Accounting Methods Spotlight / Issue 5 / May 2013

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

In this month's issue, taxpayers receive insight on LB&I's recently updated memorandum on exams involving the conversion of capitalized assets to deductible repair expenses, as well as a reminder for taxpayers emerging from NOLs to consider accounting method and Section 199 opportunities. We also discuss a range of newly issued IRS guidance, including rulings on whether: the transfer of patents was a sale subject to amortization; a taxpayer can claim bonus depreciation through an accounting method change; and a cash settlement payment for compensatory damages is ordinary business expense. Additionally, this issue contains guidance on whether: pharmaceutical litigation costs must be amortized; a publisher's pre-production development activities were Section 199 manufacturing activities; and the special government contract rule is applicable for Section 199 purposes. Finally, we discuss a recent Tax Court decision in which an individual was denied a bad debt deduction for failing to prove worthlessness.

Did you know..?

LB&I updates memorandum on exams involving conversion of capitalized assets to repair expense

The IRS Large Business and International Division (LB&I) recently issued a memorandum that provides direction to field examiners on the repair versus capitalization issue. The memorandum sets forth modified examination instructions to reflect amendments to the effective date of the temporary tangible property regulations.

The LB&I directive (LB&I-04-0313-001) issued on March 22, 2013, replaces a 2012 LB&I directive on exam procedures for the repair versus capitalization issue. The 2013 directive provides modified examination instructions for tax years beginning on or after

January 1, 2012, and before January 1, 2014, while also restating prior examination instructions for tax years beginning before January 1, 2012, and for tax years beginning on or after January 1, 2014.

These modified examination instructions direct field examiners who begin examining a return for a tax year beginning on or after January 1, 2012, and before January 1, 2014, to determine if the taxpayer has changed its method of accounting (with or without filing a Form 3115). If the field examiner determines that the taxpayer has changed its method of accounting, the examiner is directed to perform a risk assessment regarding the method change. If the field examiner determines that the taxpayer has not changed its method of accounting, the examiner is directed not to examine the issue.

The 2013 directive applies to examinations of original tax return positions relating to costs incurred to maintain, replace, or improve tangible property, and any correlative issues involving the disposition of building structural components or tangible depreciable assets. However, the 2013 directive does not apply to examinations relating to costs for which the IRS has provided specific guidance, separate from the temporary regulations, or issues not pertaining to whether expenditures incurred to maintain, replace, or improve tangible property should be capitalized under Section 263(a) (e.g., railroad track maintenance and wireless network asset maintenance).

Taxpayers should be aware that the IRS has formally extended the grace period for examinations of issues related to the temporary repairs regulations. However, the application of the grace period is nuanced. Further, the IRS continues to communicate clearly that taxpayers are expected to adopt the repairs regulations when finalized for 2014.

Taxpayers emerging from NOLs should consider accounting method, Section 199 opportunities

The Dow Jones industrial average recently closed above 15,000 for the first time, and the economy appears to be rebounding. As the economy recovers, taxpayers may find themselves shifting from a taxable loss position to a taxable income position. This can have many implications, including potential cash tax planning opportunities, some of which may be overlooked. For example, taxpayers that historically have been in losses should consider adopting or changing to more advantageous accounting methods where possible. Similarly, taxpayers moving into a taxable income position should also consider their eligibility for the Section 199 deduction.

Other guidance

Transfer of patents was a sale subject to amortization

The IRS concluded in FAA 20131201F that the transfer of patents to a corporation from its shareholder was an installment sale, not a licensing agreement, and thus the corporation must capitalize and amortize the patents instead of deducting the installment payments.

The taxpayer is a corporation and its principal shareholder is a director of the corporation and an inventor holding a number of patents useful in the corporation's business. The corporation and shareholder signed an agreement assigning to the corporation the shareholder's patents, for which the corporation paid the shareholder fixed monthly payments for a prescribed number of years. The payments made by the corporation were recorded in its books and tax returns as deductible expenses when paid and the acquired patents were not recorded on its balance sheet, nor was an amortization deduction taken. The corporation defended the deductions by asserting that the contract was intended to be a licensing agreement, not a purchase of the patents. However, the shareholder reported the received payments as capital gain from the sale of patents on its tax returns, creating inconsistent positions between the two taxpayers.

The IRS cited numerous cases in arguing that the intent of the parties cannot be taken into consideration when a contract's terms are clear and unambiguous; doing so would violate the integrity of a written contract. The IRS believed that the agreement between the corporation and shareholder was explicitly defined as a sale of the patents to the corporation. Furthermore, the IRS argued that the contract in no way suggests that the assignment of the patents was a temporary transfer, especially because it did not contain the words "rent," "use," or other similar words that would be expected in a licensing agreement. Therefore, the IRS concluded that the corporation was not entitled to deduct the installment payments and that the proper tax treatment of the patents was to capitalize them as required under Treas. Reg. Sec.1.263(a)-4(c)(1)(vii) and amortize them as allowed under Section 167(f)(2).

Taxpayer can claim bonus depreciation through accounting method change

In PLR 201313012, the IRS permitted a taxpayer to claim bonus depreciation by filing Form 3115, *Application for Change in Accounting Method*, because the taxpayer met the self-constructed acquisition rule for bonus depreciation (in particular, the 10-percent safe harbor rule) and had filed only one federal income tax return with respect to the property at issue.

The taxpayer owns a self-constructed facility, a solid-fuel generation plant, part of which constitutes Section 1245 property. The facility generally meets the requirements of bonus depreciation, but the taxpayer did not deduct bonus depreciation under Section 168(k) for the facility in the year placed in service. The taxpayer also did not elect out of bonus depreciation for any class of qualified property placed in service during the year.

In its analysis, the IRS first determined whether the taxpayer met the acquisition requirement for its facility (among other bonus depreciation requirements). Under Treas. Reg. Sec. 1.168(k)-1(b), self-constructed property is acquired for bonus depreciation purposes when construction of the property begins, which is generally when physical work of a significant nature begins. Alternatively, the bonus depreciation regulations provide an elective '10-percent' safe harbor, under which physical work of a significant nature will not be considered to begin before an accrual-basis taxpayer "incurs" more than 10 percent of the total cost of the property.

The taxpayer represented that under its current method of accounting, economic performance occurred as the property was accepted by the taxpayer. The IRS determined that the taxpayer incurred a liability under Section 461 on the turnover date, and concluded that if the taxpayer chooses to apply the 10-percent safe harbor, that date applies for determining when the taxpayer began construction of its facility. The IRS therefore ruled that the taxpayer did not incur costs attributable to the contract prior to the turnover date. Lastly, the IRS concluded that the taxpayer could claim bonus depreciation on the self-constructed Section 1245 property by filing a request for an automatic change in method of accounting.

Cash settlement payment for compensatory damages is ordinary business expense

The IRS concluded in FAA 20130501F that a voluntary compensatory payment was deductible as an ordinary and necessary business expense under Section 162(a), was not precluded by Section 162(f) or the public policy doctrine, and was not capitalizable under Sections 263(a) or 263A.

Although the facts were substantially redacted in the FAA, the taxpayer appears to be an oil company that caused environmental contamination, resulting in potential damages or liability. The taxpayer settled before any litigation commenced and made a voluntary cash payment for compensatory damages.

In its analysis, the IRS cited *Cavaretta v. Commissioner*, T.C. Memo. 2010-4, which held that amounts expended by a taxpayer to avoid or settle litigation may be included as ordinary and necessary business expenses, even if "no litigation has commenced, as long as the business felt the claim had some possibility of success, made the payment to avoid the damages or liability, and had an objectively reasonable belief that the expense was necessary." The IRS found that these conditions applied to the taxpayer and thus the payment was an ordinary and necessary business expense under Section 162(a).

The IRS further found that the compensatory payment was not a nondeductible fine or penalty as defined by Section 162(f) because compensatory damages are intended to return the parties to the status quo and do not constitute fines or penalties, nor did the underlying liability include any type of fine or penalty. Additionally, the IRS held that the public policy doctrine, which denies a deduction if it would "frustrate sharply defined national or state policies proscribing particular types of conduct," was not applicable to the compensatory payment because Section 162(f) did not apply.

Lastly, the IRS held that the settlement payment was not required to be capitalized under Section 263A. In Rev. Rul. 2004-18, the IRS held that costs incurred to clean up land that was contaminated by hazardous waste from a taxpayer's manufacturing plant must be included in inventory. However, in this case, the IRS found that the contamination was not caused by the production of inventory, and thus no portion of the settlement was required to be capitalized to inventory.

Pharmaceutical litigation costs must be amortized

In FAA 20131001F, the IRS Office of Chief Counsel concluded that the taxpayer company must capitalize legal fees incurred to obtain Food and Drug Administration (FDA) approval to market and sell certain drugs.

The taxpayer is a pharmaceutical company that develops, manufactures, markets, sells and distributes drugs. While filing certain abbreviated new drug applications (ANDAs), the taxpayer incurred legal fees defending patent infringement lawsuits filed against it. In addition, the taxpayer incurred legal fees as a new drug application (NDA) in a lawsuit it filed against another applicant. The issue the taxpayer faced was whether its legal fees could be deducted as ordinary and necessary business expenses.

The IRS concluded that the legal fees incurred by the taxpayer to defend against actions for patent infringement must be capitalized under Treas. Reg. Sec.1.263(a)-4. According to the IRS, the fees were incurred to facilitate the taxpayer obtaining the FDA-approved ANDAs, which granted the taxpayer the right to market and sell certain generic drugs before the expiration of the patents covering the branded drugs, and potentially with a 180-day exclusivity period. Those fees, the IRS said, were amounts paid 'to create or facilitate the creation of an intangible' under Treas. Reg. Sec. 1.263(a)-4(d)(5), and as a result, were required to be capitalized.

With respect to the legal fees the taxpayer incurred in litigation against another ANDA applicant, the IRS said that the fees were amounts paid to defend or perfect title to intangible property and that these fees were required to be capitalized under Treas. Reg. Sec. 1.263(a)-4(d)(9). The IRS distinguished the legal fees in this case from the litigation expenses incurred by the taxpayers in defending a claim that their patents were invalid in *Urquhart v. Comm'r*, 215 F.2d 17 (3rd Cir. 1954).

The IRS further ruled that the taxpayer's approved ANDA must be amortized as a Section 197 intangible over 15 years beginning on the first day of the month in which the FDA granted final approval without an exclusionary period and that the attorney fees would be suspended until then. After production of the drugs begins, the fees must be recovered according to Section 263A, but the legal fees incurred in defending and perfecting patents must be recovered ratably over the remaining useful lives of the patents.

Publisher's pre-production development activities were not Section 199 manufacturing activities

In CCA 201313020, the IRS concluded that planning and development activities undertaken by a publisher of books and other printed materials did not constitute a qualifying manufacture, production, growth, or extraction (MPGE) activity for purposes of the Section 199 deduction.

The taxpayer, a publisher, performed market research, resource planning, content and layout development, and editing activities that facilitated the creation of an electronic version of a book. To mass-produce its books, the taxpayer provided a contract manufacturer with the electronic version of the book and its print specifications. The contract manufacturer used its own employees, machinery, and plant to print and assemble the books. The contract manufacturer would either ship the books directly to customers or ship them to the taxpayer for packaging and distribution. The taxpayer claimed that its activities -- including design, development, creation, content and layout development, materials analysis and selection, editing, and packaging of its books – qualified under Section 199.

According to the IRS, however, the taxpayer's activities were related to the production of an electronic version of a book and thus did not result in qualified production property (QPP). The IRS concluded that an electronic book is not considered tangible personal property under Section 199 and does not fall within the types of qualifying intangible property. Because the taxpayer's activities created non-qualifying intangible assets and not QPP, the IRS concluded that those activities were not considered MPGE activities.

The IRS stated that its conclusion that the taxpayer's activities were non-MPGE activities would change if the taxpayer was determined to have the benefits and burdens of ownership of the books during the period in which the contractor manufacturer mass-produced the books.

In addition, the IRS stated that Section 199 and Section 263A are not consistent in the treatment of the production of books, and concluded that the taxpayer may be treated as a producer of tangible personal property under Section 263A, but as a producer of non-qualifying intangible property under Section 199. The IRS noted that Congress did not provide that the production of a manuscript or electronic book is a qualifying activity under Section 199. The IRS suggested that if the taxpayer's activities did qualify, then they would be treated similar to costs of producing films and would not be treated as the production of tangible personal property as allowed under Section 263A. The IRS therefore concluded that the rules under Section 263A with respect to books are not applicable for purposes of Section 199.

Finally, the IRS concluded that activities relating to the development of print specifications were non-MPGE activities because they did not produce QPP. In addition, because the taxpayer did not engage in any other MPGE activity with respect to the QPP, the IRS determined that any packaging activities would not qualify as MPGE activities.

Special government contract rule is applicable for Section 199 purposes

In TAM 201314043, the IRS determined that a taxpayer that meets the special rule for government contracts under Section 199(c)(4)(C) may be treated as deriving gross receipts from a lease, rental, license, sale, exchange, or other disposition of property in cases in which the property is not delivered to the government. The IRS also concluded that any of the taxpayer's gross receipts derived from the Federal government that were related to the transfer of intangible rights and data were allocable to non-qualified services and non-qualified property provided by the taxpayer and therefore were not domestic production gross receipts (DPGR).

The taxpayer, a government contractor, entered into two contracts with the US government, both of which were part of system development and acquisition programs. Under both contracts, the taxpayer engaged in design and development activities consistent with those performed under an Engineering and Manufacturing Development (EMD) contract.

The TAM addresses two separate issues raised by the IRS:

1. Whether the special rule for government contracts under Section 199(c)(4)(C) eliminates the requirement under Section 199(c)(4)(A)(i) that DPGR must be attributable to the disposition of qualifying production property (QPP) manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States?

2. Whether any of the gross receipts derived by the taxpayer from two contracts are non-DPGR because the gross receipts are attributable to nonqualified services or property (e.g., data or intangible rights)?

As to the first issue, the IRS concluded that the taxpayer should be treated as making a disposition of QPP under Section 199(c)(4)(A)(i) because it met the requirements of the rule for government contracts under Section 199(c)(4)(C). Accordingly, the gross receipts that the taxpayer derived from the QPP should be treated as DPGR.

As to the second issue, the IRS concluded that under each contract, a portion of the gross receipts are attributable to non-qualified property and that gross receipts from same must be treated as non-DPGR.

Finally, the TAM noted that both contracts called for the production of computer software and computer software documentation, and that to the extent the property the taxpayer transferred was computer software that meets the requirements of Section 199(c)(4)(A)(i)(I), the taxpayer's gross receipts attributable to that property were DPGR.

Cases

Individual denied bad debt deduction for failing to prove worthlessness

In *Mark A. Bishop v. Commissioner*, T.C. Memo 2013-98, the Tax Court held that an individual was not entitled to a bad debt deduction because the individual failed to show that his loan to a real estate appraisal firm in exchange for an unsecured promissory note was worthless in the year he claimed the deduction.

From 2001 until June 2006, the taxpayer was the president of IMPAC Mortgage Holdings, Inc. (IMPAC). Between 2004 and 2005, Landmark Equities Group (Landmark), a real estate appraisal firm occasionally provided services to IMPAC. In early 2006, the taxpayer learned that Landmark was developing a new product that it intended to market to investment banks. The taxpayer began to advise Landmark on staging an initial public offering (IPO). In exchange for his services, the taxpayer expected to earn a large fee based on capital raised in the IPO. At some point prior to the IPO, the taxpayer advanced Landmark $300,000. To finance the loan to Landmark, the taxpayer entered into a promissory note with a bank (PMB note). The taxpayer transferred the $300,000 to Landmark in exchange for an unsecured promissory note that Landmark executed (Landmark note). The Landmark note contained an acceleration clause in the event of default. Soon after the execution of the Landmark note, the real estate market showed signs of trouble, and Landmark's financial condition began to deteriorate. The taxpayer made several written and oral demands for repayments but Landmark never made a payment. Despite Landmark's being in default, the taxpayer did not exercise the acceleration clause. The note would not become due until April 2007.

In preparing to file his 2006 federal income tax return, the taxpayer provided his accountant the Landmark note as well as the PMB note for review, and told his accountant about his efforts to collect on the Landmark note. On that basis, the accountant determined that the taxpayer would be entitled to a bad debt deduction and claimed a $301,000 deduction for the 2006 tax year. Despite an extension to file his 2006 tax return, the taxpayer failed to file timely and did not file his tax return with the IRS until May 2008.

The Tax Court concluded that the Landmark note was a bona fide debt, rejecting IRS's contention that it was not. However the court ruled that the taxpayer failed to show that the debt became worthless in 2006 and denied the taxpayer's bad debt deduction. The court said that while the taxpayer's testimony shows Landmark was experiencing serious financial difficulties, nothing in the record indicated in 2006 that Landmark would never be able to repay any portion of the principal. Moreover, it appeared that Landmark continued to be a going concern into 2007, and the taxpayer produced no records to substantiate his own testimony that Landmark became unable to repay the debt in 2006. In addition, the court pointed out that the principal of the debt was not due until 2007, and the taxpayer did not elect to exercise the acceleration clause.

Let's talk

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