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Accounting Methods Spotlight

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Other Guidance…

Lessee must capitalize costs from construction of leased property as leasehold improvements

The IRS determined in ILM 201220028 that certain costs incurred by a lessee associated with the construction of leased property owned by the lessor must be capitalized by the lessee as leasehold improvements under § 263(a) and § 1.162-11(b) and may not be capitalized under § 263A to the basis of property produced and owned by the lessee.

The lessee entered into a sublease and construction agreement with the lessor, which provided that the lessee would lease certain real property and related improvements and that the lessee would construct certain additional improvements on the leased property. The agreement provided that the lessor would own all of the real property and most of the improvements constructed and that the lessee would own all the personal property and some of the real property improvements constructed.

The lessee used its own funds to partially finance the construction of the improvements. The costs incurred by the lessee related to both the property owned by the lessee and the leased property owned by the lessor. There was no indication in the lease that the costs incurred by the lessee with respect to the construction of property owned by the lessor were a substitute for rent.

The lessee capitalized the indirect costs incurred in connection with the construction of the leased property owned by the lessor under § 263A and added the capitalized costs to the basis of the property produced and owned by the lessee.

The IRS concluded that the indirect costs related to the property owned by the lessor were not capitalizable under § 263A because the property was not owned by the lessee, and as such, failed to meet the requirements set out by § 263A. In addition, § 263A requires that indirect costs be allocated by production, resale and other activities, a requirement that the lessee also failed to satisfy. Therefore, the IRS concluded that the indirect costs incurred by the lessee for the construction of leased property owned by the lessor should be capitalized as leasehold improvements under § 263(a) and § 1.162-11(b).

Unamortized debt issuance costs deductible as separate item

The IRS concluded in PLR 201220004 that a taxpayer's unamortized debt issuance costs are deductible as a separate item and are not taken into account in determining the amount of cancellation of indebtedness ("COD") income realized by the taxpayer upon the cancellation or exchange of debt.

The taxpayer filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. At the time of the bankruptcy filing, the taxpayer had unamortized debt issuance costs consisting primarily of underwriting fees incurred in connection with the issuance of debt. The taxpayer requested a ruling that the unamortized debt issuance costs did not adjust the issue price of the debt for purposes of determining the amount of COD income realized upon the cancellation or exchange of the existing indebtedness to which the costs relate.

According to the ruling, debt issuance costs generally are capitalized and amortized or deducted over the term of the debt instrument to which the costs relate in accordance with Treas. Reg. §1.446-5. The IRS noted that this regulation was only intended to address the timing question - that is, when the debt issuance costs were to be taken into account. Consequently, although there is language in the regulations referencing an increase or creation of OID, the reference was intended only to create a hypothetical adjustment to the issue price of the debt to determine the total amount of OID on the debt. Therefore, because there is no actual adjustment to the issue price of the debt as a result of the capitalized transaction costs incurred in connection with the borrowing, the determination of the taxpayer's COD income does not take into account the issuance costs.

Liability to pay rebates becomes fixed on purchase for purposes of the all events test

In TAM 201223015, the IRS concluded that under the all events test, an accrual method taxpayer's liability to pay certain trade promotion rebates to customers becomes fixed and determinable when customers purchase the goods.

The taxpayer is a manufacturer that sells products to operators, direct distributors, wholesalers, and retailers. Under the terms of its sales agreements, the taxpayer offers a variety of trade promotion rebates, some of which are based on minimum purchase requirements, some of which are based on a percentage of the list price, and some of which require the customer to place new products on the shelf. Pursuant to the sales agreements, most customers must request the rebate in writing (though some are triggered automatically). Under its business practice, the manufacturer generally pays rebates to customers who fail to meet the minimum purchase requirements.

The National Office found that all events had taken place to establish the fact of the liability at the time the goods were purchased. According to the National Office, the submission of the invoices to the vendor was merely a ministerial act that did not prevent the accrual of the liability. Moreover, even if the minimum purchase requirements were not met, the taxpayer's liability is still fixed at the time the goods were purchased because the taxpayer's agreements were ambiguous as to the effect of failing to satisfy the minimum purchase requirements, and the taxpayer approved payment of the rebates regardless of the amount of product purchased.

Utility can use accelerated cost recovery system for depreciation

In PLR 201223014, the IRS ruled that a public utility company was allowed to determine its depreciation deduction using an accelerated method because it satisfied the consistency requirements for the normalization method of accounting under § 168(i)(9)(B).

The taxpayer is an integrated public utility company engaged in the generation and distribution of electricity and the distribution and transportation of natural gas in various states. The taxpayer is subject to the regulations of various commissions that determine the terms and conditions of service as well as the taxpayer's rates under a rate of return basis.

One of the commissions had preapproved a certain amount of construction costs for a project. Costs incurred in excess of the cap would be recoverable only if the taxpayer could demonstrate that the amounts were reasonable and prudent. When the taxpayer completed the project, the cost cap had been exceeded. However, the taxpayer was able to demonstrate that the excess costs were reasonable. Accordingly, the commission allowed for a full recovery of all costs incurred in connection with the project. However, the commission provided a zero rate of return for costs that exceeded the cost cap. The taxpayer requested a ruling that the consistency requirements were met, which would allow the use of an accelerated cost recovery system for depreciation.

The IRS found that because the commission had included all costs in the rate base and had included all costs when computing both the accumulated deferred income taxes and the regulatory depreciation expense, the regulatory treatment of the costs for the project satisfied the consistency requirements of § 168(i)(9)(B). As such, the IRS found that the taxpayer satisfied the requirements to use an accelerated cost recovery system for depreciation on the project even though the rate of return varied amongst different elements of cost (included in the rate base) and thus did not earn a consistent rate of return.

Recent Cases....

Federal Circuit holds associated property rule invalid, reverses Claims Court

In *Dominion Resources, Inc. v. United States*, the U.S. Federal Court of Appeals held that the adjusted basis of property temporarily withdrawn from service for improvement should not be considered "production expenditures" in computing capitalizable interest for purposes of § 263A.

Dominion Resources, Inc. (Dominion) provides electric power and natural gas to individual and business customers. In 1996, Dominion replaced coal burners in two of its power plants. To replace the burners, Dominion had to temporarily remove two generating units from service.

During this period, Dominion incurred interest on debt that was unrelated to the improvements. Dominion capitalized a portion of this interest under the avoided cost principles of §263A(f) based on the direct and indirect costs of the improvement, but did not capitalize interest based on the adjusted basis of the generating units temporarily withdrawn from service as required by Treas. Reg. §.1.263-A-11(e)(1)(ii)(B) (the "associated property rule").

The IRS asserted that Dominion must capitalize an additional $3.3 million of interest under the associated property rule. Dominion settled with the IRS by capitalizing 50 percent of the contested interest, then filed suit with the Court of Federal Claims. The Court of Federal Claims, in granting summary judgment to the United States, held that Treas.

Reg. §1.263A-11(e)(1)(ii)(B) was a permissible interpretation of §263A. Dominion then appealed to the Federal Circuit in a case of first impression.

The Federal Circuit reversed the Court of Federal Claims decision on the ground that the associated property rule is invalid when applied to property temporarily withdrawn from service because it is not a reasonable interpretation of §263A. The Federal Circuit assessed the validity of the regulation under the two-step test provided by the Supreme Court in *Chevron, U.S.A., Inc. v. NRDC.*

The Federal Circuit found that §263A(f) did not address specifically the issue addressed by the associated property rule. Rather, the Federal Circuit found that the statute was ambiguous as to what costs must be considered in determining the amount of interest that must be capitalized. The court therefore turned to the second test prescribed by *Chevron* to determine whether the agency's interpretation of the statute was reasonable and hence valid. The Federal Circuit held that "Treasury Regulation §1.263A-11(e)(1)(ii)(B) as applied to property temporarily withdrawn from service is not a reasonable interpretation of the avoided-cost rule set out in the statute at I.R.C. §263A(f)(2)(A)(ii). Specifically, the regulation is unreasonable in defining 'production expenditures' to include the adjusted basis of the entire unit."

In holding the associated property rule invalid, the court rejected the IRS argument that the generating units could have been sold to pay down the debt rather than improving upon them. The court responded that there is "no reasonable explanation that assumes that a property owner would have sold the same unit that it removed from service for the sole purpose of improving. Selling the unit obviates the very reason for the improvement... [and] contradicts the avoided-cost rule that the law implemented. Thus, the regulation is not a reasonable interpretation of the statute."

Corporation's expense deductions denied, sole shareholder received constructive dividends

In *Joseph Anthony D'Errico v. Commissioner*, T.C. Memo 2012-149, the Tax Court denied a taxpayer's deductions and treated him as receiving constructive dividends because the taxpayer did not prove that the expenses were for business purposes.

The taxpayer was the sole shareholder of a C-corporation and two S-corporations. The C-corporation leased a house from the taxpayer's father, and the taxpayer claimed that the majority of the house was used for business purposes. The C-corporation also bought a Cessna airplane that the taxpayer claimed was used for business flights between the taxpayer's home and business offices. In addition, the C-corporation purchased a vehicle to be used for business purposes and incurred meals and entertainment expenses, travel, cell phone expenses, other miscellaneous expenses. The IRS disallowed the taxpayer's deductions, assessing tax deficiencies and accuracy related penalties.

According to the court, the lease for the house did not specify use for a business purpose. Although the taxpayer testified that most of the home was used for business purposes, he provided no evidence that the rent expense had a business purpose. As such, the court denied the taxpayer's rent expense deductions, as well as related deductions for insurance, phone, and utilities. The court found that the taxpayer derived a personal benefit from his use of the entire home and received constructive dividend income as a result of the rent payments made by the C-corporation.

As to the airplane, the taxpayer claimed in his testimony that he used the airplane on business related trips. However, he did not introduce a flight log of his airplane use as evidence, and produced no other evidence that the airplane was used in the C-corporation's business. As such, the deductions related to airplane were disallowed. Further, airplane magazine subscriptions and several airplane owner and pilot organization membership fees were similarly disallowed.

The court also disallowed the taxpayer's deductions related to his vehicle, meals and entertainment, and travel expenses, finding that the taxpayer did not meet the strict substantiation requirements of § 274.

For more information, please do not hesitate to contact:

James Connor	*(202) 414-1771*	*james.e.connor@us.pwc.com*
Adam Handler	*(213) 356-6499*	*adam.handler@us.pwc.com*
Jennifer Kennedy	*(202) 414-1543*	*jennifer.kennedy@us.pwc.com*
George Manousos	*(202) 414-4317*	*george.manousos@us.pwc.com*
Annette Smith	*(202) 414-1048*	*annette.smith@us.pwc.com*
Dennis Tingey	*(602) 364-8107*	*dennis.tingey@us.pwc.com*
Christine Turgeon	*(646) 471-1660*	*christine.turgeon@us.pwc.com*
James Martin	*(202) 414-1511*	*james.e.martin@us.pwc.com*