Accounting Methods – Hot Topics

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1. **Repeal of section 199 and potential “double dip” with section 199A from fiscal-year passthrough entities**
   
   a. Under the TCJA, section 199 was repealed for all taxpayers for years beginning after December 31, 2017. However, latest draft instructions for the 2018 Form 8903 and Form 1040 indicate that calendar year taxpayers can claim a section 199 deduction if they are an owner in a pass-through entity with a fiscal year beginning before 1/1/2018. A section 199 LB&I directive issued in November 2018 also includes the same language.
      
      i. When section 199 was first enacted, fiscal year entities with years beginning before 1/1/2005 couldn’t pass up their qualifying activities to calendar year taxpayers. Thus, being able to catch up on the “tail end” of section 199 repeal seems to result in equitable treatment.
   
   b. Proposed regulations for section 199A also allow a calendar year individual taxpayer to claim the 199A benefit from fiscal year entities with taxable years that end within or with 2018.
   
   c. Blue Book includes language stating that “any item taken into account in determining the qualified production activities income of the taxpayer under former section 199 cannot be taken into account in determining the combined qualified business income amount of the taxpayer under section 199A.” Similar language was echoed in Brady’s technical corrections bill released on January 2.
   
   d. Conundrum for taxpayers, particularly as they head into tax return filing season and need an answer before extension payments are due. Do they follow IRS instructions, or Blue Book? If Blue Book/technical corrections bill is the “correct” answer, does the outcome change if the owner of the pass-through is a corporation, rather than an individual, since the corporation cannot avail itself of a 199A deduction? Meaning, is the disallowance of the 199 deduction related to the double dipping issue, or does the language that repeals section 199 for years after 2017 for all taxpayers meant to be interpreted so broadly that it would effectively disallow the deduction for corporations as well?

2. **Small business taxpayer provisions under the TCJA – aggregation rules**
   
   a. General rule under 448 regs provides that all persons treated as a single employer under section 52(a) or (b), or section 414(m) or (o) shall be treated as one person for purposes of the gross receipts test.
   
   b. Section 52(a) – controlled group of corporations using the definition provided under section 1563(a), except that “more than 50%” shall be substituted for “at least 80%.”
      
      i. Section 1563(a) excludes foreign corporations as a component member, but it is unclear whether 448 considers or disregards the component member rules - no explicit language in the regs, unlike the 263A small reseller rules or R&D credit controlled rules. As such, there is uncertainty whether the gross receipts of foreign parents or CFCs would be included in applying the $25M test.
   
   c. Section 52(b) – all employees of partnerships, proprietorships, etc. under common control
      
      i. Section 52 regs define trades or businesses that are under common control to mean either parent-subsidiary group under common control or brother-sister group under common control.
         
         1. Parent-subsidiary group under common control – one or more chain of organizations connected through ownership of more than 50%
         2. Brother-sister group under common control – two or more organizations if the same five or fewer individuals/estates/trusts own 80% interest, and are in effective control (>50% ownership when looking at each owner’s identical ownership %).
d. Section 414(m) – members of an affiliated service group, which consists of a service organization and one or more other service organizations which is a shareholder or partner in the first organization, and regularly performs services for the first organization (or is regularly associated with the first organization in performing services for third persons), and any other organization if a significant portion of the business is performance of services for the other organizations and 10% or more of interests is held by highly compensated employees.

e. Section 414(o) – Separate organizations, employee leasing or other arrangements

3. Small business taxpayer provisions under the TCJA – exemption from section 471
a. For a taxpayer that meets the $25M test, its method of accounting for inventory shall not be treated as failing to clearly reflect income if taxpayer treats inventory as non-incidental materials and supplies, or conforms to taxpayer’s method in its AFS (or books and records prepared in accordance with taxpayer’s accounting procedures, if no AFS).

i. Non-incidental materials and supplies treatment – same result for resellers, because inventory is not “used and consumed” until sold. But for producers, possibility of accelerating recognition of costs if raw materials are used and consumed before year-end.
   1. Examples in Rev. Proc. 2002-28 addressing “used and consumed” determination allow a construction taxpayer to deduct cost of roofing shingles in the year paid/installled on customer’s roof, but delay the recognition of manufactured lawn ornaments until they are provided to customers, despite the fact that raw materials were paid for and consumed in the prior year. Why this inconsistency?
   2. Assuming that raw materials are deductible in the year consumed in the manufacturing process, how should associated labor and overhead be treated? Presumably these amounts would be deductible as well.

ii. Conformity with AFS/book treatment
   1. For taxpayers without AFS, how should “books and records prepared in accordance with taxpayer’s accounting procedures” be construed? For instance, if taxpayers maintain a physical count of inventory but make the appropriate journal entries to expense the amounts for book purposes, is that enough to trigger a deduction for tax as well?
   2. In practice, will IRS agents really challenge a taxpayer’s accounting procedures? Rev. Proc. 2018-40 notes that the auto method change for the exemption from section 471 is not a determination by the IRS that the proposed method is permissible. Is the IRS more concerned with potential abuse for book conformity treatment, or the application of “used and consumed” if treating the amounts as non-incidental materials and supplies?

4. Section 163(j) – Cost of goods sold depreciation, amortization, or depletion, but capitalized to inventory under section 263A
a. Section 163(j), as enacted by TCJA, provides a limitation on business interest. This limitation limits to the deduction of business interest to not exceed the sum of the business interest income of the taxpayer for the taxable year, 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus the floor plan financing interest of such taxpayer for such taxable year. Adjusted taxable income is defined as the taxable income of the taxpayer computed without regard to certain items, including, in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

The preamble to the NPRM issued by the Treasury in November 2018 notes that an amount incurred as depreciation, amortization, or depletion, but capitalized to inventory under section 263A and included in cost of goods sold, is not a deduction for depreciation, amortization, or
depletion for purposes of § 163(j). The JCT Bluebook, issued in December 2018, provides that any deduction allowable for depreciation, amortization, or depletion includes any deduction allowable for any amount treated as depreciation, amortization, or depletion. This treatment may significantly increase the amount of interest expense that is limited by leveraged manufacturing entities.

i. How does this noted treatment of depreciation, amortization or depletion compare to historic treatment of these items for purpose of the interest expense limitation of section 163(j) as enacted prior to TCJA?

ii. There has been discussion regarding whether a deduction from taxable income is different than a reduction to gross income as note in §1.61-3. To me, the regulatory language as well as case law supports the treatment that the Treasury and IRS note.

iii. We’ve made comments before that section 163(j) is not a method of accounting, but suppose the underlying computation is changed due to a section 481(a) adjustment. It would appear appropriate that if the section 481(a) adjustment increased COGS depreciation in a year beginning prior to January 2, 2022, that section 481(a) adjustment should also include the recomputation of the business interest expense disallowance along with a change to any disallowed carryover, similar to including the impact of the section 481(a) on UNICAP. Have you had discussions yet regarding the tracing through of the section 481(a) adjustment?

5. GILTI/BEAT/International /Audit protection

a. On September 13, 2018, the government released proposed regulations under section 951A. The regulations provide guidance to U.S. shareholders required to include global intangible low-taxed income generated by controlled foreign corporations in their gross income.

i. Section 1.951A-2 of the proposed regulations clarified the computation of tested income and tested loss by providing that for purposes of determining tested and tested loss, the gross income and allowable deductions of a controlled foreign corporation for a CFC inclusion year are determined under the rules of §1.952-2 for determining the subpart F income of a controlled foreign corporation. Previous comments inquired whether method changes would be required to correct any previous impermissible methods of accounting used in computing a company’s earnings and profits. How do the tested income and tested loss rules interact with the accounting method rules?

ii. The proposed regulations also provide general rules for determining the qualified business asset investment of a controlled foreign corporation. These regulations clarify that for specified tangible property placed in service before enactment of section 951A, the adjusted basis in property placed in service before December 22, 2017, is determined using the alternative depreciation system under section 168(g), as if this system had applied from the date that the property was placed into service. This appears to indicate that the books and records for maintaining depreciation for purposes section 951A would be treated as a separate item, with the “book” starting at the first year that section 951A was enacted. Suppose a taxpayer improperly computes QBAI using a method other than the alternative depreciation system. Would fixing it be considered a method or submethod change?

b. On December 13, 2018, the government issued proposed regulations related to the base erosion and anti-abuse tax (BEAT). The BEAT imposes a base erosion minimum tax amount for a taxable year that is in addition to any other tax imposed. This tax is imposed on a modified taxable income, which is determined without regard to any base erosion payment, or the base erosion percentage of any NOL deduction allowed under section 172 for the taxable year.
A “base erosion tax benefit” is any deduction which is allowed for the taxable year with respect to any base erosion payment, while the definition of a base erosion payment under § 59A(d)(1) is any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter.

A base erosion payment is also any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation). The term base erosion tax benefit also includes any deduction allowed under the chapter for the taxable year for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with such payment.

c. The AICPA responded to the IRS response to the AICPA comment letter regarding section 8.02(5) of Rev. Proc. 2015-13 (i.e., limitations on audit protection for CFCs). The letter was published on December 27, 2018 and reiterates the concerns regarding audit protection for foreign corporations. Unfortunately, without our government panelists, we can’t see if there are any updates in process, but should highlight the request made to disregard the 2017 transition tax for purposes of computing whether the taxpayer receives audit protection for a change filed in its 2018, 2019, or 2020 tax years.

i. Additionally, questions have arisen whether audit protection covers issues with the GILTI computation, section 163(j), and the BEAT computation. How does the interaction of audit protection for an accounting method change interact with these separate computations? Would audit protection in 2019 trump a BEAT payment issue where a deduction should have been taken in a prior year?