.448-2T(g)(2).

20. T.D. 9075, 68 Fed. Reg. 41,230 (July 11, 2003).

21. J. Salles, "Tax Accounting," 3(12) Corp. Bus. Tax'n Monthly 35 (Sept. 2002).

22. I.R.C. § 457(f); Reg. § 1.457-11.

23. I.R.C. § 457(f)(2)(C).

24. See I.R.C.§ 83(e)(3); Reg. § 1.83-7.

25. REG-105885-99, 2003-23 I.R.B. 1103.

26. For reaction to the final regulations, see, e.g., Fred Stokeld, "Practitioners Criticize Deferred Compensation Regs' Treatment of Stock Options," Tax Analysts Doc. No. 2003-16546 (July 11, 2003).

27. Reg. § 1.457-12(d).

28. REG-162625-02, 68 Fed. Reg. 43,055 (July 21, 2003).

29. See generally Reg. § 1.860E-1(c)(2).

30. Prop. Reg. § 1.446-6(c)-(d).

31. Prop. Reg. § 1.446-6(e).

32. Prop. Reg. § 1.446-6(g).

33. 2002-47 I.R.B. 884.

34. 2003-32 I.R.B. 299.

35. 1966-2 C.B. 1260, modified by Rev. Proc. 81-40, 1981-2 C.B. 604.

36. See generally J. Salles, "Tax Accounting," 4(1) Corp. Bus. Tax'n Monthly 34 (Oct. 2002) and 4(2) Corp. Bus. Tax'n Monthly 25 (Nov. 2002).

37. 2002-1 C.B. 1030, discussed in J. Salles, "Tax Accounting," 4(2) Corp. Bus. Tax'n Monthly 25, 25-26.