Accounting Methods Spotlight

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Did you know…?

President Obama's FY 2013 budget targets certain accounting methods

The Obama Administration recently released its FY 2013 budget, a $3.8 trillion plan that focuses on strengthening the economy and creating jobs through several key proposals. Specifically, the Administration's budget proposes to repeal LIFO and the lower of cost or market (LCM) method of valuing inventory, provide an additional extension of the 100% first-year depreciation deduction, and refine the approach to calculating the §199 deduction.

The Administration's proposal would require taxpayers that currently use the LIFO method to write up their beginning inventory to its FIFO value in the first taxable year beginning after December 31, 2013. This one-time increase would be taken into income ratably over ten years, starting in the first taxable year beginning after December 31, 2013.

In addition to repealing the LIFO method of valuing inventory, the President's budget also discusses the repeal of the LCM method. The proposal would statutorily prohibit the use of the LCM method and would require a wash-sale rule to prevent circumvention of the new rules. The proposal would result in a change in accounting method for inventories with respect to taxpayers currently using the LCM method, and any resulting §481(a) adjustment would be taken into income ratably over a four-year period beginning with the year of change.

In hopes of encouraging new investment and promoting economic recovery, an additional one-year extension of the 100-percent additional first-year depreciation deduction is included in the President's budget. Thus, qualified property acquired and placed in service through 2012 (2013 for property eligible for a one-year extension of the placed-in-service date) could be fully expensed. Alternatively, taxpayers could elect to instead depreciate their qualified property without any additional first-year depreciation deduction, if desired. The proposal would be effective for qualified property placed in service after December 31, 2011.

The Obama Administration also proposes to limit the extent to which the §199 deduction is allowed, which includes excluding from the definition of domestic production gross receipts any gross receipts derived from sources such as the production of oil and gas, the production of coal and other hard mineral fossil fuels, and certain other nonmanufacturing activities. The proposal would be effective for taxable years beginning after December 31, 2012.

Other Guidance

IRS outlines treatment of settlement proceeds following manufacturer's breach

In ILM 201203013, a taxpayer, upon entering into a purchase agreement, paid deposits to a manufacturer in exchange for the promise to deliver products by a specified date. Due to delays in product delivery, the taxpayer and manufacturer entered into a settlement agreement to terminate the original purchase agreement and to provide that the taxpayer receive consideration along with repayment of the deposits paid plus interest. During this time, but before the settlement agreement had been reached, the taxpayer entered into a second purchase agreement with an unrelated manufacturer as a result of the former manufacturer's breach. The purchase price required under the latter agreement exceeded that of the original agreement, and the excess amount was determined to be more than the additional consideration called for in the settlement agreement. The taxpayer maintained that the increase in purchase price was due to its impaired capital from the original breach, and as such, the payments received in the settlement agreement were non-taxable as a return of capital, thereby restoring the taxpayer to its pre-breach position.

In determining how the returned deposit and interest should be taxed, the IRS examined the fact that in the case of proceeds from a lawsuit, if the amount recovered is directly tied to a replacement of capital destroyed, the payment is a return of capital and not taxable except to the extent the recovery exceeds the tax basis of what is lost. In this case, the return of the deposits was not an accession to the taxpayer's wealth, and therefore non-taxable as a return of capital. The interest, however, was not considered a return of capital and was therefore includible in the taxpayer's gross income.

With respect to the remaining consideration, the IRS concluded that the taxability depends on whether the consideration restores the taxpayer to its pre-breach position or compensates the taxpayer for lost profits. In this case, the IRS concluded that the additional consideration paid to the taxpayer was not taxable because it did not compensate the taxpayer for lost profits but rather served to restore the taxpayer to its pre-breach position.

Certain restaurant and retail improvement property eligible for bonus depreciation deductions

In ILM 201203014, the IRS addressed whether qualified restaurant property and qualified retail improvement property that is placed in service after December 31, 2008, and that also meets the definition of qualified leasehold improvement property is eligible for the 50-percent additional first year depreciation deduction under §168(k)(1).

The statutory language of §§168(e)(7) and 168(e)(8) provides that qualified restaurant property and qualified retail improvement property are not considered qualified property for purposes of §168(k). However, in some cases, qualified restaurant property and qualified retail improvement property placed in service after December 31, 2008, also meets the definition of qualified leasehold improvement property, which would be considered qualified property for purposes of §168(k).

Both the General Explanation of Tax Legislation Enacted in the 111th Congress prepared in March 2011 by the Joint Committee on Taxation Staff (the "Bluebook") and §3.03(3) of Rev.

Proc. 2011-26 provide that qualified property that meets the definition of both qualified leasehold improvement property and qualified restaurant property or qualified retail improvement property is eligible for the 50% or 100% additional first year depreciation deduction, assuming all other requirements provided in §168(k) are met. The IRS further stated that if qualified restaurant property or qualified retail improvement property does not meet the definition of qualified leasehold improvement property, such property is not eligible for the additional first year depreciation deduction under §168(k) even though this property has a recovery period of 15 years.

LB&I issues new directives for wireless and telecom industries

The Large Business and International division (LB&I) has issued two new directives to provide guidance to examining agents in connection with three revenue procedures that were released in connection with the Industry Issue Resolution program. Rev. Proc. 2011-22 was issued to provide a safe harbor method of accounting for the depreciation of certain tangible assets used by wireless telecommunications taxpayers. Rev. Procs. 2011-27 and 2011-28 were issued to provide two alternative safe harbor methods of accounting, the network asset maintenance allowance method or the units of property method, to determine whether certain expenditures could be deducted as repairs or must be capitalized.

LB&I Directives 04-1111-20 and 21 instruct exam teams that they may not use the safe harbor methods provided in the revenue procedures to resolve class life issues or repair versus capitalization issues pending in open exam years prior to the effective date of the revenue procedures. The Directives instead instruct examiners to cease examination of these issues and allow taxpayers a two-year period to change to a safe harbor method. Discontinuing the examination includes revocation of any outstanding IDRs (Form 4564) and Notices of Proposed Adjustments (Form 5701). The IRS will also develop and issue Form 886-A to say that it neither accepts nor rejects the position in the tax return with respect to the issues covered by the revenue procedures. If a Form 3115 has been filed for a year under exam, the IRS will include a statement to say that the IRS neither accepts nor rejects the method described on the Form 3115.

The Directives also provide that the failure of a taxpayer to fully comply with the revenue procedures within 2 years will result in an IRS agent performing a risk assessment. If the issue is found to be material, the issue will be subject to examination.

LB&I provides guidance for examiners on benefits and burdens of ownership in contract manufacturing arrangements

The Large Business and International Division (LB&I) recently issued guidance for examiners to use in determining whether a taxpayer has the benefits and burdens of ownership under a contract manufacturing arrangement for purposes of calculating its domestic production activities deduction under §199.

The Directive provides a three step process that an examiner should use in determining whether a taxpayer has the benefits and burdens of ownership in a contract manufacturing arrangement. The three steps relate to evaluating (1) contract terms, (2) production activities, and (3) economic risks. Each step requires the examiner to answer three questions. If the answer to at least two can be answered "yes", the step is considered to have been met. If the taxpayer meets any two of the three steps, they are considered to have the benefits and burdens of ownership.

If, however, at least two of the three steps are not completed, the examiner should determine whether the taxpayer has the benefits and burdens of ownership based on all the facts and circumstances as in any examination risk assessment. The Directive explicitly instructs the examiner, when performing an all facts and circumstances determination, to consider all relevant factors, rather than relying solely on the nine questions listed in the three-step process.

Wind turbine generators considered placed in service for depreciation, renewable energy credit

In PLR 201205005, the IRS ruled that a taxpayer would not be precluded from placing into service their wind turbine generators for purposes of computing depreciation deductions under §§167 and 168 and the renewable energy production credit under §45 because of delays in being at full-capacity.

The taxpayer was developing a wind power generating facility wherein multiple turbines were going to connect to a power grid. Each turbine was a self-contained unit capable of operating independently of all other turbines and could be started up, tested, commissioned, and synchronized to the power grid separately. The taxpayer expected to be capable of producing electricity at the full capacity of each of its turbines and to be operating substantially all of its turbines on a daily basis by the desired placed in service date. The taxpayer asserted that there could be delays/limitations to operating at full capacity due to transmission upgrades not being completed on time. However, in the event of a delay, the taxpayer could nevertheless continue to produce output by making temporary modifications to an alternative back-up substation, thereby allowing the production of electricity for sale without modifying the turbines.

The IRS referenced a number of cases that have addressed placed in service questions in the context of power plants. Significant holdings from such cases conclude that facilities can be deemed placed in service upon sustained power generation near rated capacity. However, if a facility is merely operating on a test basis, it is not considered placed in service until it is available for service on a regular basis.

In this case, the taxpayer represented that they met all the factors delineated in Rev. Rul. 76-256, including that (i) all necessary permits and licenses with respect to the turbines will have been obtained; (ii) the turbines will have been synchronized to the power grid for its function of generating electricity for production of income;

(iii) the critical tests for the various components of the turbines will have been completed; (iv) the turbines will have been placed in the control of the taxpayer by the contractor; and (v) the taxpayer expects to have sold a non-de minimis amount of electricity by that date. Accordingly, the IRS ruled that the wind turbine generators would be considered placed in service for purposes of computing depreciation deductions under §§167 and 168 and the renewable energy production credit under §45.

PLR concludes sale of power purchase agreement results in capital gain

In PLR 201203003, the IRS ruled that a power purchase agreement ("PPA") granting the subsidiary of an entity the right to buy power would be classified as a capital asset under §1221 in the hands of the subsidiary and that any gain from the assignment of the rights under the agreement would be considered capital gain.

A subsidiary member of the taxpayer's affiliated group entered into a PPA, in which it acquired and held the rights to purchase the capacity and energy of a power plant through its stock ownership interest in a power company. As part of a later divisive reorganization, the subsidiary transferred its stock interest in the power company to its parent, which subsequently transferred the assignment of rights and obligations under the PPA to the taxpayer.

The taxpayer later entered into a purchase and sale agreement in which the taxpayer sold its entire stock interest in the power company to an unrelated buyer. As part of the purchase and sale agreement, the taxpayer also entered into an assignment and assumption agreement in which the taxpayer assigned its rights and obligations under the PPA to the buyer.

In determining how the proceeds from the exchange should be taxed, the IRS examined the definition of "capital asset." Among the list of exceptions provided in §1221, the only possible exception that could apply was §1221(a)(2), property of a character which is subject to the allowance for depreciation provided in §167. In this case, the original PPA was entered into prior to the enactment of §197. Accordingly, it was not considered an amortizable §197 intangible. Further, the taxpayer represented that FERC licenses are generally always renewed and that it believed the power company fully intended to renew its current license for the power plant. Therefore, the power purchase agreement was not considered to have a limited useful life for depreciation purposes and consequently not considered property subject to depreciation under §167. Because none of the exceptions under §1221 applied, the IRS concluded that the PPA was a capital asset in the hands of the taxpayer and that any gain from the assignment of such right was capital in nature.

IRS updates accuracy-related penalty guidance

In Rev. Proc. 2012-15, the IRS published the annual list of circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax penalty under §6662(d). Rev. Proc. 2012-15 applies to any income tax return filed on 2011 tax forms for a taxable year beginning in 2011, and to any income tax return filed on 2011 tax forms in 2012 for short taxable years beginning in 2012. The circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate to avoid the accuracy-related penalty are essentially unchanged from those listed in recent years. The circumstance that is most frequently applicable to corporations is an appropriate disclosure on Schedule M-3, Part III, line 37 "Other expense/deduction items with differences."

Recent Cases

Dividends paid by a life insurance company to its policyholders are deductible under the recurring item exception

In addressing the proper year for claiming a deduction for policyholder dividends, the Federal Court of Claims in *Massachusetts Mutual Life Insurance v. US*, 109 A.F.T.R.2d 2012-837, analyzed the "all-events" test under §461 and the history of the economic performance rules. The Court ultimately upheld the deductibility of the taxpayer's policyholder dividends in the year the Board of Directors approved resolutions.

The IRS did not dispute the deductibility of the policyholder dividends, but instead challenged the timing of the deduction, arguing that Mass Mutual's liability for the dividends was not fixed in the year the dividends were declared, that economic performance had not occurred by year end, and that the dividend guarantee lacked economic substance. The Court addressed two issues in reaching their conclusion: (1) whether, in the years they were adopted, the Board of Directors resolutions fixed the liability to pay the declared guaranteed minimum amounts in the following year; and (2) whether the policyholder dividends are rebates, refunds, or similar payments under Treas. Reg. §1.461-4(g)(3) that qualify for the recurring item exception under Treas. Reg. §1.461-5(b)(5)(ii).

The IRS argued that Mass Mutual's liability was not established at the end of the year because the Board of Directors was legally allowed to amend the dividend guarantee subsequent to its original declaration and that no precise dividend amounts were specifically allocated to any single, identifiable policyholder. The Court, however, concluded that Mass Mutual's dividend guarantees created an unconditional obligation to pay an aggregate group of policyholders the following year. Therefore, Mass Mutual's dividend guarantees established the fact of the liability, which met the first prong of the “all events test.”

To establish whether the policy dividends were rebates, refunds, or other similar payments, the Court noted that this term is not defined within §461(h)(3) or any other place within the Code or regulations. The Court then looked to dictionary definitions of the words, as well as cases decided by the Federal Circuit, and ultimately determined that Mass Mutual's policy dividends did constitute rebates, refunds, or other similar payments. The Court also determined that the policy dividends satisfied the matching requirement of §1.461-5(b)(iv)(B). Consequently, Mass Mutual was allowed to use the recurring item exception.

Fifth Circuit affirms insurance fund not deductible business expense

In *F.W. Services, Inc. v. Commissioner,* 109 AFTR 2d 2012-676 (5th Cir. 2012), the Fifth Circuit upheld a 2010 Tax Court decision, stating that the taxpayer's alleged "insurance premiums" were in substance deposits and not a deductible business expense under §162(a).

The taxpayer, a temporary staffing agency, took out an insurance policy with American Home which contained a "loss reimbursement" clause that required the taxpayer to reimburse claims. To satisfy these potential reimbursement claims, the taxpayer entered into a second insurance policy with National Union, which was owned by the same parent as American Home, to cover the taxpayer's reimbursement obligation under the American Home insurance policy. Under the contract with National Union, if National Union's payments to American Home exceeded the premiums the taxpayer paid to it, the taxpayer would pay National Union the difference (essentially reimbursing National Union). If the final payment was less than the premiums the taxpayer paid to National Union, National Union would refund the balance to the taxpayer.

In its tax return for the year, the taxpayer deducted the premiums it paid to both American Home and National Union as ordinary and necessary business expenses under §162(a). The IRS contended that the amounts remaining in National Union's fund at the end of the tax year were not deductible by the taxpayer, although the IRS did allow the taxpayer to claim a deduction for amounts paid from National Union to American Home during the tax year. The Tax Court agreed with the Service and held that the amount held in National Union's fund at the end of the tax year was not properly deductible.

The taxpayer contended that the two contracts with American Home and National Union should be viewed as one insurance policy and that a portion of the risk was therefore shifted from the taxpayer to American Home through all of the contracts taken as a whole. In support of its position, the taxpayer argued that the contracts should be considered as one insurance policy due to the fact that (i) the contracts were entered into on the same day as a package deal, (ii) American Home and National Union were both subsidiaries of the same parent, and (iii) American Home's policies required the taxpayer to make some provision for "loss reimbursement endorsement." The taxpayer further asserted that the only reason it contracted with National Union was to obtain the insurance policy from American Home.

Notwithstanding the various arguments put forth by the taxpayer, the Fifth Circuit upheld the Tax Court's decision, affirming that insurance, in essence, involves risk-shifting and risk-distribution. When a contract requires the "insured" to pay all losses, there is essentially no risk-shifting to the "insurer," and thus no resulting insurance. Accordingly, the Fifth Circuit affirmed the Tax Court's denial of the taxpayer's deduction and concluded that the amounts remaining in the National Union fund were not "insurance premiums" for purposes of §162(a).

Corporation denied deduction for transfer to trust to satisfy contested tax liability

In *Goodrich Corporation v. U.S.*, 109 AFTR 2d 2012-556, the U.S. District Court did not agree that the taxpayer had provided for the satisfaction of an asserted liability because the IRS did not agree in writing that the payment to a trust satisfied the liability and the taxpayer did not prove that it relinquished all authority over the money.

The taxpayer acquired Rohr and its subsidiaries at a time during which Rohr was under examination by the IRS. Following the examination, the IRS issued a notice of deficiency to Rohr asserting that it owed additional federal income taxes plus interest on the proposed deficiency. Rohr contested the liability.

Rohr subsequently created the Rohr Trust pursuant to a written trust document to provide payment for the interest on the income tax that Rohr allegedly owed to the IRS. Rohr funded the Trust by assigning unsecured promissory notes that it received from its parent, the taxpayer. On the same day the trust was created, the taxpayer notified the IRS, via certified mail, that the taxpayer had established the trust and had transferred the notes to pay Rohr's interest obligation that could arise from the settlement of the contested liability. The taxpayer filed consolidated tax returns that included its subsidiary, Rohr, and claimed a deduction for the interest expense paid to the Rohr Trust under §461(f). The IRS subsequently denied the taxpayer's interest deductions with respect to the Rohr Trust during its examination of the taxpayer's returns.

The issue before the US District Court was whether the taxpayer was entitled to a tax deduction for its transfer of the unsecured promissory notes to the trust to satisfy the contested liability with the IRS, where the IRS never affirmatively consented to the terms of the trust.

The IRS asserted that the taxpayer failed to satisfy §461(f)(2) for two reasons: (1) the taxpayer did not obtain written consent from the IRS, as required by Treas. Reg. §1.461-2(c)(1)(ii), to utilize the trust to satisfy the contested liability; and (2) the taxpayer did not relinquish all control to the trust or the trust corpus. The taxpayer disagreed and argued no written agreement was necessary where the IRS silently assented to the trust. The taxpayer further asserted that it relinquished control over the property placed into the trust as required by the statute. The court found that a plain reading of Treas. Reg. §1.461-2(c)(1)(ii) requires that the trust agreement contain the signature of the IRS, who is "the person...asserting the liability," or at a minimum, that the IRS give written consent to the trust. Because no such written agreement or affirmative assent existed, the taxpayer's deduction was denied.

Tax Court disallows deductions for business use of aircraft due to lack of substantiation

In *Scott P. Lysford and Pattie D. Lysford v. Commissioner,* T.C. Memo 2012-14, the Tax Court held that the substantiation provided by the taxpayers for business expenses and depreciation deductions related to the use of a small airplane, as well as for various other assets and their tax basis in various flow-through entities, was wholly inadequate to demonstrate any business purpose for the trips and expenditures and the deduction was disallowed.

Scott Lysford, an ex-pilot for United Airlines, began working as an independent mortgage broker in 2002. In 2003, Mr. Lysford and his wife incorporated Northshore, an S corporation, which held a number of real estate investment properties. The taxpayers used space in their home as an office for this business. Later that year, Mr. Lysford incorporated Trinity, a second S corporation, with two unrelated individuals to conduct a mortgage loan business. Trinity's office was approximately 200 miles from the taxpayers' Minnesota residence and located in the same city as Mr. Lysford's mother.

In 2005, Mr. Lysford purchased a Cessna 182 airplane and paid overhaul expenses in the name of Northshore. The taxpayer claimed to have made weekly trips by both plane and his personal automobile to the business office of Trinity. Mr. Lysford documented his frequent flights in a small spiral notebook by merely noting the date and general destination of each flight. He documented, in a separate notebook, similar sparse information relating to his automobile trips.

In their 2005 income tax return, the taxpayers claimed a depreciation deduction under §167 and expensed overhaul expenses under §179 related to the airplane. The taxpayers also claimed various other deductions, including a home office deduction. The taxpayers continued to report deductions through ownership of Northshore and Trinity on their 2006 and 2007 income tax returns related to the use of the airplane and various other business expenses.

The IRS, pursuant to an audit of the taxpayers' 2006 and 2007 income tax returns, argued that no substantiation existed for the business use of the aircraft and other assets and therefore required the taxpayers to recapture the costs deducted with respect to the airplane in 2005 and other costs claimed as current expense deductions under §179.

The Tax Court stated that, as a general rule, taxpayers have a responsibility to maintain records sufficient to determine their correct Federal income tax liability. The Tax Court stated that Mr. Lysford's entries in his spiral notebooks fell well short of the substantiation required by §274(d) and was wholly inadequate to demonstrate any business purposes for the trips and expenditures. Further, based on the fact that the taxpayers provided no credible evidence that Mr. Lysford sold any mortgages or met with specific clients, mortgage brokers, title companies, loan customers, banks, or identified a business contact in or around the area while travelling, the Tax Court concluded that the substantiation requirement under §274(d) had not been met and therefore the unsubstantiated business expenses and depreciations deductions were denied.

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