

Chapter 8
Miscellaneous Provisions
California Rules
Recent and Potential Developments

Primary Authority

- IRC §§§§455, 456, 458, 467, 468, 468A, 468B (skim)
- Regs. §1.9100 (skim)

Learning Objectives – This lesson will enable you to be able to answer these questions:

- What accounting method and period guidance is Treasury and IRS working on?
- What is “Section 9100 relief?”
- What are some of the special rules in Subchapter E on Accounting Periods and Methods?
- What accounting method and periods guidance exists in California law?
- How might convergence of IFRS and US GAAP or adoption of IFRS affect tax accounting?

§468B - Settlement Funds

- Skim §468B

Subscription Income

Some Internet companies may be selling content with delivery made via the Internet. Also, some Internet Service Providers are also providing content, such as AOL. Also, some publishers deliver newspapers and magazines, not only in tangible form, but also via the Internet. These types of companies should consider whether existing favorable tax rules on subscription income apply to them. Of course, these decades-old rules were not written with the Internet and E-commerce in mind. Two of these old provisions that may apply to some Internet “publishers” are §455, *Prepaid subscription income*, and §458, *Magazines, paperbacks, and records returned after the close of the taxable year*.

Section 455 allows eligible taxpayers to defer prepaid subscription revenue to the period in which the taxpayer’s liability to furnish or deliver the periodical arises. “Prepaid subscription income,” is defined as any amount “received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received, and which is income from a subscription to a newspaper, magazine, or other periodical.” Neither the statute nor regulations define “other periodical.” Rev. Rul. 71-139, 1971-1 C.B. 143, held that §455 applied to certain publications of a taxpayer who generated income from looseleaf services providing legal and business information and training materials. The looseleaf services were updated at stated intervals with new releases relating with prior releases. However, the training materials were not updated and could be purchased at any time. The Service referred to Webster’s dictionary to define periodical as “published or appearing with a fixed interval (more than one day) between the issues or numbers.” Based on this definition, the Service found that the looseleaf services were “other periodicals” under §455, but that the training materials were not. “A subscription for a series of books contemplates a sale of specifically described volumes, each complete in

and of itself with no inherent continuity and no contemplation that it will be updated or supplemented in any way. Such a subscription would not qualify for deferral under section 455 of the Code.”

Arguably, a publisher of a newspaper or magazine that now also distributes its periodicals via the Internet will still be entitled to the benefits of §455 as the product would still meet the definition of a “periodical” regardless of how distributed. However, an on-line content provider may not be delivering a periodical as defined in Webster’s dictionary. There may be no expectation of regular delivery and it may not be connected to prior distributions. However, the particular facts of a situation should be evaluated.

Section 458 allows an accrual method seller of magazines, paperbacks, and records to exclude from gross income amounts from returns received within a specified period following year end. In 1992, regulations under §458 were issued that also address new items that the Service believed should be covered by §458. An excerpt from the preamble to T.D. 8426 (8/26/1992) regulations under §458 provides:

“Definition of Magazine and Record - In response to suggestions from commentators, changes were made in the definitions of “magazine” and “record.” First, the definition of magazine was revised to reflect the treatment of “annuals” or “oneshots”-supplements to monthly or weekly periodicals that are issued annually-as magazines. These annual supplements are issued in basically the same format and appearance as magazines issued at regular intervals. To be treated as a magazine under section 458 of the Code, the annual publications must relate by title or subject matter to a magazine and must otherwise qualify as a magazine under section 458. Second, the definition of “record” was expanded to include video cassettes in response to commentators' concerns that the definition of “record” was unduly restrictive by its exclusion of items that also contain a visual recording. There is no evidence of any Congressional intent to exclude video cassettes at the time of the enactment of section 458 and commentators indicated that the distribution of recordings with visual content is the same as for recordings without visual content. Finally, compact discs and laser discs are specifically included as examples of ‘records.’”

A recent ruling from the Service analyzed the potential broadness of §458 in a situation involved subscriptions to video games. In TAM 9730006 the Service held that a video game cartridge qualified as a “record” per §458 and §1.458-1(b)(3) because its pre-recorded sound was a “relatively substantial and an integral part” of the item and sufficiently material compared to the non-audio components of the cartridge. Thus, a taxpayer who distributes such games could elect to exclude from gross income amounts returned within a specified time after year-end. Unfortunately for the taxpayer in the TAM, it had not properly elected to use the §458 method and had not actually used it. Thus, the Service required it to use the normal accrual method, rather than the §458 method.

Substantial Compliance

The doctrine of substantial compliance is relevant when a taxpayer has not completely satisfied the requirements of a particular code section or regulation. For example, if the regulations state that a taxpayer must do 5 tasks in order to have a valid election under a particular rule and the taxpayer only complies with 4 of the tasks, has the taxpayer substantially complied such that it has made a valid election.

The doctrine has been raised by taxpayers in a variety of contexts such as:

- *Credit Life Insurance Co. v. U.S.*, 91-2 USTC ¶50,526, 68 AFTR2d 91-5781 (Fed. Cir.) - taxpayer failed to report item as income because viewed as uncollectible (taxpayer should have reported income and bad debt deduction). Taxpayer unsuccessfully argued that it should be entitled to a bad debt deduction upon audit by the IRS because it had substantially complied with §1.166-2(d).
- *Tipps v Comm'r*, 74 TC 458 (1980); acq. 1981-2 CB 2 - taxpayer successfully argued that she had substantially complied with §1.167(k)-4 even though the task of providing detailed information was omitted and the notation that the information was available at the taxpayer's office was inserted.

As evidenced from the *Credit Life Insurance Co.* case, the doctrine of substantial compliance does not always apply, or the taxpayer has not complied enough for the court to find it applicable. Some of the guidelines that the courts have considered in applying the doctrine are explained below.

Credit Life Insurance Co.:

'substantial compliance with regulatory requirements may suffice when such requirements are procedural and when the essential statutory purposes have been fulfilled.' *American Air Filter Co. v. Commissioner*, 81 T.C. 709, 719 (1983)... *Fischer Indus., Inc. v. Commissioner*, 843 F.2d 224, 226 (6th Cir. 1988) (no substantial compliance with procedural requirements for an election of accounting method where there was 'nothing in the returns themselves that would have given the Commissioner adequate notice that' an election had taken place); *Tipps v. Commissioner*, 74 T.C. 458, 468 (1980) (substantial compliance with procedural requirements for an election of accelerated depreciation of assets where there was no prejudice to the service because the same information had been provided on other IRS forms).

Quote from *Prussner* (7th Cir. 1990):

The common law doctrine of substantial compliance should not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute.

Tipps v. Comm'r.:

Regulatory requirements that relate to the substance or essence of the statute must be complied with strictly. ... However, substantial compliance may be sufficient if the regulatory requirements in dispute are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly and prompt conduct of business, and if the omission of the required material has not operated to respondent's [IRS] prejudice.

Additional items Tax Court addressed:

- was a reasonable effort made to comply literally with the regulations?
- did the taxpayer provide the missing information promptly upon the IRS' request for it?
- did the taxpayer obtain "any unwarranted advantages by reason of a greater range of hindsight than would have been available if the required information had been supplied?"

The IRS also argued that proper and complete compliance with the regulation is required to increase the "accuracy and truthfulness of the return." The IRS was concerned that the effectiveness of potential criminal penalties under §7206(1) is decreased when taxpayers omit information from the return. The Tax Court did not give this argument much weight because there was no evidence of any motive to make a false statement. Also, other sanctions such as §7203 are still available to the IRS.

American Air Filter Co. v Comm'r., 81 TC 709 (1983):

The Commissioner 'may insist upon full compliance with his regulations' (*Angelus Milling Co. v. Commissioner*, 325 U.S. 293, 296 (1945)) when the regulatory requirements relate to the substance or essence of a statute (see *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978); *Dunavant v. Commissioner*, 63 T.C. 316 (1974); *Thorrez v. Commissioner*, 31 T.C. 655 (1958), affd. per curiam 272 F.2d 945 (6th Cir. 1959)), but we have held that substantial compliance with regulatory requirements may suffice when such requirements are procedural and when the essential statutory purposes have been fulfilled.

Several factors have been examined in determining whether to permit less-than-literal compliance with regulatory requirements: whether the taxpayer's failure to comply fully defeats the purpose of the statute; whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission; whether the Commissioner is prejudiced by the untimely election;

whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and whether the regulations provided with detailed specificity the manner in which an election was to be made.

TAM 8749003

The taxpayer must not be left room to argue later that he had never intended to make the election and must not be permitted to "wait and see" or use "hindsight to play both ends against the middle." Young, 83 T.C. at 838, and Taylor v. Commissioner, 67 T.C. 1071, 1080 (1977); acq., 1979-2 C.B. 2.

TAM 9318001 (1/11/93)

Taxpayer claimed depreciation using the units-of-production method, but did not comply with §168(f)(1) and the instructions to Form 4562, Depreciation and Amortization, because it did not attach the necessary supporting statement to the return. "For an election to be valid, there must be certainty as to what was elected and an unequivocal agreement to be bound by the rules under the applicable provisions and to assume the benefits and burdens of the election. See Valdes v. Commissioner, 60 TC 910, 914 (1973). Application of the doctrine of substantial compliance requires a showing that the election requirement is either unimportant or clearly confusing."

The IRS made reference to the *Tipps* case, Rev. Rul. 82-103 and the §1.9100 procedures. The IRS concluded that the taxpayer had not substantially complied with §168(f)(1), but determined that the taxpayer could be granted an extension of time to make the appropriate election out of §168 under §1.9100.

Rev. Rul. 82-103, 1982-1 CB 34

ISSUE

Has the taxpayer made a valid election under section 167(k)(1) of the Internal Revenue Code under the circumstances described below so that accelerated depreciation of rehabilitation expenditures can be claimed?

FACTS

PRS, a limited partnership, was formed to purchase, rehabilitate, and operate on a rental basis an existing apartment complex in a low-income area of a large city. *PRS* incurred rehabilitation expenditures as defined in section 167(k)(1)(3) of the Code. When *PRS* filed its federal income tax return for the first year in which it claimed depreciation for the rehabilitation expenditures, no statement or schedule of any kind was attached mentioning an election to accelerate depreciation under section 167(k)(1). It was not apparent from the return and supporting schedules that *PRS* had actually claimed accelerated depreciation under section 167(k)(1). However, *PRS's* books and records reflected that depreciation attributable to the rehabilitation expenditures had been computed using a straight line method, a 60-month useful life, and no salvage value.

LAW AND ANALYSIS

Section 167(k)(1) of the Code permits a taxpayer to elect, in accordance with regulations prescribed by the Secretary, to compute the depreciation deduction provided by section 167(a) attributable to rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969, and before January 1, 1984, under the straight line method using a useful life of 60 months and no salvage value.

Section 1.167(k)-4(a)(1) of the Income Tax Regulations states that an election under section 167(k) of the Code must be made by attaching a statement to the income tax return for the first tax year in which the taxpayer computes the depreciation deduction using a 60-month useful life.

Section 1.167(k)-4(b)(1) of the regulations provides that the election must contain certain information.

In *Tipps v. Commissioner*, 74 T.C. 458 (1980), *acq.*, 1981-1 C.B. 2, the court considered the question of whether certain partnerships had validly elected the benefits of the depreciation method provided by section 167(k)(1) of the Code. The partnerships attached statements to their federal income tax returns for the year of the initial election that included all the required information except for the per-unit information required by the regulations. A statement was included that the information would be available in the partnerships' offices for audit purposes. The court decided that the partnerships had made valid elections.

In reaching its decision, the court in *Tipps* was satisfied that there was substantial compliance with the regulations because it found that the taxpayers had made an election under section 167(k) that bound them and clearly identified the properties and expenditures as to which the election was being made. The court stated that the doctrine of substantial compliance could be used to correct a procedurally imperfect election when the taxpayers had clearly made an attempt to avail themselves of the election.

The *Tipps* decision is distinguishable from the instant case because in *Tipps* the taxpayers made an unequivocal election to be bound by the provisions of section 167(k) of the Code, whereas in the instant case there is no evidence of an unequivocal election under section 167(k).

The requirement of an election under section 167(k)(1) of the Code is a substantive one, and is not merely procedural. The election requirement means that a positive step must be taken by an electing taxpayer that makes it possible to determine, without looking at anything beyond the federal income tax return and supporting schedules and statements, that an election is intended. In addition, the property intended to be covered by the election must be identified. When it is not apparent from the return and schedules that an unequivocal election is intended, as was the case in *Tipps*, the requirement of section 1.167(k)-4(a)(1) of the regulations will not be satisfied.

HOLDING

The taxpayer has not made a valid election under section 167(k)(1) of the Code.

Late elections – Reg. §301.9100 (skim)

Accounting Methods and Tax Shelters - Clear Reflection of Income and Economic Reality

ACM Partnership v. Comm'r., 98-2 USTC ¶50,790, 82 AFTR2d 98-6682 (3rd Cir.); cert denied 3/22/99 (S. Ct. Dkt. No. 98-1106)—The Circuit Court affirmed in part, reversed in part, and remanded the Tax Court decision (T.C. Memo 1997-115). Basically, the courts found that a complicated structure involving a partnership, a foreign corporation, a contingent installment sale, capital gains and losses, and a plan to shelter a large gain, lacked economic substance and would not be respected for tax purposes. In addition to discussing economic substance and substance over form, there were references in both the Tax Court and Third Circuit opinions to tax accounting methods. Some of these statements are quoted below:

Tax Court: "A taxpayer's method of accounting does not clearly reflect income when it does not represent "economic reality". See *Prabel v. Commissioner*, 882 F.2d 820, 826-827 (3d Cir. 1989), affg. 91 T.C. 1101 (1988). In this case, the Commissioner has not exercised her discretion by raising the clear reflection of income issue in her pleadings or in her brief."

Third Circuit: "While ACM's transactions, at least in form, satisfied each requirement of the contingent installment sale provisions and ratable basis recovery rule, ACM acknowledges that even where the "form of the taxpayer's activities indisputably satisfie[s] the literal requirements" of the relevant statutory language, the courts must examine "whether the substance of those transactions was consistent with their form," br. at 21, because a transaction that is "devoid of economic substance...simply is not recognized for federal taxation purposes." *Lerman v. Commissioner*, 939 F.2d 44, 45 (3d Cir. 1991)."

...

"As the Supreme Court emphasized in *Cottage Savings*, deductions are allowable only where the taxpayer has sustained a "'bona fide'" loss as determined by its "'[s]ubstance and not mere form.'" 499 U.S. at 567-68, 111 S.Ct. at 1511 (quoting Treas. Reg. section 1.165-1(b)). According to ACM's own synopsis of the transactions, the contingent installment exchange would not generate actual economic losses. ... Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of "bona fide" losses that are deductible under the Internal Revenue Code and regulations."

...

"In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss which, as the Tax Court found, is "not economically inherent in" the transaction. 73 T.C.M. at 2215."

Comments: Why didn't the Service use the broad clear reflection of income requirement of §446(b) as an argument to disallow the results of the contingent installment sale transaction? Is the corporate tax shelter registration requirement of §6111(d) added by the TRA'97, really needed? Aren't there already sufficient techniques to address the concerns of Congress, such as the economic substance doctrine, the substance over form doctrine, the clear reflection of income requirement, and the ability to change the Code to eliminate transactions that Congress sees as abusive or not intended (such as it did with the repeal of *Schmidt Baking* in the IRSRRA'98)?¹

Treasury/IRS Guidance Plan

- See link on course Website and links to other proposed changes

§381 and Accounting Methods Changes

- Skim §1.381(c)(4)-1 and §1.381(c)(5)-1
- Notice of proposed rulemaking (REG-151884-03; 11/16/07)

California Rules

Calif. Bank & Corp. Law, Chapter 13, §§24631 - 24726 (reference only)

FTB Notice 2000-8 - Request for Changes in Accounting Periods or Methods (see link on class web page as well as other FTB links there)

¹ For a further discussion of ways to combat corporate tax shelters, see Sheppard, "What Should We Do About Corporate Tax Shelters?" 98 TNT 239-79 (12/14/98).

Question 1 - Based on what you have learned and experienced in this course, how would you simplify and improve the accounting method and period rules if given the opportunity to rewrite Subchapter E?

Question 2 - How might convergence of IFRS and US GAAP or adoption of IFRS affect tax accounting?

