

MSCPA FEDERAL TAX COMMITTEE  
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TAX ACCOUNTING By Lorraine A. Travers

- I. **Final, Temporary and Proposed Regulations Issued Defining “Routine and Repetitive” for Simplified Service Cost and Simplified Production Methods—Code Section 263A. [T.D. 9217, 70 Fed. Reg. 44467 (8/3/05); REG-1215-05, 70 Fed. Reg. 44535 (8/3/05)]**

Taxpayer’s production of property is “routine and repetitive” only if the property is mass-produced and has a high degree of turnover.

- II. **Rev. Proc. 2005-78 Standard Mileage Rate for 2006—Business - .445/mi.; Medical - .18; Charity - .14.**

- III. **Importer Must Include Refunds of Antidumping and Countervailing Duties in Gross Income.**

Taxpayer using FIFO method of inventory accounting paid antidumping fees and countervailing duties imposed under the Tariff Act of 1930 and included these costs in inventory costs. Several years later, taxpayer received refunds of the duties paid and National Office advised that refunds must be included in gross income in the year of receipt.

- IV. **Taxpayer’s Attempt to Deduct Costs Previously Amortized Constitutes Change in Accounting Method. (TAM 2005-48022)**

Taxpayer’s attempt to deduct pre-acquisition costs after having first amortized them as start-up expenditures is a change in method of accounting requiring the consent of the IRS.

- V. **Rev. Proc. 2006-14—Allows Replacement Cost Method for Heavy Equipment Dealer Inventory**

Safe harbor for heavy equipment dealers selling heavy equipment parts at retail—use of replacement cost method.

- VI. **Items Within Same Inventory Pools Must Be valued and Accounted for in Same Manner—TAM 200603027**

Taxpayer’s method of accounting for inventory does not clearly reflect income when taxpayer uses different methods of valuing and accounting for items that fall within the same inventory pools.

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**VII. C Corporation that Provided Valuation Opinions is not a Qualified Personal Service Corporation – PLR200606020**

Corporation provided valuation opinions for closely held interests but did not satisfy the “function test” for qualified personal service corporations.

**VIII. State Payments Includible in Gross Income – CCA 200616031**

Payments made from surplus state funds to a certain type of resident rather than to a narrow class of residents were not income tax refunds and not intended as gifts and were includible in income.

**IX. Advance Trade Discounts not Includible in Gross Income When Received—West-Pacific Food v. Commr., No. 02-71041 (9<sup>th</sup> Cir. 6/21/06).**

Grocery store chains organized partnership to purchase and warehouse inventory. Cash was received in advance but taxpayer was obligated to buy a minimum quantity of merchandise or else pay back the cash advance pro rata. Ninth Circuit held cash advances not income when received.

**X. Tool Allowances Includible in Income and Subject to Withholding**

Expenses reimbursed under a non-accountable plan are taxable—Rev. Rul. 2005-52.

**XI. Payment to Husband by Wife’s Lover Includible in Income – Peebles v. Commr., T. C. Summary 2006-61 (4/19/06).**

Payment by doctor was deemed not a gift but an effort to avoid public embarrassment and potential lawsuit.

**XII. Divorce-related Payment Deemed Non-deductible Property Settlement – Tulay v. Commr., T. C. Summary 2006-70 (4/26/06).**

Spouse was to receive a 50% interest in Husband’s retirement accounts plus \$35,000. Husband had taken hand-written notes at the attorneys’ meeting which the spouse initialed. He had designated the \$35,000 as “rehab alimony”. Court found the payment was for property settlement and not alimony.

**XIII. Taxation of Relocation Assistance—Rev. Rul. 2005-74.**

Three examples in the Rev. Rul. of which two represent two separate sales of property—one from the employee to company and from company to third party buyer and in 3<sup>rd</sup> example ruled that ownership stayed with employee and the sale was between employee and third-party buyer. In example 3, employee has compensation and employer business expense deduction.

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**XIV. Cash or Rebates for Hybrid Vehicles are Taxable Income—IR-2006-112 (7/13/06)**

Employers must include incentive amounts in compensation, included on W-2s and subject to income tax withholdings and employment tax.

**XV. Election to Treat Dividend Income as Investment Income Can be Revoked – PLR 200626026.**

Election initially made based on erroneous information from a partnership K-1 allowed to be revoked.

**XVI. 50% Meals Limit Does not Apply to Driver Leasing Company—Transport Labor Contract/Leasing, Inc. v. Commr., No. 05-3827 [8<sup>th</sup> Cir. 8/26/06)].**

Driver leasing company hired drivers as employees and leased the drivers to independent trucking companies and paid per diem meal expenses was excepted from the 50% meals deduction limit.

**XVII. IRS Issues Proposed Regs on Capitalization of Tangible Asset Costs—REG 168745-03, 71 Fed. Reg. 48590 (8/21/06).**

To reduce the amount of controversy between the IRS and taxpayers, proposed regs would provide exclusive factors for determining whether amounts paid to restore property to its former working condition must be capitalized, etc.

**XVIII. Final Regs Issued on Nonaccrual-Experience Method of Accounting—T.D. 9285, 71 Fed. Reg. 52430 (9/6/06).**

Final regs apply to taxable years ending on or after 8/31/06—a 5<sup>th</sup> safe harbor was added in final regs.

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**I. “Routine and Repetitive” for Simplified Service Cost and Simplified Production Methods Defined in Final, Temporary and Proposed Regs—T.D. 9217, 70 Fed. Reg. 44467 (8/3/05); REG--1215-06, 70 Fed. Reg. 44535 (8/3/05).**

A taxpayer’s production of property is “routine and repetitive” for purposes of the simplified service cost and simplified production methods if the property is mass-produced and has a high degree of turnover. The temporary regs provide that self-constructed property is considered produced on a routine and repetitive basis for purposes of the simplification service cost method and the simplified production method only if: (1) numerous substantially identical units of tangible personal property are produced within a taxable year using standardized designs and assembly line techniques and (2) the applicable §168(c) recovery period of the assets is not longer than 3 years.

Temp. regs also provide that, for a first taxable year ending after 8/1/05, taxpayers are granted the commissioner’s consent to change its method of accounting to comply with the temporary regs, provided that the automatic consent procedures are followed in Rev. Rul. 2002-9 as amended. For second and subsequent taxable years ending after 8/1/05, consent must be made under the advance consent guidance (Rev. Proc. 97-27 as amended).

**II. Standard Mileage Rates for 2006—Rev. Proc. 2005-78—business (.44 1/2); charitable (.14); medical (.18).**

**III. Importer Must Include Refunds of Antidumping and Countervailing Duties in Gross Income—TAM 200543050.**

Taxpayer(T) uses the FIFO method of accounting for inventory imported into the U.S. T often pays antidumping and countervailing duties imposed under the Tariff Act of 1930. These duties are included in inventory costs and recovered through cost of goods sold. Several years later T received refunds of the duties paid. The National Office advised T that the refunds must be included in income in the year of receipt. T wanted to capitalize the refunds under 263A and net against current duties paid through his cost of goods sold process. Because T used the FIFO inventory method, T received a tax benefit for the entire amount in earlier years and could not use the exception under §111.

**IV. Deducting Costs Previously Amortized Constitutes Change in Accounting Method—TAM 200548022.**

Taxpayer elected §195 treatment for a percentage of fees paid for financial advice and assistance in acquiring two companies as well as other costs incurred. During the IRS’ examination of the year of election, taxpayer filed an informal refund claim, contending that the entire amount was currently deductible under §162. The National Office advised that this constituted a change in accounting method and, therefore, a retroactive change cannot be made without the consent of the IRS.

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**V. Replacement Cost Method Allowed for Heavy Equipment Dealer Inventory—Rev. Proc. 2006-14.**

A safe harbor has been granted to heavy equipment dealers to allow them to approximate the cost of equipment parts inventory using the replacement cost method of accounting. Heavy equipment dealers engaged in the trade or business of selling heavy equipment parts at retail and that are authorized under an agreement with one or more heavy equipment manufacturers or distributors to sell new heavy equipment, may use a safe harbor method of accounting for their heavy equipment parts inventory. Under the replacement cost method, the dealer determines the costs of the heavy equipment parts in its inventory using a standard price list and must satisfy the book conformity requirements. If not currently using this method, Form 3115 needs to be filed using the automatic change in accounting method provisions.

**VI. Items in Same Inventory Pool Must Be Valued and Accounted for in Same Manner—TAM 00603027.**

Taxpayer operates several lines of businesses, including a Z segment and a B segment. With respect to its Z segment, T elected to use the retail LIFO method to account for all of its inventories and with respect to B, the dollar-value LIFO method (but not the retail method). Over the years, T obtained IRS' consent and obtained automatic consent to change its method of accounting for inventories and currently uses two methods of valuing and accounting for items that fall within some of its pools. In the Z segment, T values some of the items at approximate cost computed under the retail LIFO method and values the other items at retail LCM computed under the retail method. In its B segment, T values some of the items at cost computed under the LIFO method and values the others at LCM computed under the FIFO method.

The National Office advised that T's inventory method does not clearly reflect income because the LIFO method is not used to account for all items that fall within its IPIC method pools.

**VII. C Corporation That Provides Valuation Opinions is not a Qualified Personal Service Corporation—PLR 200606020.**

Corporation provided valuation opinions for closely-held interests. C gathered data, performed research and data analysis, drafted the report, determined the valuation conclusion, compiled the valuation report and delivered the report to the client. Clients usually paid flat fees for the appraisals. Most of the clients were professionals—lawyers, accountants and financial institutions. T sometimes provided expert testimony concerning assessments made to a client.

IRS ruled that T did not engage in the performance of services in the fields of consulting and, therefore, was not a qualified personal service corporation because it did not satisfy the **function test**. Under §448, a C Corporation is not allowed to use the cash method but there is an exception for "qualified personal service corporations". A corporation meets the **function test** if substantially all of its activities involve the performance of services in one or more of eight fields, including consulting. With respect to the fields of consulting, the performance of services in-

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cludes providing advice and counsel but not sales or brokerage services. The IRS referred to example 10 in Reg. §1.448-1T(e)(4)(iv)(B) which refers to the selling of insurance, annuities and other insurance products to clients. The IRS used this example because it felt that C did not make recommendations to its clients regarding business or legal matters and did not render advice and counsel. C simply sold a product.

**VIII. State Payments Includible in Gross Income—CCA 200616031.**

A statute was enacted by a state providing for payments to certain taxpayers who filed personal income tax returns. Individuals received payments based on their AGI and total number of exemptions. The amount of the payment decreased as AGI increased and as the number of exemptions decreased.

Individuals could not receive a payment if they were a dependent of another, not a resident of the state on the last day of the tax year and were an inmate of a public institution for more than 6 months during the tax year.

Payments were made from surplus state funds. The payments were made to most of a certain type of resident rather than to a narrow class of residents who are in economic need; the payments were not income tax refunds of current and prior years, and the payments were not intended as gifts. The Chief Counsel's Office advised that the payments were analogous to payments described in Rev. Rul. 85-39 and are, therefore, includible in gross income under §61.

**IX. Advance Trade Discounts not Includible in Gross Income When Received—Westpac Pacific Food v. Commr., No. 02-71041 (9<sup>th</sup> Cir. 6/21/06).**

Three grocery store chains were organized as a partnership(T) to purchase and warehouse inventory. The partnership is an accrual basis taxpayer. During 1990 & 1991, the partnership entered into 4 contracts to buy inventory and receive cash in advance. Each contract obligated T to buy a minimum quantity of merchandise for which T received volume discounts in the form of cash upfront. If T did not buy the required volume, the cash had to be paid back on a pro rata basis.

The 9<sup>th</sup> Circuit held that cash advances in exchange for volume purchase commitments subject to pro rata repayment if volume commitments are not met are not income when received. The 9<sup>th</sup> Cir. rejected the IRS' position that the cash advances were income because T had **complete dominion** over the money. The Court stated that one may have **complete dominion** over money but it isn't income until it is an **accession to wealth**. The Court cited examples such as, loans and customer security deposits which are liabilities rather than income when received.

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**X. Tool Allowances Includible in Income and Subject to Withholdings.**

In many industries, employers reimburse employees for tools they personally provide to perform services for the employer. Whether these reimbursements are includible in income depends generally on whether the payments are made under an accountable or non-accountable plan. Expenses reimbursed under an accountable plan are excluded from income and wages while expenses reimbursed under a non-accountable plan are taxable.

In Rev. Rul. 2005-52, the IRS clarifies the requirements for not including such payments in income under an accountable plan. The expenses reimbursed must be substantiated and to the extent payments are made before expenses are incurred, the plan must provide that the employee returns amounts in excess of the substantiated expenses. An accountable plan may not use estimates to substantiate the amount of the expenses.

In Rev. Rul. 2005-52, the example refers to an automobile repair and maintenance business. Service technicians are required to provide and maintain various tools needed in their jobs. The employer pays these employees a set amount for each hour worked as a "tool allowance". The allowance is set by the employer using data from a national survey and information provided by the employee in an annual questionnaire. The projected amount is then used in conjunction with total hours the employee is expected to work to determine the hourly tool allowance. At the end of each pay period, the employee reports the hours worked requiring the use of tools and is paid the allowance based on that. Employees are not required to provide any substantiation of expenses actually incurred and the employer does not require the employee to return any portion of the tool allowance that exceeds expenses actually incurred.

The IRS ruled in Rev. Rul. 2005-52 that this was not an accountable plan because it failed to meet the substantiation and return of excess amounts requirements. However, the IRS has indicated in **Rev. Rul. 2005-52** that it might be willing to reconsider the estimating of expenses requirement on an industry-wide basis. In **Notice 2005-59**, the IRS provided a list of factors that may be considered in determining that the existing accountable plan rules are unworkable for a particular industry and whether relief may be appropriate through the **Industry Issue Resolution Program**.

**XI. Payment to Husband by Wife's Lover is Includible in Income--Peebles v. Commr., T. C. Summary No. 2006-61 (4/19/06).**

Husband was a police officer in a small town and he discovered that his wife was having an affair with her doctor. H confronted the doctor and threatened to sue him for \$150,000. The doctor said that he did not have that kind of money and two days later in a telephone conversation, the doctor told him he had \$25,000. The two met in a parking lot and H was paid \$25,000 in cash. H recorded the exchange. The doctor apologized for the affair and indicated that the money was free money but that it could be income to H. H said that if he and spouse were divorced he would not file on grounds of adultery and the doctor would not be named in the proceedings.

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The doctor's accountant reported the \$25,000 payment to H on a Form 1099-Misc. but he and his wife did not report the amount as income on their 1999 return. The IRS issued a deficiency notice and H argued that the \$25,000 had been intended as a gift.

The Tax Court held otherwise, stating that the payment was not the result of detached and disinterested generosity or paid out of affection, respect, admiration, or charity. The Court stated that the amount was paid to avoid a lawsuit, to avoid public and professional embarrassment, and to assuage the doctor's feelings of guilt or moral obligation.

**XII. Divorce-related Payment Deemed Non-deductible Property Settlement—Tulay v. Comr., T.C. Summary 2006-70 (4/26/06).**

Individuals met with their attorneys to negotiate the terms of their divorce. At the end of the meeting, the spouse's lawyer recorded an agreement that gave spouse 50% plus \$35,000 interest in H's retirement accounts. During the meeting H had taken handwritten notes and spouse had initialed these notes. On the last page of the notes, H had labeled the \$35,000 cash payment as "rehab alimony". The marital dissolution agreement had neither a heading nor a specific designation of money to be paid to spouse as alimony.

After the marital dissolution agreement was signed and the state entered a final decree of divorce (incorporating the marital dissolution agreement), H paid S 50% plus \$35,000 from one of his retirement accounts. On his income tax return he claimed a \$35,000 deduction for alimony. The IRS disallowed the deduction and at trial H argued that the payment was rehabilitative alimony to cover the cost of S obtaining a postgraduate degree.

The Tax Court held the payment was not alimony and noted that much litigation results from the failure of negotiating parties to be precise in drafting the terms of marital agreements. After examining all of the facts and circumstances and hearing the testimony of the negotiating attorneys, the Court concluded that the payment was not alimony.

**XIII. Taxation of Relocation Assistance—Rev. Rul. 2005-74.**

Rev. Proc. 2005-74 clarifies when relocation assistance payments are taxable as a sale by the employee to the employer and when they are income to the employee and deductible by the employer. Three situations are noted in the Rev. Proc.:

1. Employer pays relocation company a fee to provide relocation assistance to employee who is being moved by employer. Relocation company, on behalf of the employer, offers to purchase the employee's residence for a fixed amount set by an independent appraisal. A blank deed is executed at the closing. The relocation company finds a buyer at a lower price and inserts the buyer's name on the deed. Employer pays relocation fee and reimburses relocation firm for its cost and the loss on the sale.

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2. Similar to one above excepting that the contract between employer and relocation company has an amended value option in which the employee may list the home with a broker from a list maintained by the relocation company. The employee can terminate the listing agreement with the broker without any commission. If the broker finds a bona fide buyer for a higher amount than the amount offered by the relocation firm, the relocation firm amends the contract with the employee to match the third-party offer and then enters into a separate contract with the buyer. The relocation company pays the employee the higher amount at the settlement and the relocation company enters into a separate sales agreement with the buyer for that amount. The relocation company's contract with the employee is not contingent on completion of the sale to the buyer.
3. Employer contracts with relocation company which uses a different amended value option. It is not required to offer a higher amended value for the home until it enters into a contract with the third-party buyer. Additionally, the employee retains the right to approve or reject any offer or counteroffer. Employee receives an appraised value offer from the relocation company, exercises the amended value option, and locates a prospective buyer for a higher amount. At the settlement, the relocation company pays the higher amount to the employee, receives a blank deed, and later inserts the buyer's name.

The IRS ruled that situations 1 & 2 represent separate sales of the property—one from the employee to the employer, through the employer's agent and a separate sale by the employer to third party buyer, concluding that the benefits and burdens of ownership passed to the employer. In situation 3, the IRS ruled that the transaction was a sale by the employee to the third-party buyer. In situation 3, expenses paid by employer or relocation company with respect to the home, including maintenance, taxes, insurance, etc. are taxable compensation to the employee and deductible by the employer as ordinary and necessary business expenses.

**XIV. Cash or Rebates for Hybrid Vehicles are Income—IR-2006-112 (7/13/06)**

Employers who provide cash incentives to their employees to encourage purchasing hybrid vehicles must include the incentives in employee's compensation and report it on their W-2. The cash incentives are subject to income tax withholding and employment tax. The Code provides for an exclusion from income for employee discounts only if the employer produces the product and certain other requirements are met.

**XV. Election to Treat Dividend Income as Investment Income Can Be Revoked—PLR 00626026.**

A trust was a passive investor and had elected to include qualified dividend income as investment income for purposes of the investment interest deduction. The trust had made that decision based on information received in a K-1 from a partnership. Later, the partnership revised the K-1 showing an increase in short-term capital gains, a decrease in long-term capital gains, a reduction of portfolio deductions and a reduction of dividend income. The revisions had a substantial impact on the trust's calculation of the investment interest expense deduction. There-

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upon, the trust requested permission to revoke its election to treat qualified dividend income as investment income.

The IRS consented to the revocation stating that the trust had made the decision based on an erroneous K-1 and had acted reasonably and in good faith because it made the election due to events beyond its control. In addition, the trust had relied on a qualified tax professional who advised it to make the election based on erroneous information, which was later corrected. The trust was not using hindsight in requesting relief and finally, specific facts have not changed since the filing of the return and making the election that made the election disadvantageous to the trust.

**XVI. Meals Deduction Limit Does not Apply to Driver Leasing Company—Transport Labor Contract/Leasing, Inc. v. Commr., No. 05-3827 [8<sup>th</sup> Cir. (8/26/06)].**

Taxpayer hired drivers as employees and leased them to independent trucking companies. The clients initially determined the drivers' total compensation and the proportion that should be allocated to per diem payments. Each client was free to change the percentage of gross compensation allocated to per diem payments. Each pay period, the client submitted a "batch report" showing each driver's gross pay and days on the road. Using that data, taxpayer paid the drivers their total compensation, including the per diem portion. Taxpayer's invoices to clients showed the drivers' aggregate gross pay separated into **employee compensation and per diem reimbursement**. Taxpayer collected from clients, information necessary to substantiate the per diem payments. Annually, the taxpayer would send a letter to the clients reporting the total per diem payments to drivers and advising that they were subject to the 50% reduction provision of §274.

The IRS agreed that substantiation requirements were met but still disallowed 50% of the deduction to taxpayer. The Tax Court agreed with the IRS because it said that the taxpayer was the common law employer of the drivers.

The 8<sup>th</sup> Circuit said that the Tax Court erred by focusing exclusively on the common law employer issue and should have determined whether the taxpayer was entitled to §274(e)(3) exception which requires a determination of: (1) whether taxpayer incurred the per diem expenses under a reimbursement or other expense allowance arrangement with another person (its clients) and if so (2) whether it accounted to such person as required under §274(e)(3)(B). The 8<sup>th</sup> Circuit found that there was substantial documentary and testimonial evidence establishing that taxpayer entered into a reimbursement or other expense allowance arrangement and that the data gathered by taxpayer and furnished to its clients regarding the per diem payments satisfied the requirements of Reg §1.62-2(c)-(f) and, therefore, §274(e)(3). This proved that the taxpayer bore the expense within the meaning of Reg. §1.274-2(f)(2)(iv)(a) and was excepted from the §274(n) limitations.

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**XVII. IRS Issues Proposed Regs on Capitalization of Tangible Asset Costs—REG 168745-03, 71 Fed. Reg. 48590 (8/21/06).**

To minimize controversy between taxpayers and the IRS regarding the capitalization of expenditures, the IRS has issued proposed regulations which would provide exclusive factors for determining whether amounts paid to restore property to its former working condition must be capitalized as an improvement. The Prop. Regs would also provide guidance concerning the economic useful life of a unit of property and activities that substantially prolong the economic useful life, as well as rules for determining the appropriate unit of property to which the proposed rules should be applied.

Several safe harbors are provided as well as simplifying assumptions; however, a de minimis rule is not provided. The Prop. Regs. would provide that capital expenditures generally include amounts paid to sell, acquire, produce or improve tangible property. If another section of the Code or regulations prescribes a specific treatment of an amount, the provisions of that section would apply instead of the rules in the Prop. Regs.

**XVIII. Final Regs. Issued on Nonaccrual-experience Method of Accounting for Service Receivables—T.D. 9285, 71 Fed. Reg. 52430 (9/6/06)—Taxable Years Ending on or After 8/31/06.**

The final regs require a taxpayer using any nonaccrual-experience method of accounting to test against the taxpayer's actual experience for the taxable year of the exclusion unless the taxpayer is using one of the safe harbor methods. The final regs. allow taxpayers to choose a period of at least 3 taxable years but not more than 6 taxable years for purposes of making computations in any of the safe harbor methods, as long as the taxable years are the most recent and are consecutive.

Safe Harbor #1—the revenue-based moving average method;  
Safe Harbor #2—the actual experience method;  
Safe Harbor #3—the modified Black Motor Method  
Safe Harbor #4—the modified moving average method  
New--Safe Harbor #5—safe harbor comparison method