

Recent IRS and court rulings provide guidance on a range of tax accounting issues



In this month's Accounting Methods Spotlight, taxpayers are given timely insight into how the 'tax benefit rule' may create state tax benefits. In addition, this month's issue provides updates on a range of federal income tax matters including application of the 'next day rule' to transaction costs, whether certain incentive payments are includable in gross income, and whether proceeds of a negligence suit are a return of capital. Also included are recent court decisions addressing the application of Rev. Proc. 2004-34 to tuition payments, whether advanced litigation expenses are subject to a change in method of accounting, whether certain settlement payments are deductible, and whether an abandoned purchase option was subject to ordinary loss treatment.

Did you know..?

Tax benefit rule may create state tax benefits

On occasion, taxpayers receive payments related to an item that was previously deducted. For example, a taxpayer may receive a state income tax refund that was deducted in a prior year. Similarly, a taxpayer may receive a payment on a debt that previously had been written off as uncollectible. In these situations, the judicially developed tax benefit rule of inclusion requires that the recovery be recognized as income. However, Section 111 excludes certain recoveries from income.

Section 111 is a taxpayer relief provision that permits taxpayers to exclude from income certain recoveries of prior deductions to the extent the prior deduction did not generate a tax benefit. Often times the exclusion provided by Section 111 will be inapplicable because the prior deduction either (a) offset taxable income in the year of the deduction or (b) resulted in an NOL that was, or will be, utilized. However, there are situations where a prior deduction does not generate a tax benefit to the taxpayer (e.g., an NOL that expires unused). In these situations, Section 111 would operate to exclude the recovery from income. This is often the case in many states that have

adopted provisions similar to Section 111. As a general rule, state NOL carryforward provisions are much more limited than the federal rules. Accordingly, the exclusionary provisions of Section 111 may provide substantial benefits to taxpayers on the state level (e.g., California's historical 50 percent NOL haircut, states with limited NOL carryforward provisions, etc.).

Other guidance

IRS considers application of 'next day rule' to transaction costs

The IRS recently released AM 2012-010, a generic legal advice memorandum (GLAM) addressing application of the 'end-of-the-day rule' and the 'next-day rule' of Reg. Sec. 1.1502-76(b) in determining when a target corporation should report certain deduction items with respect to liabilities it incurred on the day it joins or leaves a consolidated group.

The GLAM involves a target company (Target) that joins a consolidated group as part of an acquisition transaction. The GLAM addresses the treatment of three separate liabilities that Target incurs on the date of acquisition, which are all assumed to become deductible on that date. In the first example, Target is obligated to pay its employees an amount that becomes fixed and determinable on the acquisition date, but the actual amount is not paid until several days after the acquisition. In the second example, Target is obligated to pay success-based fees to service providers that become fixed and determinable on the acquisition date and are paid upon the successful closing of the acquisition. In the third example, under the terms of the acquisition, Target's bondholders had the opportunity to tender their bonds at a premium. The bondholders were required to tender their bonds before the acquisition date, but Target is not obligated to purchase them. However, after the acquisition closed, Target reacquires the tendered bonds and uses its own funds or funds from Acquiring to pay the bondholders at a premium.

The GLAM concluded that the end-of-the-day rule should apply to examples one and two, and that application of the next-day rule would be inappropriate. The IRS reasoned that although the acquisition fixes the amount of the liabilities in examples one and two, they are attributable to transactions that precede the acquisition date (i.e., services performed by Target's employees and consultants) and result from events that were not within the acquiring company's control. As a result, the corresponding deductions should be reported on Target's last short-year return for the tax year ending on the day of the acquisition.

The IRS concluded that it may be appropriate to apply the next-day rule to the third example because (i) the deduction arises as a result of a transaction on the acquisition date (i.e., Target's repurchase of the tendered bonds); (ii) the transaction occurs in the post-closing portion of the acquisition date; and (iii) the transaction occurs based on a post-closing decision made by Target while under the acquiring company's control. Notably, Target was under no obligation to repurchase the bonds before the acquisition. Therefore, the IRS concluded that it may be reasonable for Target to report the premium deduction on its tax return for the short tax year beginning the following day under the next-day rule.

Electronic health record incentive payments are includable in income

In CCA 201307005, the IRS concluded that electronic health record (EHR) incentive payments made by the Centers for Medicare and Medicaid Services (CMS) must be included in the gross income of the recipients, unless received as a conduit or agent for another, such as a practice group.

Under the American Recovery and Reinvestment Act of 2009 (ARRA), CMS started its EHR Incentive Program to encourage healthcare professionals and hospitals to use EHRs over paper records to positively impact and evolve their patients' care, such as sharing certain data with patients or issuing prescriptions electronically. If healthcare providers could demonstrate such 'meaningful use' of EHRs, they were eligible for an

incentive payment from CMS that was not intended to be a reimbursement for EHR system implementation expenses.

In its analysis, the IRS looked to the broader definition of gross income as 'all accessions to wealth' as held in *Commissioner v. Schleier*, 515 US 323, 327 (1995). Under Section 61, all income is presumed to be included in gross income unless the item of income is specifically identified as one of the narrow exclusions in the Code or is a return of capital. The IRS concluded that since CMS makes the incentive payment based on the type of use of EHRs instead of as a reimbursement of expenses for implementation of EHRs, this would not constitute a return of capital. Additionally, the IRS confirmed that the incentive payments do not fall under any of the narrow exclusions within the Code. Therefore, the incentive payments must be included in the recipient's gross income.

The conclusion by the IRS presumes that the recipient of the incentive payment is the person who earned the income. However, in the case that the recipient is a healthcare professional that is merely a member or representative of a larger practice group, and passes any incentive payments received on to the practice, the IRS affirms that the person is acting as a conduit or agent of another and does not have a claim of right to the income. Therefore, the individual recipient is not required to include the payment in his or her gross income.

IRS determines that proceeds of negligence suit are not a return of capital

The IRS concluded in CCA 201306018 that a settlement payment received from an accounting firm in a negligence suit is not a return of capital and thus must be included in the taxpayers' gross income.

The taxpayers are a husband and wife who filed joint income tax returns. With the recommendation by their accounting and tax advisor, the husband transacted in an abusive management S corporation employee stock ownership plan (ESOP) as part of his automobile dealership operations, and as a result, voluntarily participated in the Global Settlement Initiative (GSI) to settle on owed taxes, penalties, and interest to the IRS. The taxpayers sued their tax advisor for accountant malpractice among other things, and the advisor resolved all claims by paying a lump sum settlement to the taxpayers.

The taxpayers argued that the settlement proceeds are a return of capital because the tax advisor's negligence, including the failure to prepare and file necessary documents with the IRS, caused them to have to participate in the GSI and pay more tax than they owed otherwise. The IRS pointed out that the taxpayers' facts are notably different than those in the case they relied upon, *Clark v. Commissioner*, 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4. The IRS argued that in *Clark*, the tax return preparer made an error which caused the taxpayers to pay more taxes than required based on the underlying transactions, which was why the court found the related indemnification payment to be a return of capital. The IRS argued that in the current case, the additional tax paid by the taxpayers was a result of the advisor's failed tax advice on the underlying abusive ESOP transaction rather than an error on the taxpayers' tax return. Therefore, the IRS concluded that the settlement payment was not a return of capital but rather, under the all encompassing definition of income under Section 61(a), must be included in the taxpayers' gross income.

Cases

Private school permitted to apply Rev. Proc. 2004-34 to tuition payments

The United States Tax Court held in *Cvancara v. Commissioner*, T.C. Memo 2013-20, that advance payments received as tuition to a private school were properly accounted for using the deferral method under Rev. Proc. 2004-34.

The taxpayer formed and operated Desert Academy, LLC, a private early-elementary school that used the accrual method of accounting. The Commissioner issued a notice of deficiency to Desert Academy for failing to report certain gross receipts. The Commissioner argued that the taxpayer was not eligible to use the deferral method under Rev. Proc. 2004-34 and thus did not properly include advance payments received by Desert Academy in income in the year of receipt. According to the Commissioner, Desert Academy's advance payments were subject to a condition subsequent because parents were entitled to a refund of their child's tuition if withdrawn from the school, and thus advance payments were earned in the year of receipt.

The Court relied upon the guidelines of Rev. Proc. 2004-34 in its analysis, which permits accrual method taxpayers to defer certain service income for up to one year under the deferral method. Under section 5.02(3)(b) of Rev. Proc. 2004-34, if a taxpayer does not have an applicable financial statement, as Desert Academy did not, the deferral method can be used so long as any advance payment is included in income in the year of receipt to the extent earned (i.e., the year in which the services are provided), while the rest of the advance payment can be deferred to the next taxable year. This section also specifically states that "the determination of whether an amount is earned in a taxable year must be made without regard to whether the taxpayer may be required to refund the advance payment upon the occurrence of a condition subsequent." The Court found that the Commissioner did not take this statement into account, and as a result, the taxpayer properly elected to use the deferral method for advance payments.

Advanced litigation expenses were loans and subject to change in method of accounting

In *Humphrey, Farrington & McClain PC v. Commissioner*, T.C. Memo 2013-23, the US Tax Court held that litigation expenses paid by the taxpayer on behalf of its clients were not deductible currently as ordinary and necessary business expenses, but instead should be treated as loans for which the taxpayer is able to claim a bad debt deduction for any unreimbursed expenses after the case is closed. The Court also held that this determination of treatment is a change in method of accounting that requires a Section 481(a) adjustment.

The taxpayer is a law firm that conducts litigation mainly on behalf of consumers (e.g., product liability, false advertising, medical malpractice) predominantly under contingent fee arrangements. As part of the fee arrangements, the taxpayer pays all litigation-related expenses, including court-filing fees, expert witnesses, and travel, initially for its clients. Its clients are only required to reimburse all or part of the advanced litigation expenses if they win the case. The taxpayer capitalizes some of the advanced expenses and deducts others based on the likelihood of reimbursement of the fee arrangement, noting that almost all of the contingent fee arrangements resulted in deductible treatment.

The Court agreed with the IRS' argument that the degree of uncertainty of reimbursement is not the basis for which an expense is deductible and cites numerous other court cases with the same finding. As long as the taxpayer has a contingent right of reimbursement, the advanced litigation expenses must be treated as loans. Additionally, in the case of class-action lawsuits, the fact that the court must approve any expense awards to class counsel is not an impediment to the contingent arrangement because the Court argues it is a 'basic legal principle' that class counsel is entitled to reimbursement for all expenses under the common-fund doctrine.

Lastly, the Court argued that under Section 446, a change in the treatment of any material item constitutes a change in method of accounting, thereby requiring a Section 481(a) adjustment. According to the Court, a material item is any item with a tax treatment that does not permanently distort the taxpayer's lifetime taxable income (i.e., an item that creates a timing difference). Because the IRS' proposed treatment of the advanced litigation expenses (i.e., a bad debt deduction) results in

the same outcome as the taxpayer's prior treatment of the expenses (i.e., a business expense deduction), except for the difference in timing, the advanced expenses qualify as a material item and thus are allowed to be changed to a different method of accounting by the IRS.

Settlement payments related to determination of purchase price not deductible

In *Ash Grove Cement Co. et. Al. v. United States*, 111 A.F.T.R.2d 2013-767, a US District Court granted the government's motion for summary judgment, concluding that the IRS correctly denied the taxpayer's deduction for litigation expenses stemming from the acquisition of a business because the expenses were capital in nature, and as a result were non-deductible.

In 2000, Ash Grove was involved in a multiple step, tax-free reorganization transaction. In January 2002, a minority shareholder filed a class action complaint against all of the taxpayer's directors as well as the taxpayer, alleging that the transaction had improperly diluted the liquidation value of the shares held by the minority stockholders and, therefore, their proportionate voting power. In August 2005, the litigation was settled without the taxpayer or its officers or directors admitting any liability. As part of the settlement, the taxpayer placed \$15 million into a trust to be divided up among the class members, and also paid \$43,345 for legal fees incurred to defend the directors.

On its federal income tax return for 2005, the taxpayer deducted the settlement payment and the payment of legal fees as an ordinary and necessary business expenses under 'Legal Settlement Expense.' The IRS disallowed the deduction for these payments, stating that the payments should be considered capital expenditures under Section 263. The taxpayer paid the tax deficiency and timely filed a Form 1120X, claiming a refund. The IRS denied the refund claim and the taxpayer filed a complaint in district court.

The taxpayer argued that this analysis failed to distinguish between the claims that the directors breached their fiduciary duties and the directors' indemnity claims. According to the taxpayer, the \$15 million in litigation expenses are deductible as ordinary and necessary business expenses because the suit did not allege any wrongdoing by, or seek monetary damages from the taxpayer. Thus, the taxpayer only incurred the expenses as a result of honoring its indemnity obligations. Because indemnity expenses are ordinary and necessary business expenses, the taxpayer argued that it should be allowed a deduction.

The district court, citing *Woodward v. Commissioner*, 397 US 572 (1970), agreed with the IRS because the origin of the claim in the appraisal litigation was the determination of the purchase price. As a result, the court determined that the litigation and appraisal fees were properly treated as part of the cost of the stock (capital expenditures) and were not deductible.

Abandonment of purchase option was subject to ordinary loss treatment

The Tax Court, in *Phillip Scot Sutton et ux. v. Commissioner*; T.C. Summ. Op. 2013-6, held that a taxpayer was entitled to claim an ordinary loss deduction for the abandonment of an option to purchase property because the taxpayer was in the business of purchasing and developing property and would have held the property for sale in the ordinary course of his business, making it an ordinary asset.

In 2003, Phillip Scot Sutton accepted employment as the general manager of the Jon Gibson Co. (Gibson), a real estate developer in California. However, in 2005, the taxpayer formed Sutton Enterprises, LLC (Sutton) to purchase and develop real property for himself, but continued to work for Gibson as an employee managing Gibson's existing properties, and as an independent contractor through Sutton.

In 2006, the taxpayer purchased five properties for his business but was unable to find any buyers due to the economic downturn. In early 2007, the taxpayer entered into a 'Residential Purchase Agreement' (option) to purchase real property in El Dorado Hills, California (El Dorado Hills property), with the intention to develop the property for sale. However, again due to the economic downturn, the taxpayer was unsuccessful in his efforts. In 2008, he signed a 'Release of Contract' abandoning the option and forfeiting \$48,000 in deposits that he had made in 2007 and 2008. The taxpayer subsequently ended his employment with Gibson and closed Sutton.

In 2009, the taxpayer filed his Form 1040, US Individual Income Tax Return, for 2008. Among the expenses he reported was an ordinary loss of \$16,000 on the abandonment of the option. In 2011, the IRS mailed the taxpayer a notice of deficiency for 2008, in which it determined that the taxpayer's loss was a capital loss.

Section 1234(a)(1) provides in general that gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). Therefore, the character of the taxpayer's loss on the abandonment of the option should have the same character as the El Dorado Hills property, the underlying property to which the option relates. However, the IRS argued that the El Dorado Hills property would have been a capital asset in the taxpayer's hands, because the taxpayer purchased the option as an investment.

In determining whether the El Dorado Hills property would have been a capital asset or an ordinary asset in the taxpayer's hands, the court considered the factors set forth in *United States v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969). These factors include (1) the taxpayer's purpose in acquiring the property and the duration of his ownership, (2) the purpose for which the property was subsequently held; (3) the taxpayer's everyday business and the relationship of realty income to total income, (4) the frequency, continuity, and substantiality of sales of property, (5) the extent of developing and improving the property to increase sales, (6) the extent to which the taxpayer used advertising, promotion, or other activities to increase sales, (7) the use of a business office for the sale of property, (8) the character and degree of supervision or control the taxpayer exercised over any representative selling the property, and (9) the time and effort the taxpayer habitually devoted to the sales.

After considering all facts and circumstances, the court found the taxpayer's argument persuasive and concluded that the taxpayer would have held the property primarily for sale to customers in the ordinary course of his trade or business, as opposed to an investment, had he acquired it. The evidence presented by the IRS was insufficient to show that the taxpayer purchased the El Dorado Hills property with the intent that it would appreciate over time like an investment. As such, the court found that the property would have been an ordinary asset in the taxpayer's hands, and, accordingly, the taxpayer was entitled to an ordinary loss deduction for 2008 on the abandonment of the option.

Let's talk

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