Accounting Methods Spotlight

A Washington National Tax Services (WNTS) Publication

October 16, 2012

This month's features:

- Accounting methods play key role in determining E&P of foreign corporations
- IRS simplifies procedures for accounting method changes involving §381(a) transactions
- Proposed regulations will likely require many producers to change their UNICAP method
- Safe harbor for allocating success-based fees not applicable to milestone payments
- IRS concludes that 'go shop' provision in merger agreement does not impact the bright-line date for a covered transaction
- Vineyard operators may expense all or part of costs in year property is placed in service
- Remediation expenses previously claimed as capital losses not deductible

Did you know…?

Accounting methods play key role in determining E&P of foreign corporations

The characterization of earnings repatriated from a foreign corporation (FC), Subpart F income attributable to an FC (and certain exceptions to Subpart F) and interest expense apportionments are dependent on the current and/or accumulated earnings and profits (E&P) of the FC. Because E&P is a US tax concept, determining E&P—including the adoption or change of tax accounting methods—should be made in accordance with US tax law.

Under § 964 regulations finalized in June 2009, a US multinational company (MNC) may have the opportunity to "protect" historic E&P of the FC by changing voluntarily from an impermissible US tax accounting method to a permissible method or the opportunity to change to more favorable proper US tax accounting methods to either increase or decrease E&P of the FC, depending on their tax posture. Any such method changes generally will require the consent of the IRS.

Proper accounting methods and their impact on E&P also should be considered as taxpayers become more focused on the prospect of international tax reform and repatriation or other strategies in advance of international tax reform enactment. Depending on the transition rules that are enacted, taxpayers may have a unique ability to manage E&P or correct impermissible methods in the pre-enactment period to avoid future adverse book and cash tax consequences.

Common method issues that arise in the computation of E&P that require IRS consent to change include using book depreciation as opposed to E&P depreciation (which typically requires longer recovery periods), failing to properly account for inventory by not complying with the uniform capitalization (UNICAP) rules or by allowing book inventory reserves, failing to properly account for reserves in accordance with §461, and including all advance payments received during the tax year in computing E&P rather than using a permissible method to defer such advance payments (e.g., Rev. Proc. 2004-34 or Reg. §1.451-5).Text.

Other Guidance…

IRS simplifies procedures for accounting method changes involving §381(a) transactions

Recently, the IRS released Rev. Proc. 2012-39, which modifies certain procedural rules for changes in method of accounting found in Rev. Proc. 2011-14 and Rev. Proc. 97-27. Under the final §381(c)(4) regulations, a taxpayer that was required to change from an impermissible method of accounting pursuant to the regulations was generally precluded from using the automatic consent procedures described in Rev. Proc. 2011-14 to make the change. Another concern with the final regulations under §381(c)(4) was that the regulations require a taxpayer to change from an impermissible method of accounting but did not provide for a special window period or otherwise waive the scope restrictions for taxpayers under IRS examination.

Rev. Proc. 2012-39 now waives the scope limitation that previously precluded a taxpayer from making an automatic accounting method change for a taxable year in which it engages in a § 381(a) transaction. In addition, Rev. Proc. 2012-39 waives the scope limitation in both Rev. Proc. 2011-14 and Rev. Proc. 97-27 that prohibits taxpayers under IRS examination from seeking consent to change to an accounting method other than the principal or carryover method. The changes apply to §381(a) transactions that occur on or after August 31, 2011.

In addition to modifying the procedural rules for §381(a) transactions, Rev. Proc. 2012-39 also modifies section 3.09 of the Appendix of Rev. Proc. 2011-14, which allows a taxpayer in the business of transporting, delivering, or selling electricity to change their method of accounting to the safe harbor method of accounting described in Rev. Proc. 2011-43, to extend the waiver of scope limitations to the third tax year ending after December 30, 2010.

Finally, Rev. Proc. 2012-39 modifies section 8.04 of the Appendix of Rev. Proc. 2011-14, which allows taxpayers to change the method of accounting for amounts paid or incurred for the installation of energy efficient commercial building property under § 179D, to make clear that designers that are allocated a § 179D deduction may not use the automatic change in method of accounting provisions of Rev. Proc. 2011-14 because the allocation of the deduction does not involve a change in method of accounting.

Proposed regulations will likely require many producers to change their UNICAP method

The IRS has issued proposed regulations on allocating costs to certain property produced by the taxpayer or acquired by the taxpayer for resale. The proposed regulations provide rules for the treatment of negative additional costs, and generally address three areas:

- A prohibition on negative amounts
- A new modified simplified production method
- A simplified definition of §471 costs and elimination of separate provisions for new taxpayers

Prohibition on negative amounts: To reduce the distortions that occur by including negative amounts under the simplified methods, the proposed regulations provide that, subject to certain exceptions, taxpayers may not include negative amounts in additional §263A costs. In addition, the proposed regulations allow producers with average annual gross receipts of $10 million or less to include negative amounts in additional §263A costs under the simplified production method. The proposed regulations also allow taxpayers using the simplified resale method to remove §471 costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional §263A costs. The proposed regulations generally prohibit treating cash or trade discounts described as negative amounts under any of the simplified methods.

New modified simplified production method: The proposed regulations allow producers to use a new modified simplified production method that the IRS believes will reduce the distortions that exist under the traditional simplified methods by more precisely allocating additional §263A costs, including negative amounts, among raw materials, work-in-process, and finished goods inventories. Under the modified simplified production method, producers determine the allocable portion of preproduction-related additional §263A costs (such as storage and handling for raw materials) using a preproduction cost absorption ratio.

Simplified definition of §471 costs and elimination of separate provisions for new taxpayers: To provide greater simplicity and consistency among taxpayers, the proposed regulations adopt a single definition of §471 costs that applies to taxpayers that were in existence before the effective date of §263A and to newer taxpayers, whether using the simplified production method, the modified simplified production method, or the simplified resale method.

The regulations are proposed to apply to tax years ending on or after the date the regulations are published as final regulations. Notice 2007-29 would be superseded as of the date these regulations are published as final regulations. Comments on the proposed regulations and requests for a public hearing must be submitted to the IRS by December 4, 2012.

Safe harbor for allocating success-based fees not applicable to milestone payments

In ILM 201234027, the IRS addressed the treatment of milestone payments for purposes of applying the 70/30 safe harbor rule for success-based fees set forth in Rev. Proc. 2011-29. The IRS concluded that nonrefundable milestone payments made to a service provider in connection with a covered transaction described in Reg. §1.263(a)-5(e)(3) are not success-based fees; thus, the 70/30 safe harbor is not applicable.

For example, the taxpayer, under the terms of an engagement letter, will pay a service provider $10 million upon the successful closing of a covered transaction. Pursuant to the agreement, the service provider will receive a $1 million milestone payment when the merger agreement is signed and an additional $1 million milestone payment upon shareholder approval of the transaction. Both milestone payments will be applied as a credit against the total $10 million fee due upon successful consummation of the covered transaction. In the event that the transaction does not successfully close, the milestone payments of $2 million are nonrefundable.

The IRS stated that the nonrefundable milestone payments described in the ILM are incurred upon the occurrence of a specific event rather than the successful closing of the covered transaction. Therefore, the IRS concluded that the milestone payments are not success-based fees and that the taxpayer may apply the Rev. Proc. 2011-29 safe harbor only to the remaining $8 million payment. With respect to the milestone payments, the IRS noted that the taxpayer must establish, based on all the facts and circumstances, whether the investment banker's activities were facilitative under Reg. §1.263(a)-5(e).

Based on the IRS position in the ILM, taxpayers electing to apply the 70/30 safe harbor will be required to separately analyze any nonrefundable milestone payments paid in conjunction with a covered transaction. The proper federal income tax treatment of the milestone payments should be based on the nature of the services provided as well as when those services were performed relative to the bright-line date.

IRS concludes that 'go shop' provision in merger agreement does not impact the bright-line date for a covered transaction

In ILM 201234026, an acquiring corporation was to acquire a target corporation in a covered transaction defined in Reg. §1.263(a)-5(e)(3) pursuant to a merger agreement dated March 31, 2012. However, the agreement allowed the target corporation to look for another acquirer until April 30, 2012. If within that time the target corporation received a better offer, the acquiring corporation would have an opportunity to match or decline the offer. Upon declining the offer, the target would be able to abandon its agreement with the acquiring corporation.

Under Reg. § 1.263(a)-5, a taxpayer must capitalize an amount paid to facilitate certain business acquisitions or reorganizations. Reg. §1.263(a)-5(e)(1) further provides that an amount paid in the process of investigating certain covered transactions described Reg. §1.263(a)-5(e)(3) would be considered facilitative if the amount concerns activities that occurred on or after a bright-line date. The bright-line date is defined as the earlier of (1) the date a letter of intent, exclusivity agreement, or similar written communication is executed by representatives of both parties entering into an agreement, or (2) the date that the material terms of a transaction are approved by the parties' boards of directors.

The IRS concluded that the "go shop" provision did not negate the execution of the merger agreement nor did it trump the approval of the merger agreement agreed upon by the corporations' boards of directors. As such, the "go shop" provision did not affect the bright-line date, which in this case is March 31, 2012.

Vineyard operators may expense all or part of costs in year property is placed in service

The IRS concluded in ILM 201234024 that individuals who planted a vineyard in 2005 and placed it in service in 2009 may elect to expense all or part of their costs in 2009 because the vineyard met all the requirements of § 179(d)(1) and therefore qualifies as § 179 property.

The taxpayers began planting a vineyard in 2005 and capitalized the costs of land preparation, labor, rootstock, and planting over a period of three years. The vineyard was placed in service in 2009, and the taxpayers claimed a deduction under IRC § 179 for the costs incurred in planting the vines.

The IRS determined that the vineyard qualified as § 168 property, that the vineyard was considered §1245 property, and that the vineyard was used in an active trade or business. Because the taxpayers satisfied all the requirements of §179, the IRS concluded that the taxpayers were entitled to expense in 2009 the cost of the vineyard, including capital expenditures made to develop the vineyard to an income-producing stage.

Recent Cases….

Remediation expenses previously claimed as capital losses not deductible

The United States Tax Court held in *Thrifty Oil Co. Et al. v. Commissioner*, 139 T.C. No. 6,that a taxpayer was not entitled to deduct environmental remediation expenses because those same losses were claimed as capital losses in prior years.

Thrifty Oil Co. acquired an unprofitable oil refinery. Subsequent to suspending operations, the taxpayer incurred liabilities related to environmental contamination. In order to accelerate its deductions, the taxpayer entered into a transaction that led to the creation of a capital loss. In later years (the years at issue), the taxpayer took an additional deduction when the expenses were actually paid.

The Tax Court denied the claim under the double-deduction doctrine, which states that double deductions for the same economic loss are generally disallowed absent express permission from Congress. The taxpayer argued that the capital loss and the environmental remediation expenses did not represent the same economic loss. The taxpayer also contended that the capital loss resulted from different assets, and as a result, the deductions were economically different. The Court agreed that the calculation of basis was an important factor but also noted that equally important is the amount realized, which takes into consideration the contingent environmental remediation liabilities. The Tax Court also stated that it was irrelevant that the asset establishing the taxpayer's basis in the capital asset was not the same asset that gave rise to the remediation expense deductions. Finally, the taxpayer's claim that the capital loss deduction was improper did not prevent the application of the double-deduction rules.

For more information, please do not hesitate to contact:

James Connor	*(202) 414-1771*	*james.e.connor@us.pwc.com*
Adam Handler	*(213) 356-6499*	*adam.handler@us.pwc.com*
Jennifer Kennedy	*(202) 414-1543*	*jennifer.kennedy@us.pwc.com*
George Manousos	*(202) 414-4317*	*george.manousos@us.pwc.com*
Annette Smith	*(202) 414-1048*	*annette.smith@us.pwc.com*
Dennis Tingey	*(602) 364-8107*	*dennis.tingey@us.pwc.com*
Christine Turgeon	*(646) 471-1660*	*christine.turgeon@us.pwc.com*
James Martin	*(202) 414-1511*	*james.e.martin@us.pwc.com*