Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:

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TY:

Legend

Taxpayer =
Subsidiary =
State A =
Business X =
Business Y =
Date 1 =

Dear :

This letter is in response to a ruling request from Taxpayer dated June 13, 2012, amended by facsimile dated December 12, 2012. Taxpayer requests consent under § 1.381(c)(4)-1(a)(4)[1] of the Income Tax Regulations from the Commissioner to change its method of accounting related to six items: (1) advertising services; (2) program services; (3) royalties associated with the use of intellectual property; (4) equipment disposal costs; (5) equipment returns; and (6) rebates.

FACTS

Taxpayer is principally engaged in Business X, as was Subsidiary. The taxpayer uses an accrual method as its overall method of accounting.

The methods of accounting subject to this ruling request involve the six items and the proper timing of these items, primarily when each of the six items is fixed, determined with reasonably accuracy, and economic performance is met.

[1] All references to § 1.381(c)(4)-1 of the Income Tax Regulations refer to the regulations prior to amendment by T.D. 9534, effective for transactions occurring on or after August 31, 2011.

These include:

1. Liabilities where services are performed for Taxpayer: advertising and program services.

2. A liability involving the use of intellectual property and the frequency of use: certain royalties.

3. A liability requiring Taxpayer to dispose of unit of property. Taxpayer periodically removes units of property from service, paying a third party for the removal.

4. Payment liabilities involving equipment returns and a rebate. Taxpayer has agreements with its vendors that, in situations where the vendors were unable to sell sufficient quantities of Taxpayer's equipment, Taxpayer will re-purchase the equipment from the vendor, providing the vendor with a rebate allowance. Taxpayer also provides rebates on equipment purchased by customers of its vendors if the customers mail in a rebate request.

The taxpayer represents that, on Date 1, Subsidiary merged with and into the taxpayer in a transaction that qualified under § 368(a) of the Internal Revenue Code, specifically as a reorganization under § 368(a)(1)(D). Prior to the merger, the methods of accounting used by Subsidiary for the six items (and five types of liabilities) were different than the methods of accounting for these items used by the taxpayer. Prior to the merger, the method of accounting used by Subsidiary for the six items was, consistent with its financial statement, to deduct all these liabilities, regardless of whether any of the liabilities were fixed, determined with reasonable accuracy, or economic performance had occurred. Taxpayer's method of accounting for the six items was to deduct a fixed percentage of the amount accrued for financial reporting purposes, regardless of whether any of the liabilities were fixed, determined with reasonable accuracy, or economic performance had occurred. Accordingly, both Subsidiary and Taxpayer were on improper methods of accounting for these items.

After the transfer, Taxpayer represents that the principal method of accounting for each of the six items, determined under § 1.381(c)(4)-1(c), was Taxpayer's method of accounting. Taxpayer represents that its methods of accounting do not clearly reflect income under § 446(b) because each is an impermissible method. Therefore, because Taxpayer may not use its methods of accounting after the Date 1 transfer, Taxpayer has requested that the Commissioner determine the appropriate method of accounting for each of the six items under § 1.381(c)(4)-1(d)(1)(i).

Taxpayer requests that the Commissioner determine that Taxpayer may treat as incurred and deduct the six items subject to this ruling in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

LAW AND ANALYSIS

Section 381(a)(1) of the Internal Revenue Code provides that in the case of the acquisition of assets of a corporation by another corporation in a distribution to such other corporation to which § 332 (relating to liquidations of subsidiaries) applies, the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in § 381(c) of the distributor or transferor corporation, subject to the conditions and limitations specified in §§ 381(b) and (c).

Section 381(c)(4) of the Code provides that the acquiring corporation shall use the method of accounting used by the transferor corporation on the date of transfer unless different methods were used by several transferor corporations or by a transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

Section 1.381(c)(4)-1(b)(3)(ii) of the Income Tax Regulations provides that to the extent that different methods of accounting were employed on the date of transfer by the parties to a transaction described in § 381(a) with respect to any trades or businesses which are integrated or required to be integrated in accordance with § 446(d) and the regulations thereunder, the acquiring corporation shall adopt the principal method of accounting determined under § 1.381(c)(4)-1(c) or the method of accounting determined in accordance with § 1.381(c)(4)-1(d), whichever is applicable.

Section 1.381(c)(4)-1(c)(1) provides that the acquiring corporation shall use the principal method of accounting (as determined under § 1.381(c)(4)-1(c)(2)), provided that such method of accounting clearly reflects the income of the acquiring corporation.

Section 1.381(c)(4)-1(c)(2)(ii) provides that the determination of the principal method of accounting shall be made by making a comparison of the total of the adjusted bases of the assets immediately preceding the date of distribution or transfer and the gross receipts for a representative period (ordinarily the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer) of the component trades or businesses which are integrated or are required to be integrated. If this comparison shows that one or more component trades or businesses, having the greatest total of the adjusted bases of assets, also has the greatest amount of gross receipts, then the method of accounting of such one or more component trades or businesses shall be the principal method of accounting.

Section 1.381(c)(4)-1(d)(1)(i) provides that if the acquiring corporation may not continue to use under § 1.381(c)(4)-1(b), the method of accounting used by it or the transferor corporation or corporations on the date of transfer, and may not under § 1.381(c)(4)-1(c) use the principal method of accounting, or, if there is no principal method of accounting, then the Commissioner shall determine the appropriate method or combination of methods of accounting to be used.

Section 1.381(c)(4)-1(d)(1)(iii) provides that the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if, on the date of transfer, each of the several corporations that were not using the method or combination of methods of accounting adopted pursuant to §§ 1.381(c)(4)-1(d)(1)(i) or (ii) had initiated a change in accounting method.

Section 461(a) of the Code provides that the amount of any deduction must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred and generally is taken into account for federal income tax purposes in the taxable year in which (1) all events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

Section 461(h)(1) provides that, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 461(h)(2)(A)(i) and § 1.461-4(d)(2)(i) provide that, if the liability of a taxpayer arises out of the providing of services by another person to the taxpayer, economic performance occurs as the services is provided.

Section 461(h)(2)(A)(iii) and § 1.461-4(d)(3)(i) and (ii) provide that, if the liability of a taxpayer arises out of the use of property by the taxpayer, and all or a portion of the liability is determined by reference to the frequency or volume of use of the property, economic performance occurs as the taxpayer uses the property based on such frequency or use.

Section 461(h)(2)(B) and § 1.461-4(d)(4)(i) provide that, if the liability of a taxpayer arises out of the providing of services or property by the taxpayer to another person, economic performance occurs as the taxpayer incurs costs in connection with the satisfaction of the liability.

Section 1.461-4(g)(3) provides that if the liability of the taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed.

Historically, the costs of removing a depreciable asset generally have been allocated to the removed asset and, thus, generally have been deductible under § 165 when the asset is retired. *See* Preamble to T.D. 9564, 2012-14 I.R.B. 614 (Apr. 2, 21012) (*citing* § 1.165-3(b); § 1.167(a)-1(c); § 1.167(a)-11(d)(3)(x)). *See also* Rev. Rul. 2000-7, 2000-9 I.R.B. 712 (Feb. 28, 2000). Under Rev. Rul. 2000-7, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset under § 263(a) or § 263A even where the retirement and removal occurred in connection with the installation of a replacement asset.

CONCLUSION

Taxpayer may not continue to use the principal methods of accounting for the six items subject to this ruling because each is an impermissible method pursuant to § 1.381(c)(4)-1(d)(1)(i). Permission is hereby granted to Taxpayer to change its method of accounting for the six items. Taxpayer must treat as incurred and take into account as a deduction the six items in the taxable year in which all the events have occurred that establish the fact of the liabilities, the amount of the liabilities can be determined with reasonable accuracy, and economic performance has occurred with respect to each of the liabilities, in accordance with § 1.461-1(a)(2)(i).

- With respect to the two items where economic performance occurs as services are provided to Taxpayer under § 1.461-4(d)(2)(i), advertising and program services, Taxpayer must deduct such amounts in full in the year the advertising is provided to Taxpayer, and the program services are performed for Taxpayer. This contrasts with Taxpayer's prior method where it deducts only a percentage of such services.

- With respect to the item where economic performance occurs based on Taxpayer's frequency of use under §1.461-4(d)(3)(ii)(A), royalties owed on the use of intellectual property, Taxpayer must deduct the costs of use as the property is used. This contrasts with Taxpayer's current method where it deducts only a percentage of such use.

- With respect to disposal of any unit of property, economic performance occurs under § 1.461-4(d)(2) as services are provided to Taxpayer, with the disposition of the equipment by the third party. Taxpayer may deduct the costs of such equipment disposal, generally under § 165, in the year the unit of property is retired. Rev. Rul. 2000-7. This contrasts with Taxpayer's current method where it deducts a percentage of the estimated costs of removal and retirement, prior to actually incurring any cost of removal.

- Finally, with respect to the two payment liabilities involving equipment returns and a rebate. Taxpayer must deduct the costs of the equipment returns and the rebates in the year the liability is fixed and when payment is made to the customer. This contrasts with Taxpayer's current method where it deducts a percentage of the estimated costs of re-purchasing equipment, and where it deducts a percentage of the estimated amount of rebates to be paid, both prior to the liability for equipment returns and rebates being fixed and prior to economic performance being satisfied by payment. Taxpayer will not use the recurring item exception provided for in § 1.461-5, nor will Taxpayer use the 3½ month rule provided for in § 1.461-4(d)(6)(ii) for either of these payment liabilities.

Taxpayer represents that it will compute any adjustment necessary to reflect its changes in methods of accounting for the six items pursuant to § 1.381(c)(4)-1(d)(1)(iii) and will take any increase or decrease in tax into account on its tax return for the taxable year that includes the date of the transfer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Thomas D. Moffitt
Chief, Branch 2
(Income Tax & Accounting)