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

This month's Accounting Methods Spotlight highlights important guidance for helping taxpayers implement the final tangible property 'repair' regulations, as well as welcomed clarity from the IRS on the treatment of milestone payments. This issue also includes rulings on: Section 9100 relief for an extension of time to file the mandatory statement for the safe harbor allocation method for success based fees; deduction of construction support payments; proposed IRS adjustments that were determined to constitute a change in method of accounting; and depreciation classification of certain interior, non-load bearing partitions. In addition, this month's issue discusses a case in which a divided Tax Court allowed a deduction for premiums paid to a captive insurance company.

Did you know..?

IRS provides important guidance for helping taxpayers implement the final tangible property repair regulations

Rev. Proc. 2014-16, released on January 24, 2014, provides taxpayers with general procedures for obtaining automatic consent for accounting method changes required to comply with the final tangible property 'repair' regulations and portions of the 2011 temporary regulations.

The final repair regulations, which are effective for taxable years beginning on or after January 1, 2014, address the deduction and capitalization of amounts paid to acquire, produce or improve tangible property under Sections 162 and 263(a). These final regulations replaced and removed the temporary repair regulations issued on December 23, 2011. The final repair regulations are broad in scope and will affect most taxpayers that acquire, produce or improve tangible property.

If a taxpayer wishes to change an accounting method to comply with either the final or 2011 temporary repair regulations, then a Form 3115 (Application for Change in Accounting Method) must be filed requesting permission to make the accounting method change. In furtherance of this requirement, Rev. Proc. 2014-16 adds new automatic accounting method changes to the Appendix of Rev. Proc. 2011-14, including changes in the treatment of materials and supplies, changes in the treatment of rotable spare parts, changes to deduct repairs, and changes to capitalize improvements . The automatic accounting method changes to adopt portions of the 2011 temporary regulations also are described within Rev. Proc. 2014-16.

Rev. Proc. 2014-16 provides a great deal of flexibility and a number of tax planning considerations for taxpayers in implementing the final repair regulations. For example, taxpayers may choose to 'early adopt' the final repair regulations for tax years beginning on or after January 1, 2012. Alternatively, the final repair regulations provide taxpayers with the choice of applying the 2011 temporary regulations for tax years beginning on or after January 1, 2012, and before January 1, 2014. Accordingly, all taxpayers must determine if they intend to adopt the final or temporary repair regulations for 2012 and 2013 (transition relief is provided for taxpayers that wish to adopt the final regulations but already have filed 2012 and 2013 Federal income tax returns).

In addition, Rev. Proc. 2014-16 provides two new automatic accounting method changes unrelated to the final tangible regulations -- a change to a reasonable allocation method under section 263A for self-constructed assets and a change in capitalized costs for real property acquired by lenders through foreclosure, or a similar transaction.

Also notable, Rev. Proc. 2014-16 modifies the procedures for concurrently changing the method of accounting for costs under §263A (UNICAP), likely because tangible property costs often are required to be capitalized under UNICAP once they otherwise are deductible (e.g., as depreciation or a repair deduction). Specifically, the Rev. Proc. waives the scope limitations of Rev. Proc. 2011-14, including the limitation for taxpayers under exam, for both the repair and UNICAP method changes if filed on a single Form 3115 for taxable years beginning before January 1, 2015. As a result, taxpayers under IRS exam using an impermissible UNICAP method may have an opportunity to change to a proper method and obtain audit protection for prior years, even if UNICAP is an issue under consideration by exam.

For a deeper discussion of the content of Rev. Proc. 2014-16 and a full listing of the method changes provided for, click this link to PwC's WNTS Insight.

For a deeper discussion of the UNICAP scope waiver, click this link to PwC's WNTS insight.

IRS provides clarity on the treatment of milestone payments

On January 27, 2014, the IRS Large Business and International Division released LB&I-04-0114-001 (the 2014 directive), an updated memorandum regarding 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 for purposes of applying the safe harbor in Rev. Proc. 2011-29.

As background, Rev. Proc. 2011 – 29 provides a safe harbor election for taxpayers seeking to allocate success-based fees between facilitative and non-facilitative amounts for 'covered transactions' described in Reg. Sec. 1.263(a)-5(e)(3). In lieu of requiring contemporaneous documentation specified in Reg. Sec. 1.263(a)-5(f), the safe harbor allows a taxpayer to treat 70 % of a success based fee as an amount that does not facilitate the covered transaction, and capitalize the remaining 30 % as an amount that facilitates the covered transaction.

However, it was unclear whether the 70/30 safe harbor in Rev. Proc. 2011-29 applied to milestone payments that were applied against a success-based fee, but were not contingent on the success of the transaction. In response to this uncertainty, LB&I

issued a directive in 2013 (the 2013 directive) that instructed LB&I examiners not to challenge a taxpayer's treatment of `eligible' milestone payments if certain requirements were satisfied. The 2013 directive defined an 'eligible milestone payment' as a milestone payment paid for investment banking services that was creditable against a success-based fee. A 'milestone payment' was defined as a non-refundable amount that was contingent on the achievement of a milestone. A 'milestone' generally was defined as an event occurring in the course of a covered transaction (regardless whether the transaction is ultimately completed) provided that the event occurred after the earlier of the signing of a letter of intent, the execution of an exclusivity agreement, or approval of the transaction by the board of directors.

The updated LB&I memorandum expands the definition of a 'milestone' by removing the condition that a milestone can occur only after the signing of a letter of intent, exclusivity agreement, or approval of the transaction by the taxpayer's board of directors. The 2014 directive simply defines a milestone as an event, including the passage of time, occurring in the course of a covered transaction (whether the transaction ultimately is completed or not). All other aspects of the 2014 directive are consistent with the 2013 directive.

The broader definition of a milestone in the 2014 directive provides much needed clarity to taxpayers regarding the treatment of certain milestone payments. Under the 2014 directive, an amount that is (1) paid for investment banking services, (2) contingent upon the achievement of a specific event, (3) non-refundable, and (4) creditable against a success-based fee will qualify as an eligible milestone payment for purposes of the safe harbor election, regardless of when the milestone takes place in relation to other events.

For taxpayers electing to use the safe harbor described in Rev. Proc. 2011-29, the revisions to the directive greatly simplify the analysis regarding the proper federal income tax treatment of milestone payments. Furthermore, the 70/30 safe harbor can now be applied to a wider range of payments made to investment bankers during the course of a covered transaction. Therefore, taxpayers that have incurred milestone payments and concluded that such payments were ineligible for the 70/30 safe harbor should re-evaluate their analysis in light of the 2014 directive.

For a deeper discussion of the 70/30 safe harbor, click this link to our PwC WNTS Insight.

Other guidance

IRS grants Section 9100 relief for an extension of time to file the mandatory statement for the safe harbor allocation method for success based fees

The IRS in PLR 201405010 granted a taxpayer an extension of time to file the mandatory statement required by Rev. Rul. 2011-29 for a taxpayer to elect to use the safe harbor method of allocating success-based fees.

The safe harbor provides that the IRS will not challenge a taxpayer's allocation of a success-based fee between activities that facilitate a transaction described in Reg. Sec. 1.263(a)-5(e)(3) and activities that do not facilitate the transaction if the taxpayer follows a 70/30 facilitative/non-facilitative split and attaches a statement to its original federal income tax return for the tax year the success-based fee is paid or incurred.

In the ruling, the taxpayer intended to use the Rev. Proc. 2011-29 safe harbor with respect to certain qualifying success based fees it incurred during the course of the year, and reflected the 70/30 split on its tax return. The taxpayer relied on its tax preparer to include the mandatory statement required under the Rev. Proc.; however, the statement was not attached. Upon discovering the omission from the taxpayer's return, approximately 1 month after the timely electronic filing of the taxpayer's

Federal Income Tax return, the tax preparer promptly notified the taxpayer. The taxpayer then filed for relief under Reg. Sec. 301.9100-3 which lead to the ruling here.

The IRS in the ruling found that the government's interest would not be prejudiced by granting relief to the Taxpayer and thus granted Taxpayer an extension of time to file the required statement.

Capitalization of construction support payments is not required

In CCA 201405014, the IRS concluded that 'construction support payments' that a manufacturer paid to retailers for product display areas, and for conforming to certain image requirements that met the manufacturer's specifications, are not required to be capitalized.

The taxpayer distributes certain products through a network of retailers. As part of this process, the taxpayer has a standing offer to its retailers to enter into an agreement requiring the retailers to maintain their space in conformity with the taxpayer's seven critical image requirements. In exchange, the taxpayer would agree to make construction support payments to retailers that must be repaid immediately if within 15 years the retailer no longer conforms to the taxpayer's image requirements or no longer sells the taxpayer's products. Notably, the agreement does not obligate the retailer to purchase any specific quantity of the taxpayer's products. It only requires the retailer to conform its premises to the taxpayer's design requirements.

The taxpayer sought assistance from the IRS on whether the construction support payments are required to be capitalized under Treas. Reg. Sec. 1.263(a)-4. Treas. Reg. Sec. 1.263(a)-4 provides specific categories of intangible assets for which capitalization is required, which include, costs to: (i) acquire an intangible; (ii) create an intangible; (iii) create or enhance a separate and distinct intangible asset; (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin; or (v) facilitate the acquisition or creation of an intangible.

In concluding that the taxpayer's payments should not be capitalized, the IRS indicated that the taxpayer's payments did not confer any interest in tangible property. Further, the IRS stated that the construction support payments did not create or enhance a separate and distinct intangible within the meaning of Treas. Reg. Sec. 1.263(a)-4(b)(3) because the taxpayer's rights had no value other than promoting its products. In addition, the IRS determined that no other category under Treas. Reg. Sec. 1.263(a)-4 was applicable, in particular because the retailers were not required to purchase any specific amount of the taxpayer's products, and as a result, the construction support payments made by the taxpayer to its retailers were not required to be capitalized.

Proposed IRS adjustments constitute a change in method of accounting

The IRS determined in CCA 201403015 that a change from open transaction treatment to realization treatment is considered an accounting method change under Section 446, and therefore necessitates an adjustment under Section 481(a).

The facts considered in this CCA were entirely redacted; however, it is clear that under audit, the IRS examining agent proposed changes to the taxpayer's method of accounting for certain items accounted for under the 'open transaction doctrine.' The taxpayer then sought advice from the IRS on whether a change from open transaction treatment to realization treatment (as direct owner of the underlying assets) constitutes a change in method of accounting under Section 446 of the Internal Revenue Code, and if so, whether a Section 481(a) adjustment should be recognized in connection with this change that reflects amounts attributable to closed taxable years.

Under Section 446(b), if a taxpayer has not used a regular method of accounting, or if the taxpayer's method does not produce a clear reflection of taxable income, the

computation of taxable income shall be made under a method that in the opinion of the Secretary clearly reflects income. Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes any change in the overall plan of accounting for income or deductions, or a change in the treatment of any 'material item.' A 'material item' includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction."

If a change in method of accounting is involved, an examining agent has broad discretion to propose a change in the taxpayer's method of accounting from an impermissible method to a permissible method of accounting. Further, in accordance with Rev. Proc. 2002-18, an examining agent proposing an adjustment with respect to a method of accounting must apply the law to the facts to determine the new method, propose the adjustment in the earliest year under exam, and impose a section 481(a) adjustment that is taken into account entirely in the year of change.

In the CCA, the IRS examined the applicable case law, and concluded that a change in characterization is a change in method of accounting. See, for example, *Cargill Inc. v. U.S.* 91 F.Supp.2d 1293 (D.Minn., 2000); *Witte v. Commissioner*, 513 F.2d 391 (D.C. Cir. 1975); *Capital One v. Commissioner*, 130 T.C. 147 (2008), aff'd 659 F.3d 316 (4th Cir. 2011).

The IRS then determined that the proposed change in characterization from open transaction treatment to realization treatment represented a change in method of accounting because it involved the proper time for inclusion of the item in income or for taking a deduction. Moreover, this conclusion was not changed by the fact that the adjustment in the case effectively recharacterized one type of income (long term capital gain) into different types of income. The IRS also concluded that the taxpayer must make an appropriate adjustment under Section 481(a).

IRS rules on the depreciation classification of certain interior, non-load bearing partitions

The IRS, in PLR 201404001, ruled that zip-type partitions installed within owned and leased property must be included in asset class 57.0 of Rev. Proc. 87-56 under Section 168, and that conventional drywall partitions are classified as non-residential real property under Section 168(e)(2)(B).

The ruling addressed the classification of two different types of interior non-load bearing drywall partitions: zip type partitions and conventional drywall partitions. With respect to the zip type partitions, the taxpayer requested a ruling that these partitions were included in asset class 57.0 of Rev. Proc. 87-56 for purposes of Section 168. Asset class 57.0 includes assets used in wholesale and retail trade, and personal and professional services. With respect to the conventional drywall partitions, the taxpayer requested a ruling that these types of partitions installed within property they owned and/or leased would be classified as non-residential real property under Section 168(e)(2)(B).

For purposes of determining the appropriate depreciation classification for assets such as zip type and conventional drywall partitions, the tax treatment hinges on, among other things, whether the partition is considered to be tangible personal property or a structural component of the building.

The IRS, citing the Senate Finance Committee comments issued in connection with the Revenue Act of 1978, noted that legislative history contemplated movable and removable partitions would not qualify as permanent structural components, but rather would be tangible personal property. Furthermore, Rev. Rul. 75-178 provides that the classification of property, such as movable partitions, as 'personal' or 'inherently permanent' should be made on the basis of the manner of attachment to the structure and how permanently the property is designed to remain in place. Thus, the depreciation classification of the zip type and conventional drywall partitions in the PLR turned on whether the partitions are inherently permanent structures.

The Service cited *Whiteco Industries, Inc. v. Comm'r*, 65 T.C. 664 (1975) as the relevant authority in providing factors for the Service and the Taxpayer to consider when reaching the determination of whether the property is inherently permanent.

The taxpayer in the PLR represented that the zip type and conventional drywall partitions should be considered 'not inherently permanent' and 'inherently permanent', respectively, when applying the *Whiteco Industries* factors. As such, the ruling clarifies that the zip type partitions installed within the taxpayer's property are included in asset class 57.0 of Rev. Proc. 87-56 for purposes of Section 168 as long as any subsequent lessee or sub-lessee is also engaged in activities which would be included under asset class 57.0. Additionally, the IRS found that drywall partitions installed within the taxpayer's property are classified as non-residential real property under Section 168(e)(2)(B).

Cases

Divided Tax Court allows a deduction for premiums paid to a captive insurance company

In *Rent-A-Center v. Commissioner*, 142 T.C. No. 1 (January 14, 2014), a majority of the US Tax Court held that payments made by a parent company to a subsidiary 'captive' insurance company on behalf of other wholly-owned subsidiaries were properly deductible as insurance premiums.

At issue in the case were payments made by Rent-A-Center, Inc. (RAC), the parent of a group of approximately 15 affiliated subsidiaries. In 2002, RAC incorporated and capitalized Legacy Insurance Co., Ltd. (Legacy), a wholly owned Bermudian subsidiary registered as an insurance company in Bermuda. RAC entered into insurance policies with Legacy and other third-party providers on behalf of its subsidiaries.

Legacy issued policies that covered workers compensation, automobile, and general liability risks for the RAC subsidiaries. Premiums under the policies were determined using actuarial forecasts and although RAC was a listed policyholder on the Legacy policies and paid the annual premium, no premium was allocated to RAC because it did not hold any assets that gave rise to the insured risks. Rather, RAC established a monthly rate to allocate the premiums to its subsidiaries based on factors such as each subsidiary's payroll, number of vehicles, and the number of stores each subsidiary owned.

Upon examination, the IRS concluded that amounts RAC paid to Legacy on behalf of its other subsidiaries were not deductible as insurance premiums under Section 162, in part because Legacy was a sham entity created primarily to generate federal tax savings. As a result, the IRS asserted a deficiency of over $43 million.

The majority of the Tax Court disagreed with the Service and found that Legacy was not a sham, but a bona fide insurance company, and that the RAC payments to Legacy constituted insurance premiums based on criteria the courts have applied in other cases such as *AMERCO v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992), and *Harper Group v. Commissione*r, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992), specifically whether the arrangements involve risk shifting, risk distribution, insurance risk, and meet the commonly accepted notions of insurance.

The dissenting opinions, among other things, both took exception to the majority's apparent overruling of the court's prior conclusion in *Humana Inc. & Subs. v. Commissioner*, 88 T.C. 197 (1987), aff'd in part and rev'd in part, 881 F.2d 247 (6th Cir. 1989), that an arrangement between sibling corporations cannot constitute insurance. The Sixth Circuit reversed the Tax Court on that issue. Rent-A-Center is appealable to the Fifth Circuit.

The long-awaited decision in *Rent-A-Center*, is not only the first captive insurance case in several years, but also the first since the IRS abandoned its economic family theory in 2001 and replaced it with other safe-harbor rulings. Although the IRS may

decide to appeal the case, the opinion will in some cases confirm the legitimacy of existing captive insurance arrangements, and in other cases provide clearer guidance for companies deciding whether to establish captive insurance programs. Companies that are under IRS examination or in appeals on their captive insurance programs also may find their positions are stronger as a result of the opinion.

For a deeper discussion of *Rent-A-Center v. Commissioner*, click this link to PwC's WNTS Insight.

Let's talk

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