New IRS guidance sheds light on tax accounting issues

In this month's issue, taxpayers receive insight on a recent LB&I memorandum that addresses the examination of milestone payments. We also discuss another LB&I directive that provides taxpayers more time to use the safe harbor method for capitalization of electric transmission and distribution property expenses as well as a revenue procedure that provides safe harbor repairs guidance for electric generation taxpayers. This issue also discusses a range of other newly issued IRS guidance, including rulings on whether: a termination payment must be capitalized as an intangible asset; a taxable acquisition is a covered transaction for Section 263(a) purposes; and an extension of time can be given to file for using the LIFO method. Additionally, this issue contains guidance on whether: late-payment penalty relief can be provided to taxpayers due to delayed 2012 tax forms; gain on the sale of merchant contracts is ordinary income; a taxable cooperative can aggregate patronage and nonpatronage income for purposes of computing its domestic production activities deduction; and a simplified proportional method can be used to account for OID on pooled credit card receivables.

Did you know..?

IRS addresses examination of milestone payments

The IRS Large Business and International Division (LB&I) recently issued a memorandum (LB&I-04-0413-002) directing LB&I staff to not challenge the treatment of certain 'eligible milestone payments' paid in the course of a covered transaction in which the taxpayer also incurs a success-based fee and certain other requirements are met. Therefore, the IRS will not challenge the taxpayer's treatment if the taxpayer treats 70 percent of the payment as non-facilitative and 30 percent as facilitative, and otherwise complies with the directive.

Taxpayers often engage investment banks and law firms to provide various services in the investigation of a potential transaction. The service provider may require payments upon the occurrence of certain events -- e.g., upon signing an engagement letter, the issuance of a fairness opinion, signing a merger agreement, or obtaining shareholder approval -- or simply the passage of time. These payments, which are referred to as milestone payments, generally are creditable against the total amount due upon the successful consummation of the transaction, but are not refundable in the event the transaction ultimately is unsuccessful.

The directive defines 'milestone' as an event occurring in the course of a covered transaction (regardless whether the transaction is ultimately completed) that is the execution of an agreement or an event described in Reg. Sec. 1.263(a)-5(e)(1)(i) or (ii). Under this definition, a milestone cannot occur before the earlier of a letter of intent, exclusivity agreement, or approval of the transaction by the board of directors. Furthermore, the directive defines 'milestone payment' as a non-refundable amount that is contingent on the achievement of a milestone, and defines 'eligible milestone payment' as a milestone payment paid for investment banking services that is creditable against a success-based fee. Because the directive provides a very specific definition of 'milestone,' it is possible that a taxpayer may incur fees related to a milestone that are not covered by the directive. In this case, the taxpayer must perform a separate analysis to determine whether the amounts paid are facilitative or non-facilitative.

Engagement letters entered into between taxpayers and service providers often include up-front payments and additional payments payable prior to the successful closing of a transaction that are based on specified points in time. In light of the specific definition of 'milestone' in the recently issued directive, taxpayers seeking to determine whether these amounts are subject to the safe harbor election under Rev. Proc. 2011-29 should analyze carefully payments made to service providers to determine whether such payments constitute 'eligible milestone payments, so that the taxpayer will not be challenged if it elects to treat 70 percent of the eligible milestone payment as non-facilitative and 30 percent as facilitative.

Other guidance

IRS extends directive on capitalization of electric transmission, distribution property expenses

The IRS Large Business & International (LB&I) division recently released a directive (LB&I-04-0513-003), that modifies the planning and examination guidance set forth in LB&I Directive 4-1111-019 (November 25, 2011). The new directive gives taxpayers additional time to use the safe harbor method set forth in Rev. Proc. 2011-43 for taxpayers to determine whether expenditures to maintain, replace or improve electric transmission and distribution (T&D) property expenses must be capitalized under Section 263(a) or deducted under Section 162.

Under Rev. Proc. 2011-43, the scope limitations for filing an automatic accounting method change are waived for a taxpayer's first or second year ending after December 30, 2010. Since some taxpayers that own T&D property were unable to adopt the safe harbor method of accounting under Rev. Proc. 2011-43 within this time period, the new directive provides that an IRS examiner should allow a taxpayer with applicable asset expenditures to adopt the safe harbor method under Rev. Proc. 2011-43 for its first, second, or third tax year ending after December 30, 2010.

IRS issues safe harbor 'repairs' guidance for electric generation

The IRS recently issued Rev. Proc. 2013-24, which provides safe harbor definitions of units of property and major components that taxpayers may use in determining whether expenditures to maintain, replace, or improve steam or electric power generation property must be capitalized under Section 263(a). In addition, Rev. Proc. 2013-24 provides guidance on obtaining automatic consent to change to a method of accounting that uses all, or some, of the unit of property definitions.

Rev. Proc. 2013-24 applies to taxpayers that have a depreciable interest in power generation property primarily used in the trade or business of generating or selling steam or electricity. It provides guidance that taxpayers may use to determine whether the cost to replace a particular generation asset is a capital improvement or deductible expense. A key factor is whether the replacement is for an entire unit of property or a major component -- in which case it would be capitalized -- or whether the replacement is for a smaller component and thus deductible.

The new guidance provides safe harbor definitions of 'unit of property' and 'major component' that, if used by an eligible taxpayer, will not be challenged by the IRS. Rev. Proc. 2013-24 applies only to the property defined in Appendix A of the guidance.

Rev. Proc. 2011-43 provides a safe harbor method of accounting that taxpayers may use to determine whether expenditures to maintain, replace, or improve T&D property must be capitalized under Section 263(a). Rev. Proc. 2013-24 and Rev. Proc. 2011-43 complete the guidance available to an electric utility company to assist in determining the appropriate units of property, which is the first step in determining whether expenditures to repair electric generation and T&D property should be expensed or capitalized.

A taxpayer that chooses to change to the accounting method provided by Rev. Proc. 2013-24 must use the automatic change procedures in Rev. Proc. 2011-14, as modified by Rev. Proc. 2013-24. Rev. Proc. 2013-24 waives the normal scope limitations (for example, for taxpayers under exam) but only for the taxpayer's first, second, or third tax year ending after December 30, 2012 -- i.e., 2012, 2013, or 2014 for calendar-year taxpayers.

A Section 481(a) adjustment must be used to implement the accounting method change. Similar to the electric T&D property guidance provided by Rev. Proc. 2011-43, the new procedure allows for a test period and extrapolation approach to determine the Section 481(a) adjustment. Appendix B of Rev. Proc. 2013-24 offers guidance to taxpayers that choose to apply the accounting method provided in the new guidance.

Payment to terminate agreement must be capitalized as 'created intangible assets'

In PLR 201317003, the IRS concluded that a termination payment made to a franchisee is capitalizable as a created intangible asset under Treas. Reg. Sec.1.263(a)-4(d)(7)(i)(B) and should be recovered under the principles of Section 167.

The taxpayer is a corporation that has developed certain technology capabilities as a leader in its industry. The taxpayer entered into two franchise agreements, both essentially perpetual, to grant exclusive rights to a franchisee to distribute, sell, or provide goods, services, or facilities worldwide in connection with two of its products. Each of the agreements met the definition of a franchise under Section 1253(b)(1). After some years, the taxpayer realized it could increase its profits by removing its franchise business and terminated the agreements upon consent by the franchisee. The taxpayer was required to pay a termination payment to the franchisee to end its contractual arrangements.

The IRS began its analysis of whether the termination payment is capitalizable by looking at the rules under Treas. Reg. Sec.1.263(a)-4, which apply to amounts paid to acquire or create intangibles. The IRS concluded that the termination payment is required to be capitalized as a 'created intangible asset' rather than an 'acquired intangible asset' because the taxpayer paid another party to terminate certain agreements as explicitly described under Treas. Reg. Sec.1.263(a)-4(d)(7)(i).

The IRS then analyzed whether the termination payment should be recovered under Section 167 or amortized under Section 197. The IRS looked to the Tax Court's holding in *Rodeway Inns of America v. Commissioner*, 63 T.C. 414 (1974), which said that a taxpayer's termination payment to end an exclusive right to another person was depreciable under Section 167. Furthermore, Treas. Reg. Sec.1.167(a)-3(b) provides a 15-year useful life safe harbor if the useful life of an intangible asset cannot be reasonably estimated, as in this case. The IRS concluded that it could not determine whether the taxpayer had acquired or reacquired any Section 197 intangible that constituted the acquisition of a trade or business and therefore concluded that termination payment should be recovered under Section 167.

Taxable acquisition is covered transaction

The IRS concluded in PLR 201319009 that a certain taxable acquisition was a 'covered transaction' within the meaning of Treas. Reg. Sec.1.263(a)-5(e)(3).

The taxpayer is a publicly traded corporation that was organized as a holding company under a merger agreement providing for the combination of two companies, Company 1 and Company 2. The merger was effectuated such that the Company 1 step acquisition of exchanging Company 1's stock with Parent's stock was a tax-free exchange under Section 351. Additionally, the Company 2 step acquisition of converting Company 2's stock into the right to receive cash or Parent's stock was a taxable acquisition. After the transaction, Parent, Company 1, and Company 2 were related within the meaning of Section 267(b).

Under the Section 263(a) rules, amounts paid to facilitate certain types of transactions, such as the acquisition of an ownership interest or a Section 351 exchange, must be capitalized. Furthermore, there is a bright-line test under Treas. Reg. Sec.1.263(a)-(5)(e) to determine whether amounts paid in certain covered transactions are facilitative, which is generally true if the activity occurs after the earlier of a letter of intent, exclusivity agreement, or board of directors' approval. However, the bright-line test only applies to amounts paid in certain covered transactions. The taxpayer argued that its Company 2 acquisition qualified as a covered transaction because it satisfied one of three defined categories, particularly that it was a taxable acquisition of an ownership interest resulting in related parties under Section 267(b). The taxpayer asked the IRS to rule on whether the Company 2 acquisition was a covered transaction, which the IRS held to be correct.

Extension granted to apply to use LIFO method

In PLR 201317006, the IRS granted an extension of time for a taxpayer's parent to file a missing Form 970, Application to Use LIFO Inventory Method, on behalf of the taxpayer.

Following an internal restructuring, the taxpayer received inventory and intended to use the last-in, first-out (LIFO) inventory method. The taxpayer held no inventory prior to the restructuring. The taxpayer should have filed a Form 970 under Treas. Reg. Sec.1.472-3(a) with its parent's income tax return for the taxable year in which the LIFO method was first used. The taxpayer's parent discovered the mistake during a routine internal review of its tax return and immediately requested relief from the IRS in order to file the Form 970. The IRS held that the taxpayer had acted reasonably and in good faith and thereby granted an extension of 30 days from the date of ruling to file Form 970.

Late-payment penalty relief provided for delay of 2012 tax forms

In Notice 2013-24, the IRS offers late-payment penalty relief to taxpayers who were affected by the delayed publication of some 2012 IRS forms. As a result of the American Taxpayer Relief Act of 2012 (ATRA) enacted on January 2, 2013, a number of tax forms had to be revised by the IRS, causing a delay in release of those forms until February or March 2013. The IRS automatically assesses penalties on taxpayers who have made a late tax payment and sends a notice to the taxpayers. However, as a result of the delayed forms, the IRS will abate these penalties for any taxpayer who has requested an extension to file a 2012 income tax return that includes one of the forms listed in the notice and who has made timely 2012 estimated tax payments. Among the delayed 2012 forms listed in the notice were: Form 3800, General

Business Credit; Form 4562, Depreciation and Amortization; Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations; Form 6765, Credit for Increasing Research Activities; and Form 8903, Domestic Production Activities Deduction. Taxpayers affected should respond to the IRS assessment notice by submitting a letter describing its eligibility for the late-payment penalty relief.

Gain on sale of merchant contracts is ordinary income

I n FAA 20131901F, the IRS ruled that income from a taxpayer's sale of merchant contracts must be treated as ordinary income and not capital gain, as the contracts were not capital assets to the taxpayer.

The taxpayer maintains relationships with merchants, providing servicing and clearing operations. The taxpayer sold part of his business to third party purchasers, resulting in significant taxable gains. The taxpayer originally reported the taxable gains as ordinary income. Subsequently, the taxpayer filed an amended income tax return recharacterizing the sale of the merchant contracts as capital. As a result, the taxpayer was able to offset the gains from the sale with capital losses arising in another taxable year.

The taxpayer argued that the merchant contracts qualify as a Section 1221 capital asset, as they are not excluded by Sections 1221(a)(1) – (8).Further, the taxpayer contends that the merchant contracts are not precluded by the six factors identified in *Foy v. Commissioner*, 84 T.C. 50, 70 (1985), concerning the characterization of contract rights. According to the taxpayer, any premium paid for the merchant contracts qualifies as goodwill or going concern value, and therefore, weighs in favor of treating the merchant contracts as a capital asset.

The IRS concluded that the taxpayer's recharacterization of the sale of the merchant contracts was incorrect, stating that the sale of merchant business relationships, or accounts, represent the right to receive ordinary income, and is not capital gain. The IRS noted that the courts have imposed a limitation on property that qualifies as a capital asset and that the prevailing view is that the right to receive income from performance of personal services is taxable as ordinary income. The IRS further stated that under the *Foy* factors, the taxpayer's contract rights did not represent an equitable interest in property which itself is a capital asset, but instead represented the taxpayer's rights to receive ordinary income. The IRS also concluded that the taxpayer did not have any goodwill or going concern attributable to the merchant contracts.

Taxable cooperative can't aggregate patronage, nonpatronage income for domestic production activities deduction

In FAA 20131802F, the IRS concluded that a taxable cooperative cannot compute its domestic production activities deduction (DPAD) under Section 199 by aggregating patronage and nonpatronage sourced activities. Instead, it is required to separately compute its DPAD for patronage and nonpatronage sourced income.

The taxpayer, a subchapter T cooperative, computed its DPAD by aggregating its patronage and nonpatronage sourced activities. The taxpayer's nonpatronage activities had negative qualified production activities income (QPAI), which if calculated separately from patronage activities, would have resulted in a DPAD of zero. By aggregating its patronage and nonpatronage activities, the taxpayer was able to turn half of its nonpatronage wages into additional DPAD.

The taxpayer contended that such an aggregation is allowed because it found no basis in Section 199 or the related regulations that requires a cooperative to perform two separate calculations. The IRS, however, advised that income from patronage and nonpatronage business activities cannot be aggregated for the purpose of calculating the DPAD. According to the IRS, such aggregation gives a taxable cooperative an unfair advantage over a corporation. The IRS pointed out that the taxpayer is doing indirectly what it cannot do directly by using nonpatronage sourced W-2 wages to artificially increase the amount of Section 199 deduction that is solely used against patronage income. Using *Farm Service Cooperative v. Comr.*, 619 F.2d 718 (8th Cir. 1980) as support, the IRS said that the taxpayer's aggregation approach is contrary to the rule that cooperatives cannot deduct W-2 wages from nonpatronage activities against patronage sourced income (or vice versa).

Although the IRS agreed that Section 199 does not explicitly require cooperatives to perform separate DPAD calculations, they indicated that it is indisputable that Section 199(d)(3) is a deduction against patronage sourced earnings only. As a result, the IRS advised the taxpayer to perform separate DPAD calculations for its patronage and nonpatronage activities.

IRS allows proportional method to account for OID on pooled credit card receivables

The IRS recently issued Rev. Proc. 2013-26, which allows taxpayers to use a simplified 'proportional method' of accounting as a safe harbor method of computing original issue discount (OID) for pools of credit card receivables for purposes of Section 1272(a)(6).

Notice 2011-99, issued in November 2011, included a proposed revenue procedure that described the proportional method of accounting. The proportional method was intended to reduce administrative burdens and controversy for taxpayers and the IRS in computing OID accruals on a pool of credit card receivables under Section 1272(a)(6). The IRS requested comments on the proposed revenue procedure, and Rev. Proc. 2013-26 reflects the comments that the IRS received in response to Notice 2011-99. Some of the changes reflected in Rev. Proc. 2013-26 include the following:

- The revenue procedure applies to any taxpayer that holds a pool of credit card receivables and is not limited to credit card issuers
- A taxpayer may use the proportional method for amounts treated by the revenue procedure as OID (for example, amounts that otherwise are market discount)
- When individual accounts are transferred out of a pool or written off, a taxpayer may attribute to those accounts a portion of a pool's unaccrued OID that is proportional to their outstanding balances
- A taxpayer may adopt the proportional method, or change to the proportional method under the automatic consent procedures, for a tax year that ends on or after December 31, 2012.

Under Rev. Proc. 2013-26, the proportional method is the product of the unaccrued OID related to the pools of credit card receivables as of the beginning of the period (beginning OID), multiplied by the quotient of the payments of stated redemption price at maturity (SRPM) during the period, divided by the SRPM at the beginning of the period (beginning SRPM). To apply Rev. Proc. 2013-26, the required computations must be made monthly.

The revenue procedure also describes the exclusive procedures by which a taxpayer may obtain the Commissioner's consent to change to the proportional method.

Let's talk

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

James Connor, *Washington, DC*
+1 (202) 414-1771
james.e.connor@us.pwc.com

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

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

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

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

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

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

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