Accounting Methods Spotlight / Issue 11 / November 2013

New IRS guidance and recent court rulings shed light on tax accounting issues

In this month's Accounting Methods Spotlight, taxpayers are reminded of the 90-day window available for filing Form 3115. This month's issue also discusses updated examiner guidance addressing Section 199 'benefits and burdens' issues, a field attorney advice reiterating that cash bonuses are not deductible until the year of payment, and two private letter rulings concluding that up-front incentive payments are currently deductible. In addition, this month's issue discusses the long awaited release of a Tax Court decision addressing the Section 199 benefits and burdens test in the contract manufacturing context.

Did you know..?

90-day window available for filing Form 3115

January 1, 2014 is an important date for many calendar-year taxpayers, as it will mark the opening of the '90-day window' within which those that have been under exam by the Internal Revenue Service (IRS) for all of 2013 may voluntarily file an accounting method change provided the propriety of the accounting method is not an 'issue under consideration' in an examination.

The 90-day window period provides such taxpayers an opportunity to file a Form 3115, Application for Change in Accounting Method, without first securing the consent of the IRS director (or his delegate, which generally is the revenue agent). The 90-day window often is the only viable option for taxpayers to change from an improper method of accounting because it is typically not prudent to request director consent and alert the IRS to the improper method. Moreover, taxpayers wanting to change from a proper method also may want to file in the 90-day window to avoid the sometimes time consuming task of seeking

director consent. Accordingly, calendar-year taxpayers under exam should begin to identify potential accounting method changes that could be filed during the 90-day period ending March 31, 2014.

Other guidance

IRS releases updated examiner guidance addressing Section 199 'benefits and burdens' issues

The IRS Large Business and International Division (LB&I) recently issued updated Industry Director Directive LB&I-04-1013-008 (the Updated Directive or Directive), which provides guidance to examiners for use in determining whether a taxpayer has the benefits and burdens of ownership under Federal income tax principles (B&B) of qualifying production property, qualified films, or utilities produced under a contract manufacturing arrangement for purposes of Reg. sec. 1.199-3(f)(1).

Like the previous version of the Directive issued in July 2013 (the July 2013 Directive), the Updated Directive permits the parties to a contract manufacturing arrangement to designate which party may claim the Section 199 domestic production activities deduction. The Updated Directive instructs LB&I examiners to request three statements from a taxpayer for each contract. If a taxpayer provides all three statements, examiners are instructed not to challenge that the taxpayer has the B&B for purposes of Section 199 over each qualifying property upon which a qualifying activity is performed under the contract manufacturing arrangement. The following statements and certifications are required:

- Statement that explains the basis for the taxpayer's determination that it had the B&B in the year or years under examination (B&B Statement).
- Certification Statement signed by the taxpayer (Taxpayer Certification Statement).
- Certification Statement signed by the counterparty (Counterparty Certification Statement).

The updated directive provides two significant taxpayer friendly changes. First, if a taxpayer needs more than 60 days to obtain the Counterparty Certification Statement, they may now request an extension of time. Second, and more importantly, the Updated Directive removes the requirement contained in the July 2013 Directive that the taxpayer certify that it was not required to record a reserve for financial statement purposes that it had the B&B (financial statement reserve certification).

The determination of B&B has been one of the most difficult and controversial areas of Section 199, primarily due to the potential for IRS 'whipsaw' in which both parties to a contract manufacturing agreement seek to claim the Section 199 deduction with respect to the same qualifying activity. By allowing the parties to a contract manufacturing arrangement to designate which party is eligible for the Section 199 deduction, the Directive will help reduce the uncertainty underlying a Section 199 deduction involving contract manufacturing arrangements and simplify the B&B analysis required to support a Section 199 claim. However, it remains to be seen whether, and how many, taxpayers can obtain the requisite certifications to avail themselves of the Updated Directive.

FAA concludes cash bonuses not deductible until year of payment

In Field Attorney Advice (FAA) 20134301F, the IRS concluded that a taxpayer was not entitled to deduct cash bonuses paid to employees until the end of the year in which the bonuses were actually paid. The IRS reasoned that certain provisions of the bonus plan prevented the all events test from being met until payment actually occurred.

The taxpayer had a large number of bonus plans through which employees may be awarded cash bonuses (the Plans). Under the Plans, employee bonuses are calculated using formulas that are largely driven by metrics at the company, sector, unit, and/or individual employee level. Additionally, some, but not all, of the Plans took into account the employee's individual performance evaluation for the year. Bonuses

awarded under the Plans are generally not paid until after the close of the taxable year when a committee of the board of directors (the Committee) approves the amount and payment of the bonuses. Until the Committee approves the bonus, the taxpayer retains the right to modify or eliminate the bonus entirely.

An accrual method taxpayer generally takes a liability into account for Federal income tax purposes in the same taxable year in which (1) all the 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. The all events test looks to whether an actual legal right or obligation exists as of the close of the taxable year, not the probability that a particular legal right or obligation will occur at some point in the future.

The IRS found that the liability was neither fixed nor determinable when the taxpayer retains the right to modify or eliminate the bonus after the close of the taxable year. The IRS recognized that in some cases the all events test has been held to have been met absent an actual legal liability; however, in those cases, the court found another event that fixed that taxpayer's liability (i.e., the payment itself, board action, etc.). Such event, in the IRS' opinion, was not present here.

The IRS also noted that the taxpayer's liability was neither fixed nor determinable as long as the bonus payments were dependent on subjective employee performance appraisals and were dependent upon committee approval.

Up-Front incentive payments are currently deductible

In PLRs 201341029 and 201341031, the IRS concluded that up-front incentive payments made by an electric utility company to customers who purchase and install renewable energy systems are currently deductible under Section 162(a) as an ordinary and necessary business expense, and should not be capitalized under Section 263(a).

The taxpayer is a subsidiary member of the consolidated group, and provides electric service to residential, commercial, industrial, and public sector customers. The taxpayer is subject to the regulatory authority of Commission. Commission adopted certain rules requiring electric companies to produce a certain amount of renewable energy each year. Compliance with the renewable energy requirements is measured by 'renewable energy credits' (RECs). A utility meets its renewable energy requirements by retiring a sufficient amount of RECs to satisfy the renewable energy requirements. Under the rules, at least a certain percentage of the renewable energy must come from 'distributed energy' -- that is, energy created by equipment owned by the particular utility's customer and located on that customer's premises.

As a result, the taxpayer was required to implement a plan to comply with the rules and to allocate specific funding for each segment of the plan, including the distributed energy requirement. To meet its distributed energy requirement, the taxpayer makes up-front incentive (UFI) payments as incentives for customers to purchase and install certain systems. The amount of UFI payments is regulated by Commission and is subject to change year to year and also mid-year.

Based on the taxpayer's specific set of facts, the IRS concluded that the UFIs are currently deductible as ordinary and necessary business expenses under Section 162(a) and not subject to capitalization under Section 263(a). According to the IRS, Commission's imposition and oversight of the rules show that the UFIs are ordinary expenses of the taxpayer. Moreover, as an electric utility operating in the state, the taxpayer is subject to the regulatory authority of Commission and must comply with the renewable energy requirements. The UFIs are paid in order to comply with rules of the governmental entity regulating the taxpayer's right to conduct its business operations in the state; therefore, the UFIs are necessary expenses.

Cases

Tax Court addresses Section 199 benefits and burdens test in contract manufacturing context

The US Tax Court has released its long-awaited decision in *ADVO v. Commissioner*, 141 T.C. No. 9 (2013). In *ADVO*, the court addressed for the first time how Section 199 applies to taxpayers that manufacture products through agreements with contract manufacturers. The court held in favor of the IRS and disallowed the Section 199 deduction claimed by ADVO with respect to income derived from certain advertising materials.

The taxpayer, ADVO Inc., is a direct mail advertising company engaged in the distribution of advertising material, referred to as solo direct mail and shared mail packages, distributed through the US Postal Service to residential recipients. ADVO's shared mail packages consisted of individual printed wraps, inserts, and a detached address label combined into a single delivery mechanism. In varying degrees, ADVO's graphics print department assisted its customers with the design of the advertisement graphics, which were supplied solely by ADVO or directly by customers. After an advertisement is complete, ADVO's graphics print coordinators (GPCs) send the PDF files containing the artwork to one of ADVO's contract printers to print. When the printed materials are received back, ADVO used a machine to wrap and prepare the materials for mailing.

The central issue to be decided in this case was whether ADVO or the contract printers had the benefits and burdens of ownership for Federal income tax purposes (B&B) of the advertising materials during the printing process. In its analysis, the court used a list of nine factors to determine whether ADVO had the B&B of the advertising materials. These factors, which are based on *Grodt & McKay v. Commissioner*, 77 T.C. 1221 (1981), Section 936, and an example in the Section 199 regulations, reflect the court's opinion that the holdings in cases decided under Section 263A are not binding for purposes of Section 199. The non-exclusive list of factors includes the following:

1. Legal title to the goods
2. Intention of the parties
3. Equity (at-risk) interest in the property
4. Creation of a present obligation
5. Right of possession and control
6. Payment of property taxes
7. Risk of loss or damage
8. Profits from operation and sale; and
9. Active and participation and sale in the management and operations\

Based upon an analysis of the above factors, the court held that ADVO did not have the B&B of the printed materials while the advertising material was being printed.

The *ADVO* decision provides further guidance on the historically controversial Section 199 B&B analysis. Prospectively it is anticipated that the IRS will begin to examine contract manufacturing arrangements using, at a minimum, the B&B factors analyzed by the *ADVO* court. Accordingly, taxpayers that currently are claiming a Section 199 deduction for production activities performed pursuant to a contract manufacturing arrangement should review the *ADVO* decision to determine the extent to which the facts of the case align with their particular circumstances.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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