New IRS rulings provide guidance on tax accounting method issues

In this month's Accounting Methods Spotlight, taxpayers are reminded to carefully consider settlement agreement language and descriptions, as it may determine deductibility. This month's issue also discusses final regulations on the treatment of sales-based royalties and sales-based vendor allowances, the treatment of cooperative advertising allowances, and whether a hotel owner was entitled to bonus depreciation for properties it constructed.

Did you know..?

Settlement agreement language may determine deductibility

Across different industries, there is a growing trend of large settlements as a result of civil and criminal investigations by the government that culminate in the payment of both criminal and civil fines and penalties. Although Section 162(f) denies a deduction for both criminal and civil penalties paid to a government for a violation of law, there is an exception that fines and penalties are deductible if they are remedial in nature. In addition, certain amounts associated with settlement payments, including legal fees, prejudgment interest, and investigatory costs, can be deductible. In contrast, a fine having a punitive purpose is nondeductible.

Therefore, it is critical that taxpayers distinguish between nondeductible punitive fines and deductible compensatory payments in determining the amount of the settlement that is deductible for federal income tax purposes. In general, courts and the IRS consider the nature of the claim, the express language used in the settlement agreement, as well as other evidence, including correspondence between the parties during the negotiation process and other communications, in determining the characterization of the settlement payment for purposes of Section 162(f).

Other guidance

IRS releases final regulations on the treatment of sales-based royalties and sales-based vendor allowances

On January 13, 2014, the IRS released final regulations under Sections 263A and 471 relating to the capitalization and allocation of sales-based royalty costs and the adjustment of inventory costs for certain sales-based vendor allowances. The final regulations adopt, with changes, proposed regulations that were issued in December 2010. Under the final regulations, capitalizable sales-based royalty costs are treated as a production cost that is allocated entirely to cost of goods sold. Similarly, sales-based vendor chargebacks earned by a taxpayer are allocated entirely to cost of goods sold. The final regulations are effective for taxable years ending on or after January 13, 2014.

Sales-based royalty costs are defined as fees, payments or royalties that are incurred only upon the sale of property produced or acquired for resale. The proposed regulations provided that sales-based royalties that were capitalizable as indirect costs under section 263A were allocable only to property that had been sold. In response to comments that this treatment overly burdened taxpayers using simplified allocation methods, the final regulations allow taxpayers the option to either allocate capitalizable sales-based royalties entirely to property sold or to allocate such royalties partially to property sold and partially to ending inventory under either a facts and circumstances method or a simplified method.

With respect to sales-based vendor allowances, the proposed regulations provided that the amount of an allowance, discount, or price rebate that a taxpayer earned by selling specific merchandise (i.e., a sale-based vendor allowance) was a reduction in the cost of the merchandise sold or deemed sold under the taxpayer's cost flow assumption. The preamble to the final regulations acknowledges that the proposed regulations were overly broad in that they could be interpreted as requiring taxpayers to allocate all sales-based vendor allowances that arise from selling inventory to cost of goods sold, regardless of the specific terms and conditions of the agreement between the vendor and the taxpayer. As a result, the final regulations limit the application of the rule to a specific allowance, sales-based vendor chargebacks. A sales-based vendor chargeback is defined as an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. The final regulations reserve the treatment of all other sales-based vendor allowances.

In light of this development, taxpayers should re-evaluate their current methods of accounting for sales-based royalties and sales-based vendor chargebacks to determine if they are in compliance with the final regulations. The regulations did not provide for an automatic accounting method change to comply with the final rules. Therefore, a taxpayer that is required to change a method of accounting to comply with the final regulations would be required to file a Form 3115, Application for Change in Accounting Method, under the advance consent provisions set forth in Rev. Proc. 97-27.

IRS provides guidance on treatment of cooperative advertising allowances

In AM 2014-001, the IRS provided generic legal advice as to whether cooperative advertising allowances that inventory retailers receive from product vendors for placing advertisements of the products in flyers may be treated as domestic production gross receipts (DPGR) for purposes of Section 199. The IRS concludes that retail fliers are eligible as "other similar publications" under the advertising exception in Reg. Sec. 1.199-3(i)(5)(ii); thus, gross receipts derived from placing vendor advertisements in the flyers qualify as DPGR if the taxpayer meets all other applicable requirements of Section 199.

Vendors and retailers commonly enter into cooperative advertising arrangements that require retailers to produce printed advertisements of vendors' products and to distribute the printed advertisement flyers in the retailers' stores. Retailers are responsible for all aspects of the production and distribution of the flyers and normally bear all up-front costs. Under the terms of these agreements, retailers receive allowances from vendors for providing specific advertising services. These allowances can be provided to the retailers through a direct payment, a reduction in the amount owed by the retailers for prior purchases, the issuance of a credit to the retailers for future purchases. Vendors may pay allowances periodically or at fixed intervals. In some cases, vendors may also require retailers to submit invoices, reimbursement substantiation claims, or proofs of performance of the advertising services required under agreements before paying the allowances.

In general, gross receipts from advertising are non-DPGR under Reg. Sec. 1.199-3(i)(5)(i) because the receipts are derived from providing a service. However, the regulations provide an exception which allows advertising-related gross receipts to qualify as DPGR in cases of certain tangible personal property. Specifically, under Reg. Sec. 1.199-3(i)(5)(ii), a taxpayer's gross receipts that are derived from the disposition of newspapers, magazines, telephone directories, periodicals, and other similar printed publications that are MPGE in whole or in significant part within the United States include the advertising income from advertisements placed in those media, but only if the gross receipts, if any, derived from the disposition of the newspapers, magazines, telephone directories, or periodicals are (or would be) DPGR.

The IRS advised that whether allowances may be treated as DPGR depends on the facts and circumstances of each co-operative advertising agreement, including the language of the agreements between vendors and retailers. According to the IRS, if the purpose and intent of the allowance is to compensate the retailer for advertising services, the allowance is a separate item of gross income for purposes of Section 61. If the allowance is a separate item of gross income, the allowance may be included in DPGR under Section 199 if the flyers fit within the advertising exception in Reg. Sec. 1.199-3(i)(5)(ii). However, if the purpose of the allowance is to reach an agreed upon price for the retailer's products and is not compensation for services, the allowance is a purchase price adjustment and is not a separate item of gross income for purposes of Section 61 and, as a result, may not be included in DPGR under Section 199.

Hotel owner not entitled to bonus depreciation

In FAA 20140202F, the IRS concluded that the owner and operator of a hotel complex was not entitled to bonus depreciation for some properties it constructed because it failed to demonstrate when costs were incurred for each property.

The taxpayer owns and operates a hotel complex that consists of several adjacent buildings, including a casino, a hotel, a restaurant and convention center building, and above-ground parking structures. Over several years, the taxpayer completed four separate construction projects involving four existing buildings at the hotel complex. For the property at issue, the taxpayer engaged an architect for the design phase of the project and a contractor to perform the construction services for the entire project. The architect and contractor each had a separate contractual relationship with the owner.

Upon completion of the project, the taxpayer hired a consultant to perform a cost segregation study to classify the various items of property constructed within the project for depreciation purposes. The study segregated the construction costs and classified them as 15-year, 7-year, or 5-year property under a modified accelerated cost recovery system (MACRS) or as nonresidential real property with a 39-year recovery period. The cost segregation study allocated the total cost of each identified asset but did not identify the dates the costs were incurred for each asset.

For all items of property in the project assigned a recovery period of 20 years or less that were placed in service after January 1, 2008, the taxpayer claimed the 50 percent additional first year depreciation deduction under Section 168(k). During a review of the cost segregation study, the IRS questioned the eligibility of these assets for the 50 percent additional first year depreciation deduction under Section 168(k).

The taxpayer submitted a position paper in which it argued that the project was provided under a 'turnkey contract' and final acceptance of the project by the taxpayer did not occur until the contractor completed all work required for final acceptance. Therefore, the taxpayer concludes that because final completion and acceptance of the work occurred in Year 6, it did not incur costs until such time. Thus, the project meets the acquisition date requirement of Section 168(k) under the 10 percent safe harbor rule of Reg. Sec. 1.168(k)-1(b)(4)(iii)(B)(2).

The IRS, however, determined that the project did not constitute a true 'turnkey project' in which a contractor is responsible for turning over the completed project to its customer in a 'ready-to-use condition.' Rather, the IRS determined that the project was a design-dig-build project and that each property should be separately analyzed under Section 168(k) to determine its eligibility for bonus depreciation.

The IRS then considered the all events test and economic performance requirements under Section 461 to determine whether the taxpayer met the 10 percent safe harbor rule to qualify for bonus depreciation. The IRS concluded that neither the pay applications nor the cost segregation study provided by the taxpayer clearly indicate when the costs of any separately identifiable properties were incurred. Specifically, since the pay applications were not broken down for each individual property, it was not possible to determine when the total costs of separate properties that could be eligible for bonus depreciation, such as depreciable landscaping, business signage, or decorative items, were incurred. As a result, the IRS determined that the taxpayer had not met its burden of proof to show that properties were eligible for bonus depreciation and therefore was not entitled to bonus depreciation on any of the properties.

Let's talk

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