New IRS and Court rulings provide guidance on tax accounting method issues

In this month's issue, you will receive insight on recent favorable REIT rulings, as well as related IRS proposed regulations on the definition of real property for REITs. In addition, we have included discussions on: the IRS' automatic consent procedures to comply with new UNICAP regulations addressing sales-based royalties and sales-based vendor chargebacks; a recent ruling on reverse like-kind exchange transaction; and, a ruling granting a taxpayer permission to use an alternative method of basis recovery to report payments from a contingent payment installment sale. This month's issue also discusses the Tenth Circuit's affirmation of a district court decision denying the ordinary business deduction for litigation expenses incurred as part of a reorganization, and a Supreme Court decision to deny certiorari in a case that could have clarified when a deductible liability accrues with respect to policyholder dividends.

Did you know..?

Taxpayers receive favorable REIT rulings and IRS proposes regulations on definition of real property for REITs

Over the past several years, a number of companies holding non-traditional real estate assets (*i.e.*, assets such as cell towers that are not the traditional real estate assets such as buildings and land, but are nonetheless considered real property under the real estate investment trust rules) have elected to become real estate investment trusts (REITs) for federal income tax purposes. In order to be a REIT, a company must predominantly own real property and derive a predominance of its income from real property rents and mortgage interest. As a REIT, a company can avoid paying corporate-level income taxes (through a dividends paid deduction) if it distributes at least 90 percent of its taxable income to shareholders in the form of dividends.

In general, these companies have obtained private letter rulings from the IRS confirming that their non-traditional assets qualified as real estate assets under the REIT rules. The IRS' acknowledgment of the different types of non-traditional real estate assets that may be held by a REIT, as well as the relaxation of the rules governing taxable REIT subsidiaries, has driven several corporations to convert to REITs in recent years, while others with eligible assets have undertaken or are in the process of undertaking tax-free spin-offs of such assets into REITs.

However, last year, the IRS announced that it had suspended issuing REIT private letter rulings involving non-traditional assets while it was forming an internal group to study the contours of the real property definition under the REIT rules, creating uncertainty among taxpayers as to whether the IRS was changing its view regarding non-traditional real estate assets for REIT purposes.

Nevertheless, in April 2014, two taxpayers announced that they had received favorable private letter rulings regarding the eligibility of their outdoor advertising displays (i.e., billboards) to qualify as real property for REIT purposes. In Rev. Proc. 2014-3, the IRS announced that it would no longer rule that outdoor advertising displays constitute real property for purposes of REITs, but mentioned the Section 1033(g) election to treat outdoor advertising displays as real property. Therefore, the rulings likely are based on the companies making elections under Section 1033(g). If so, the IRS would be permitting the election to treat outdoor advertising displays as real property to be effective outside of a transaction involving Section 1033 (which deals with involuntary conversions).

In addition, on May 9, 2014, the IRS released proposed regulations that clarify the definition of real property for purposes of the asset tests applicable to REITs. The proposed regulations define real property to include three broad categories: (1) land, (2) inherently permanent structures, and (3) structural components. In addition, the proposed regulations identify certain types of intangible assets that are real property for purposes of the REIT rules. The proposed regulations provide that each distinct asset (each unit of property) is tested individually to determine whether the distinct asset is real property (*i.e.*, land, inherently permanent structure, or structural component) or personal property.

The proposed regulations also provide a safe harbor list of distinct assets that are deemed inherently permanent structures or structural components and therefore clearly would be treated as real property for purposes of the REIT rules. If an asset is not specifically listed in the regulations as constituting real property, then it must be analyzed through an analysis of the facts and circumstances. Under the proposed regulations, outdoor advertising displays for which an election has been properly made under Section 1033(g) are included in the safe harbor list of inherently permanent structures (i.e., real property).

The proposed regulations are consistent with a number of prior published and private rulings. Thus, the proposed regulations are intended to be a clarification and not a modification of the existing definition of real property for REIT purposes. While the proposed regulations are solely for purposes of the REIT rules, the IRS is requesting comments on whether and how differing definitions of real property in various regulations should be reconciled. These proposed regulations are proposed to be effective when they are finalized.

IRS guidance

IRS provides automatic consent procedures for new UNICAP regulations addressing sales-based royalties and sales-based vendor chargebacks

In Rev. Proc. 2014-33, the IRS provides procedures for taxpayers to obtain automatic consent to change their method of accounting for sales-based royalties or sales-based vendor chargebacks to comply with final regulations issued under Sections 263A and 471 in January 2014.

Sales-based royalties generally refer to licensing fees, payments, or royalty costs related to the use of intellectual property that become due only upon the sale of property. Final Section 263A regulations clarify that sales-based royalty costs, like other royalties, may be capitalizable to property a taxpayer produces or acquires for resale. However, under the final Section 263A regulations, taxpayers may choose either to allocate capitalizable sales-based royalties entirely to property sold, thereby resulting in immediate recognition of such royalties, or to allocate such royalties between property sold and ending inventory under either, a facts and circumstances method or a simplified method.

A sales-based vendor chargeback is defined by the final Section 263A regulations as an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to receive by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. Sales-based vendor chargebacks protect taxpayers from realizing a loss or reduced profit on the sale of certain inventory when the taxpayer is obligated by contract to resell the merchandise at a specific price. Under the final regulations, sales-based vendor chargebacks must be treated as an adjustment to the cost of merchandise sold or deemed sold under the taxpayer's inventory cost flow assumption, thereby resulting in immediate recognition of such allowances.

Under Rev. Proc. 2014-33, automatic consent is provided for the following changes in method of accounting:

1. From not capitalizing sales-based royalties to capitalizing these costs and allocating them entirely to cost of goods sold under a taxpayer's method of accounting;
2. From not capitalizing sales-based royalties to capitalizing these costs and allocating them to inventory property under a taxpayer's method of accounting;
3. From capitalizing sales-based royalties and allocating these costs to inventory property to allocating them entirely to cost of goods sold;
4. From capitalizing sales-based royalties and allocating these costs entirely to cost of goods sold to allocating them to inventory property; or,
5. To no longer include cost adjustments for sales-based vendor chargebacks in the formulas used to allocate additional Section 263A costs to ending inventory under a simplified method.

In addition, the revenue procedure waives certain scope limitations for the changes described above for a taxpayer's first and second taxable years ending on or after January 13, 2014, including the limitations for taxpayers under exam, before appeals or before a federal court, for changes impacted by a section 381 transaction, and for changes made within the past 5 years.

IRS rules on reverse like-kind exchange transaction

In PLR 201416006, the taxpayer and two related parties entered into separate but linked qualified exchange accommodation arrangements (QEAAs) with the same exchange accommodation titleholder (EAT) for the same replacement property, and the IRS concluded that the fact that the taxpayers in the QEAAs were related or that one or more of the taxpayers could acquire an undivided interest in the replacement property did not cause the transaction to be outside the safe harbor provisions of Rev. Proc. 2000-37 for reverse exchanges.

In Rev Proc. 2000-37, the IRS provided safe harbor provisions for structuring reverse exchanges through parking arrangements. A reverse exchange is where the taxpayer receives the replacement property prior to the disposition of the relinquished property, and can be structured as an "exchange last" transaction, in which the taxpayer may acquire the replacement property through an EAT and "park" the replacement property until the taxpayer transfers the relinquished property to the third party buyer in either a simultaneous or deferred exchange. Under the safe harbor provided by Rev Proc. 2000-37, the IRS treats an EAT as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA and meets certain requirements enumerated in the revenue procedure, one of which is that the EAT must acquire a qualified indicia of ownership (QIO, which can be bare legal title) in the parked property.

In PLR 201416006, the taxpayer and Affiliates 1 and 2 each owned commercial office buildings, and each had targeted the same replacement property through transactions separately structured to qualify as reverse like-kind exchanges. The taxpayer, as well as Affiliates 1 and 2, entered into QEAAs with the same unrelated EAT (EATX). All parties represented that each would comply with the requirements of Rev Proc. 2000-37, including the requirement that they each have a bona fide intent to acquire property as replacement property in a like-kind exchange under Section 1031 at the time EATX acquires QIO in the replacement property. In addition, the taxpayer's QEAA provides that the taxpayer acknowledges that EATX has entered into concurrent QEAAs for replacement property with Affiliate 1 and Affiliate 2, which give Affiliate 1 and Affiliate 2 rights to acquire replacement property, in whole or part, through separate QEAAs, to complete like-kind exchanges. Further, the QEAA provides that the taxpayer's right to acquire replacement property terminates upon prior notice by either of its Affiliates to EATX of its intent to acquire the same property. However, the agreement also provides that if Affiliate 1 or Affiliate 2 states its intention to acquire only a portion of replacement property, then EATX's obligation to transfer the balance of replacement property to the taxpayer is unaffected. Essentially, these separate QEAAs allow separate taxpayers the flexibility to exchange alternative properties or the fractional undivided interests of the same parked replacement property.

Under the facts of the ruling, the taxpayer would assign its right in the contract to purchase replacement property to EATX, which will then acquire title to replacement property using funds that taxpayer, Affiliate 1, Affiliate 2, or any related entity provides. Within 45 days, taxpayer, Affiliate 1, and Affiliate 2 will each identify property that each proposes to transfer as relinquished property. Taxpayer and EATX will enter into an exchange agreement under which taxpayer will assign to EATX its right under the QEAA to acquire the replacement property. Within 180 days from the time that EATX acquires title to the replacement property, EATX will transfer the replacement property to the taxpayer in exchange for taxpayer's relinquished property, consistent with Treas. Reg. Section 1.1031(k)-1(g)(4).

This ruling is consistent with, and expands, the holding of PLR 201242003 (July 12, 2012), in which there were two QEAAs rather than three QEAAs as in PLR 201416006. Use of separate QEAAs is important where the potential properties are held by different entities. With two separate PLRs reaching the same conclusion, taxpayers should have increased confidence in entering into similar arrangements, whereby an EAT can facilitate reverse exchanges within the safe harbor of Rev. Proc. 2000-37 for multiple taxpayers under multiple QEAAs for the same parked replacement property.

IRS approves alternative basis recovery method on installment sale of business

In PLR 201417006, the IRS granted permission for a taxpayer to use an alternative method of basis recovery under Temp. Treas. Reg. Section 15A.453-1(c)(7)(ii) to report payments from a contingent payment installment sale.

In the ruling, the taxpayer is a limited liability corporation taxed as a partnership for federal income tax purposes that owns 100% of the issued and outstanding membership interest of Company A, a disregarded single member limited liability company. Company A, in turn, owns 100% of the issued and outstanding membership interest of Company B, a disregarded single member limited liability company.

Company A agreed to sell Company B to an unrelated third party, Company C. Under the purchase agreement negotiated between the parties, the Company B purchase price consisted of a lump sum payment and assumption of Company B liabilities by Company C in Year 1 and the possibility of contingent payments in years 2 through 7. The contingent payments are formula driven and represent a formulaic method of rewarding Company A for its efforts in certain criteria. The payments to Company A are not guaranteed and are premised on continued growth of Company B.

Under the general rule, a contingent payment installment sale will be treated as having a maximum selling price if, under the terms of the agreement, the maximum amount of sales proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. Such is not the case in sale of Company B due to the formulaic approach of the year 2 through year 7 payments. When a maximum selling price cannot be determined, but the term of the agreement is fixed, the general rule provides that the taxpayer's basis shall be allocated to the taxable years in which payments are to be received in equal annual increments.

Section 15A.453-1(c)(7)(ii) provides that a taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate, prior to the due date of the return including extensions for the taxable year in which the first payment is received, that the application of the general rules would substantially and inappropriately defer recovery of basis. In order to prove this contention, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis, and (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable rule.

In PLR 201417006, the taxpayer proposed a method of basis recovery based on the estimated amount of aggregate payments to be received by the taxpayer during the 7-year term. Although projections of future productivity generally are not allowed, the regulations provide that in certain special circumstances a reasonable projection may be acceptable based upon a specific event that has already occurred. In this case, the taxpayer estimated future contingent payments based on Company B's historic growth rate. The IRS allowed this estimate, and in doing so agreed to let the taxpayer use an alternative method of basis recovery as the taxpayer was able to demonstrate the aforementioned requirements of Section 15A.453-1(c)(7)(ii).

Although PLRs cannot be relied upon by other taxpayers, taxpayers selling assets under contingent installment arrangements may want to consider whether a similar alternative method of basis recovery would be available to them.

Cases

Tenth Circuit affirms decision denying ordinary business deduction for litigation expenses incurred as part of a reorganization

In an unpublished opinion, *Ash Grove Cement Co. v. United States*, 10th Circuit, No. 13-03058, the Tenth Circuit affirmed a district court decision denying a tax refund to

Ash Grove Cement Company ('Ash Grove') after it was determined that business expense deductions related to the settlement of a lawsuit were properly characterized by the IRS as capital expenditures.

The expenses at issue stem from a class action lawsuit by Ash Grove minority shareholders regarding a reorganization transaction which took place in 2000. In the transaction, Ash Grove acquired Vinton Corporation ('Vinton'), a two-thirds shareholder in Ash Grove prior to the transaction, and its subsidiary, Lyman-Richey Corporation. Vinton shareholders exchanged their shares of Vinton for shares of Ash Grove in the reorganization. After the transaction, an Ash Grove minority shareholder filed a class action against Ash Grove and each member of its board claiming that the reorganization constituted self-dealing by the majority shareholder and that the transaction unfairly diluted his and other minority shareholders' interest in Ash Grove.

In August 2005, the suit was settled without the admission of liability by Ash Grove. As part of the settlement, Ash Grove paid $15 million into a trust and also paid $43,345 in legal fees. Ash Grove deducted these payments as ordinary and necessary business expenses under Section 162. The IRS disallowed the deductions based upon its determination that the payments should have been capital expenditures under Section 263. The district court granted summary judgment in favor of the IRS and the Tenth Circuit took the issue up on appeal.

Courts have repeatedly held that litigation costs arising out of corporate reorganizations are capital expenditures. As such, Judge Carlos F. Lucero, writing for the Tenth Circuit court, applied the 'origin of claim' test articulated by the Supreme Court in *Woodward v. C.I.R.,* 397 U.S. 572, to determine whether the payments were ordinary and arose in connection with Ash Grove's profit-seeking activities or whether it related to the reorganization. Ash Grove claimed that the litigation did not involve the purchase of a capital asset or setting the price of a capital asset and thus must appropriately be characterized as an ordinary and necessary business expense. Judge Lucero disagreed, finding that the complaint "expressly concerned the terms of the reorganization" citing specifically issues with the purchase price and that the complaint sought, among other remedies, a rescission of the transaction.

The court ultimately denied Ash Grove's business deduction for the shareholder class action litigation expenses. As such, this ruling could have a negative impact on taxpayers who find themselves in shareholder litigation regarding capital transactions.

Supreme Court denies certiorari in a case that could clarify when liability accrues

On April 28, 2014, the Supreme Court denied a petition for certiorari to New York Life Insurance Co in its appeal of a Second Circuit decision denying a deduction for certain policy holder dividends.

In the underlying case, *N.Y Life Ins. Co. v. U.S.*, 724 F.3d 256 (2nd Cir. 2013), the Second Circuit Court of Appeals affirmed a district court's decision that deductions for policyholder dividends did not satisfy the 'all-events' test under the principles of Section 461. The taxpayer, New York Life Insurance Company, deducted two types of policyholder dividends: (1) an annual dividend mandated by state law that was 'credited' but not paid until the policy's anniversary date; and (2) a voluntary termination dividend that was calculated and 'accrued' but not paid until death, maturity, or surrender. The court found that neither type of policyholder dividend deduction met the 'all-events' test.

In *Mass. Mutual Life Ins. Co. v. U.S.*, 103 Fed. Cl. 111 (2012), a case with almost identical facts, the Court of Federal Claims allowed a deduction for the guaranteed minimum amount of policyholder dividends in advance of actual payment.

The denial of certiorari in this case is a missed opportunity for the Supreme Court to clarify the rules regarding when a deductible liability accrues with respect to policyholder dividends. As a result, companies that pay policyholder dividends under circumstances similar to those in *New York Life* and *Massachusetts Mutual* should consider carefully how the recent decisions might affect when those dividends may be deducted.

Let's talk

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