# *Recent IRS developments and court rulings provide guidance on tax accounting issues*

In this month's Accounting Methods Spotlight our readers receive a summary of government officials' comments at the recent ABA Section of Taxation meeting, as well as a further discussion of the recently released final tangible property 'repair' regulations. This month's issue also discusses a recent field attorney advice on the amortization of certain contracts for personal services. Finally, this month's issue takes a look at a court decision which examines a UNICAP adjustment under section 263A and whether certain costs incurred by a home builder are capitalizable or deductible.

## *Did you know..?*

### *Government officials provide updates at September ABA meeting*

The ABA Section of Taxation recently held its fall meeting in San Francisco. The panel discussions featured several government officials and tax professionals who addressed a variety of tax accounting issues, including the latest federal tax policies, initiatives, regulations, legislative forecasts and planning ideas.

Several panels addressed the recently finalized regulations on the capitalization of tangible assets. Specifically, government officials answered numerous technical questions related to the regulations, including questions with respect to the 'de minimis rule,' improvements, and transition guidance. The government reiterated that its goal in issuing the final repair regulations was to create a consistent application of principles from case law and other authorities, to establish bright lines where possible, and to provide some safe harbors.

In addition to the repair regulations, officials also discussed the waiver of scope limitations under Rev. Proc. 2011-43, which addresses the capitalization of expenditures for electric transmission and distribution property, and noted that it is likely to be extended. The government acknowledged that current limits in the revenue procedure are problematic for many in the industry.

Government panelists also mentioned that the repair regulations industry issue resolutions (IIRs) for cable network property, natural gas transmission and distribution property, and retail stores are forthcoming.

## *Other guidance*

### *Final tangible property repair regulations: Effective dates and transition*

The IRS and Treasury Department on September 13, 2013, released final regulations under Sections 162(a) and 263(a) on the deduction and capitalization of expenditures related to tangible property (the final repair regulations). The final repair regulations retain many of the provisions from the December 2011 temporary regulations. However, the final repair regulations refine and simplify some of these rules and create a number of new safe harbors.

In general, the entirety of the final repair regulations apply to tax years beginning on or after January 1, 2014. However, the following rules apply only to amounts paid or incurred in tax years beginning on or after January 1, 2014:

- Materials and supplies (Treas. Reg. § 1.162-3);
- The de minimis rule or "capitalization threshold" related to the acquisition or production of property (Treas. Reg. § 1.263(a)-1(f));
- The special rule for costs related to the acquisition of real property (Treas. Reg. § 1.263(a)-2(f)(2)(iii));
- Employee compensation and overhead costs related to the acquisition of real or personal property (Treas. Reg. § 1.263(a)- 2(f)(2)(iv));
- The treatment of inherently facilitative amounts related to the acquisition or production of real or personal property (Treas. Reg. § 1.263(a)-2(f)(3)(ii));
- The safe harbor for small taxpayers for improvements to a unit of property and improvements to leased property (Treas. Reg. § 1.263(a)- 3(h));
- The optional regulatory accounting method for amounts paid to repair, maintain, or improve tangible property (Treas. Reg. § 1.263(a)-3(m));
- The election to capitalize repair and maintenance costs (Treas. Reg. § 1.263(a)-3(n));
- Section 263A direct material costs (Treas. Reg. § 1.263A-1(e)(2)(i)(A)); and
- Section 263A indirect material costs (Treas. Reg. § 1.263A-1(e)(3)(ii)(E)).

Taxpayers may choose to apply the final repair regulations to any tax year beginning on or after January 1, 2012. For taxpayers choosing to early adopt the final repair regulations, they will apply to tax years beginning on or after January 1, 2012, or to amounts paid or incurred in tax years beginning on or after January 1, 2012. The final repair regulations also provide taxpayers choosing to early adopt with certain transition relief.

*Changes in method of accounting:* In general, any change to comply with the final repair regulations is a change in method of accounting to which the provisions of Section 446(e) and the regulations thereunder apply. The final repair regulations generally require a full Section 481(a) adjustment, which means taxpayers should evaluate their current methods of accounting for any methods governed by the final repair regulations to determine what changes, if any, are required to conform to these new rules. However, the de minimis rule and the several other provisions noted above are implemented on a cut-off basis rather than with a Section 481(a) adjustment, which means those methods of accounting apply only to amounts paid or incurred after January 1, 2014.

*Pending guidance:* The preamble to the final repair regulations confirms that the IRS will issue separate revenue procedures that will provide procedures under which taxpayers may obtain automatic consent to change their methods of accounting to comply with the final repair regulations for tax years beginning on or after January 1, 2012. We also expect the revenue procedures to provide audit protection for all tax years prior to the tax year for which a taxpayer changes its methods of accounting to comply with the final repair regulations, and to provide other necessary procedural rules, such as whether any resulting Section 481(a) adjustment is taken into account over the traditional spread period.

## *Baseball signing bonuses amortizable over useful life of player's contracts*

In FAA 20133901F, the IRS determined that a professional baseball team must amortize signing bonuses paid to its minor league players over the useful life of the player's contract, and not over the average life of contracts disposed of, a period less than the term of each player's contract.

The taxpayer operates a professional baseball team and is affiliated with several minor league baseball teams, two of which are included on the taxpayer's tax return. The other affiliates are separate legal entities not owned by the taxpayer. However, the taxpayer operates under an agreement whereby it incurs and pays the payroll expense and certain operating costs as defined under Major League Baseball rules for all of its affiliates.

When a player signs a contract to play for one of the taxpayer's teams, a signing bonus is often paid. Generally, the taxpayer capitalizes and amortizes the signing bonuses of its major league players over the life of the players' contracts. The taxpayer, however, capitalizes and amortizes the signing bonuses of the minor league players over the average life of contracts disposed of, a period less than the actual life of the players' contracts. Under the Minor League Uniform Player Contract, a player is bound to play for the team for seven separate championship seasons, after which the player becomes a minor league free agent. However, there are several situations whereby a contract may be terminated by the player by applying to the Commissioner of Major League Baseball and providing the taxpayer sufficient time to remedy situation. In addition, the taxpayer may terminate the player contract by written notice if the player fails to comply with specific requirements.

Treas. Reg. § 1.167(a)-3(a) provides that an intangible asset may be the subject of a depreciation allowance if it is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy. Under Treas. Reg. § 1.167(a)-1(b), "the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of income."

In general, Rev. Rul. 67-379 provides that the useful life for a baseball player's contract is the period over which the team controls the player's ability to sign a contract with another team. Under Treas. Reg. § 1.167(a)-14(c)(1)(ii), the cost or other basis of a taxpayer's right to receive an unspecified amount of tangible property or services over a fixed period is amortizable ratably over the period of the right.

In this instance, the IRS found that the taxpayer had control over the minor league players until the players had completed seven championship seasons with the taxpayer and that the players could not unilaterally terminate the contract with the taxpayer.

As a result, the IRS concluded that because the taxpayer controls the minor league players for a seven year term, the useful life of the contract is seven years and not some shorter period reflecting the average actual time before contracts are dissolved.

## Cases

### *Home builder must capitalize costs related to production of real property*

In *Frontier Custom Home Builders, Inc. v. Commissioner,* T.C. Memo 2013-231 (9/30/13), the Tax Court held that Frontier Custom Home Builders, Inc. ("Frontier") must capitalize indirect production related expenses and must allocate employee remuneration between capitalizable and deductible activities.

Frontier, a Texas corporation, has been a builder of custom and speculative homes since 1994. On its 2005 tax return, Frontier capitalized direct material and labor costs and post-production-period carrying costs but claimed deductions for salaries, year-end bonuses, and other miscellaneous expenses.

The IRS made an adjustment to Frontier's income totalling $1,888,625 under the uniform capitalization (UNICAP) rules of Section 263A. Frontier argued that the UNICAP adjustments were inappropriate because its business model was focused on the sale and marketing of homes, not production-related services as required under Section 263A.

The Tax Court disagreed with Frontier's argument that its activities are more reflective of a sales and marketing company stating that, "[t]he creative design of custom homes is ancillary to the actual physical work on the land and is as much a part of a development project as digging a foundation or completing a structure's frame." Moreover, the Tax Court disagreed with Frontier's contention that salaries and bonuses paid to employees should be wholly deductible costs. Important to this analysis was Frontier's inability to produce contemporaneous records demonstrating how much time was spent on each activity by its employees. The Tax Court found that the employees' services were mixed service costs under Section 263A and were partially allocable to production activities. As a result, the court concluded that the portion of salaries related to production activities should be capitalized rather than deducted.

With respect to bonus payments, Frontier argued that the bonus payments were deductible because they were determined by profits from homes sold and thus cannot be related or capitalized to ending inventory. Frontier proffered that the bonus distribution should be allocated exclusively to homes sold by year end because the payment came from the money obtained from those homes sold. The Tax Court found this argument unpersuasive, stating that such a method of accounting does not clearly reflect income and would allow any production costs to escape capitalization by identifying them as being paid out of profits.

In line with its finding that Frontier was engaged in production-related services for purposes of Section 263A, the Tax Court held that indirect costs such as payroll taxes, employee benefit programs, insurance, etc. should also be capitalized to the extent they relate to production-related activities or capitalizable property.

## *Let's talk*

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


Adam Handler, Los Angeles
+1 (213) 356-6499
adam.handler@us.pwc.com

Jennifer Kennedy, Washington, DC
+1 (202) 414-1543
jennifer.kennedy@us.pwc.com

George Manousos, Washington, DC
+1 (202) 414-4317
george.manousos@us.pwc.com

Annette Smith, Washington, DC
+1 (202) 414-1048
annette.smith@us.pwc.com

Dennis Tingey, Phoenix
+1 (602) 364-8107
dennis.tingey@us.pwc.com

Christine Turgeon, New York
+1 (646) 471-1660
christine.turgeon@us.pwc.com

James Martin, Washington, DC
+1 (202) 414-1511
james.e.martin@us.pwc.com