Recent IRS guidance sheds light on tax accounting issues

This month's Accounting Methods Spotlight highlights modifications to revenue procedure 2014-1 that reduce Form 3115 filing requirements and user fees for certain partnerships and foreign corporations. In addition, this month's issue discusses IRS rulings concluding that: consent is not required for a taxpayer to make a change in method of accounting for depreciation for domestic earnings and profits; a taxpayer's lawsuit settlement liabilities are deductible business expenses, certain inventory is not eligible for the enhanced charitable contribution deduction; and, legal fees and other costs related to self-insured workers compensation claims do not qualify as specified liability losses under Section 172(f).

Did you know..?

Modifications to revenue procedure 2014-1 reduce Form 3115 filing requirements and user fees for certain partnerships and foreign corporations

Each year the IRS updates its annual revenue procedures providing the relevant procedures by which taxpayers may request certain IRS rulings and determination letters. As part of this update, the IRS modified the procedures under Rev. Proc. 2014-1 for entities wholly-owned by a consolidated group that want to request a change in method of accounting on a single Form 3115, Application for Change in Accounting Method, for an identical change in method of accounting.

Prior to Rev. Proc. 2014-1, the annual revenue procedure allowed the common parent of a consolidated group to request an identical change in method of accounting (i.e., a request to change from the same present method of accounting to the same proposed method of accounting) on a single Form 3115 for two or more (i) members of the consolidated group, or (ii) separate and distinct trades or businesses of that taxpayer or member(s) of the consolidated group (e.g., single member LLCs). In addition, a single Form 3115 could be filed for one or more controlled foreign corporations (CFCs) wholly owned by a consolidated group, but that

Form 3115 could not also include U.S. entities or U.S. trades or businesses.

Including multiple applicants on a single Form 3115 is beneficial because it reduces the number of Forms 3115 required to be filed and results in reduced user fees for taxpayers filing a change in method of accounting under the advance consent procedures of Rev. Proc. 97-27. In general, taxpayers requesting a change in method of accounting under Rev. Proc. 97-27 must include a user fee check in the amount of $7,000. The user fee, however, is reduced to $150 for each additional applicant seeking the identical change in method of accounting on the same Form 3115 after the $7,000 has been paid for the first applicant. However, prior to Rev. Proc. 2014-1, corporate structures that included lower-tier partnership(s) were prohibited from filing a single Form 3115 for identical items, and were required to pay a minimum user fee of $7,000 for each Form 3115 that was filed for a partnership. Similarly, consolidated groups with CFCs were prohibited from including such CFCs in a single Form 3115 even if the consolidated group and the CFCs were requesting to change to and from identical methods of accounting.

Section 15.07(4) of Rev. Proc. 2014-1 makes significant modifications to the annual revenue procedure by allowing the common parent of a consolidated group to be eligible for reduced user fees when requesting an identical change in method of accounting on a single Form 3115, for two or more of the following in any combination:

(a) members of the consolidated group;

(b) separate and distinct trades or businesses of the consolidated group (e.g., single member LLCs);

(c) partnerships that are wholly-owned within the consolidated group; or

(d) CFCs and noncontrolled Section 902 (10/50) corporations where (i) all controlling U.S. shareholders of the CFCs and all majority domestic corporate shareholders of the 10/50 corporations, as applicable, are members of the consolidated group; or (ii) the taxpayer is the sole controlling U.S. shareholder of the CFCs or the sole domestic corporate shareholder of the 10/50 corporation.

Although these modifications apply to advance consent accounting method changes, it appears that the updates also extend to automatic accounting method changes filed under Rev. Proc. 2011-14. Taxpayers filing a Form 3115 under Rev. Proc. 2011-14 are referred to Section 15.07(4) of Rev. Proc. 2011-1 (or successor) to determine which entities or trades or businesses may be included on a single Form 3115 when requesting to change identical methods of accounting. As a result, taxpayers requesting automatic consent to change their method of accounting for multiple applicants within a consolidated group should be able to rely on the modifications to Rev. Proc. 2014-1 to include additional entities or trades or businesses on a single Form 3115.

Additional IRS guidance

IRS rules consent not required to change depreciation method of accounting for domestic earnings and profits

In PLR 201410029, the IRS ruled that the consent of the Secretary is not required for a taxpayer to make a change in method of accounting for depreciation for purposes of determining its domestic earnings and profits (E&P) under Section 312 after the taxpayer changed its method of accounting for U.S. federal income tax purposes for the same assets under Sections 446(e) and 481(a). Rather, the IRS ruled that correlative adjustments were required in computing depreciation of such assets for E&P purposes. Moreover, because the taxpayer was required to take into account the Section 481(a) adjustment arising from the change in method of accounting for depreciation for U.S. federal income tax purposes, the taxpayer should take the

correlative adjustments arising from the change in computing depreciation for E&P purposes over the same period of time.

In the ruling, a common parent of an affiliated group of corporations that file a consolidated U.S. federal income tax return filed a Form 3115 to change the method of accounting for itself and certain subsidiaries for depreciation of certain property for U.S. federal income tax purposes. Under the taxpayer's present method accounting, the taxpayer classified certain property placed in service after 1986 as 5-year property under the general depreciation system (GDS). For E&P purposes, the taxpayer depreciated such property under the alternative depreciation system (ADS) using a 9-year recovery period. Further, the taxpayer classified and depreciated certain other property placed in service after 1980 and before 1987 as 5-year property under the Accelerated Cost Recovery System (ACRS). For E&P purposes, the taxpayer depreciated this property placed in service after 1980 and before 1987 using a 12-year recovery period.

The taxpayer requested permission to change its method of accounting for certain property placed in service after 1986 to depreciate such property as non-residential real property over a GDS 39-year recovery period, using the straight-line method and mid-month convention. In computing its E&P, the taxpayer is required to depreciate such property as non-residential real property, over an ADS 40-year recovery period, using the straight-line method and mid-month convention. Similarly, the taxpayer requested permission to change the method of accounting for certain property placed in service after 1980 and before 1987 to depreciate such property as 15-year, 18-year, or 19-year real property, as applicable under ACRS. For E&P purposes, the taxpayer is required to depreciate such property using either a 35-year or 40-year recovery period.

The taxpayer requested a ruling regarding whether a change in computing depreciation for E&P purposes is a change in method of accounting under Sections 446 and 481(a) that requires independent consent from the Secretary. The IRS ruled that, when a change in a taxpayer's method of accounting for depreciation for U.S. federal income tax purposes under Sections 446(e) and 481(a) requires a correlative change in computing depreciation for E&P purposes under Section 312(k), independent consent of the Secretary is not required to make a change in method of accounting for depreciation for E&P purposes. In doing so, the IRS acknowledged that the taxpayer's request to change its method of accounting for depreciation for U.S. federal income tax purposes will suffice for both purposes. In addition, citing Rev. Proc. 79-47, the IRS ruled that any correlative adjustments arising from the change in computing depreciation for E&P purposes under Section 312(k) are taken into account over the same period of time as the related Section 481(a) adjustment for U.S. federal income tax purposes.

It is important to note that this PLR addresses a change in method of accounting for domestic E&P as opposed to foreign E&P. Taxpayers seeking to change their method of accounting for foreign E&P (as computed under section 964) must request the consent of the Secretary (i.e., file a Form 3115) to change such method as required under the section 964 regulations.

Lawsuit settlement liabilities were deductible business expenses

The IRS ruled in PLR 201412002 that a taxpayer's payment of liabilities incurred to settle a securities lawsuit, including legal fees and other expenses attributable to the lawsuit, were deductible as ordinary and necessary business expenses under Section 162.

In this case, the taxpayer and a target corporation entered into a merger agreement under which the taxpayer acquired all of the target corporation's outstanding stock in a stock-for-stock transaction. Following litigation proceedings against the taxpayer and target corporation for alleged misrepresentations and omissions in certain transaction related disclosures, the taxpayer made settlement payments to settle all claims against the taxpayer and target corporation. The ruling that was requested

was whether the taxpayer's settlement payments, as well as legal and other expenses attributable to the lawsuit, were deductible under Section 162 as ordinary and necessary business expenses, or were required to be capitalized under Section 263(a).

An expenditure is generally deductible under Section 162 if it is (i) paid or incurred during the taxable year; (ii) sustained in carrying on a trade or business; (iii) an expense; (iv) a necessary expense; and (v) an ordinary expense. See e.g., *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345, 352 (1971). However, the regulations under Section 263(a) require amounts paid or incurred in connection with certain transactions to be capitalized, rather than immediately deducted. Specifically, Treas. Reg. § 1.263(a)-5(a) provides, in pertinent part, that a taxpayer must capitalize amounts paid to facilitate certain business acquisition or reorganization transactions, which include a merger.

A business expense, however, is not converted into a capital expenditure merely because the amount paid is incurred in connection with a reorganization or other capital transaction. Rather, a taxpayer must consider the nature of the expenditure and determine the origin and character of the claim for which the expenditure was incurred. As such, the courts generally apply the "origin of the claim" doctrine to determine whether the expenditure was incurred for the acquisition, creation or disposition of a capital asset. The origin of the claim doctrine, as set forth by the Supreme Court in *U.S. v. Gilmore*, 372 U.S. 39, 47 (1963), considers the origin and character of the claim with respect to which the expense was incurred, not its potential consequences, in determining deductibility. As a result, if litigation arises from a capital transaction, any settlement costs and legal fees associated with such litigation would be characterized as acquisition costs, and therefore, capitalized under Section 263(a).

Relying on the origin of the claim doctrine, the IRS determined that the settlement payments, legal fees and other payments related to the manner in which, and the extent to which, the taxpayer informed its shareholders about certain aspects of the transaction in its securities filings. While the facts in the case involved a capital transaction, the plaintiff's claims were that the alleged misrepresentations and omissions harmed the value of their investment in the taxpayer following the transaction. The plaintiffs' claim did not challenge the validity of the merger transaction or the price of the merger. Rather, the claims in the litigation had their origin in the conduct of the taxpayer's ordinary and necessary business activities and did not otherwise facilitate a capital transaction. Accordingly, the IRS ruled that the underlying payments were deductible as ordinary and necessary business expenses under Section 162.

IRS concludes certain inventory not eligible for the enhanced charitable contribution deduction

In a Chief Counsel Advice (CCA 201414014), the IRS concluded that a corporation's donation of certain grooming and hair products did not qualify for the enhanced charitable contribution deduction under Section 170(e)(3).

The taxpayer, a corporation, donated various hair care and grooming products such as soaps, shampoos, conditioners, wrinkle creams, hair gels, perfumes, nail polishes, etc. to an organization described under Section 501(c)(3). The tax-exempt charitable organization acknowledged the receipt of such products and provided the taxpayer with several letters that included representations required under Section 170(e)(3) to be eligible to claim the enhanced deduction. While the IRS did not challenge the eligibility of soaps, shampoos and conditioners as "qualified donations" under Section 170(e)(3), it did challenge the eligibility of wrinkle creams, hair gels, perfumes, hair sprays, hair texturizers, curling irons, hair dyes, nail polishes, epilators, and hair restoration treatments (Donated Products) on the basis that such products are not needed for the care of the ill, the needy, or infants under Section 170(e)(3)(A)(i).

In general, Section 170(a) allows a deduction for charitable contributions made within the taxable year. If the contributions are made in property other than money, the deduction is equal to the fair market value (FMV) of the donated property at the time of such contribution. In the case of inventory, however, Section 170(e)(1) requires a reduction in the amount of the deduction, limiting it to the lesser of the FMV or the adjusted basis of the property.

Congress enacted Section 170(e)(3) in response to a decline in donations of food, clothing, medical equipment and supplies, and other necessary items for the needy and disaster victims. Under this section, taxpayers are allowed an enhanced deduction in the case of "qualified contributions" of inventory. A qualified contribution is a charitable contribution of property by a corporation to a tax-exempt organization if (i) the use of the property by the donee is related to the purpose or function constituting the basis for its exemption under Section 501 and the property is to be used by the donee solely for the care of the ill, the needy, or infants; (ii) the property is not transferred in exchange for money, other property, or services; (iii) the taxpayer receives a written statement from the donee representing that its use and disposition of the property is in accordance with (i) and (ii); and (iv) such property must satisfy the Federal Food, Drug, and Cosmetic Act regulations, if applicable.

Acknowledging that the taxpayer received the required documentation under Section 170(e)(3) from the charitable organization, the IRS analyzed whether the first requirement of the enhanced deduction was met. That is, whether the Donated Property was to be used by the donee solely for the care of the ill, the needy, or infants. The IRS requested a "detailed description of the care provided or the existing need or needs that are alleviated or satisfied" by the Donated Products. In response, the taxpayer stated only that that "the Donated Products allow the charity to carry out its charitable purpose." However, contributions of goods that allow a charity to carry out its charitable purpose but are not needed for the care of the ill, needy or infants do not qualify for the enhanced deduction.

In the CCA, the IRS examined whether the Donated Products met the requirement of caring for the ill, the needy, or infants by looking to the definitions of "care of the ill," "care of an infant" and "care of the needy" under the regulations. In concluding that the Donated Products were not needed for the care of the ill, the IRS stated that the Donated Products were not medical in nature, did not serve a medical purpose, and did not alleviate or cure an existing illness. Likewise, the IRS concluded that the Donated Products did not satisfy a bona fide need of infants. Finally, with respect to care of the needy, a needy person is defined as a person who lacks the necessities of life, involving physical, mental, or emotional well-being, as a result of poverty or temporary distress. Care of the needy must relate to the particular need that causes the person to be needy because a person may be needy in some respects and not needy in other respects. In the view of the IRS, the Donated Products did not alleviate or satisfy a "necessity of life" of a needy person, such as the need for food, clothing, or shelter (or other basic needs). A person who cannot afford the donated products may be needy, but the donated products do not relate to the specific need that caused the person to be needy. According to the IRS, the Donated Products were "luxury items," rather than necessities of life. As such, the IRS concluded that the taxpayer was not eligible to claim the enhanced deduction under Section 170(e)(3) for the Donated Products.

Self-insured taxpayer's legal fees do not qualify as specified liability losses

In a recent Field Attorney Advice (FAA 20141002F), the IRS rejected a taxpayer's argument that certain legal fees and other expenses incurred in connection with contesting and investigating workers compensation claims qualified as specified liability losses (SLLs) under Section 172(f).

In this case, the taxpayer sustained a net operating loss (NOL) that included deductions for workers compensation benefits and costs associated with workers

compensation benefits. The taxpayer claimed that the applicable portion of the NOL may be carried back as a SLL under Section 172(f). The IRS issued a Notice of Proposed Adjustment (NOPA) disallowing SLL treatment for deductions claimed in connection with contesting or investigating workers compensation claims in various states.

Section 172(a) generally allows as a deduction for a taxable year an amount equal to the aggregate of (1) the NOL carryovers to such year, plus (2) the NOL carrybacks to such year. Under Section 172(b)(1)(A), a NOL for any taxable year is carried back two years and carried forward to each of the 20 taxable years following the year of the loss.

Section 172(b)(1)(C), however, provides a special rule in the case of SLLs allowing such losses to be carried back up to 10 years. Section 172(f) defines a SLL as, among other things, a deduction taken into account in computing the NOL for the taxable year which is paid in satisfaction of a liability under a Federal or State law requiring a payment under any workers compensation act. In addition to the Federal and State law requirement, the act (or failure to act) giving rise to such liability must occur at least three years before the beginning of the taxable year.

In the FAA, the taxpayer argued that the legal fees and other costs incurred in contesting or investigating workers compensation claims were required to be paid under each state's workers compensation laws. As a result, such costs satisfied the requirement under Section 172(f) and were properly treated as SLLs. The Associate Area Counsel disagreed that such amounts were required under the applicable state law based on an analysis of each state's workers compensation act. In addition, even if the taxpayer established that such expenses were required under each state's respective workers compensation act, the IRS found in the FAA that the taxpayer had not established that the acts or failures to act which gave rise to the liabilities for legal fees and other expenses occurred at least three years before the beginning of the period in question. As a result, the IRS concluded that the legal fees and other expense liabilities may not be treated as SLLs. Similarly, the IRS rejected the taxpayer's argument that treating the legal fees and administrative costs as SLLs would place self-insured employers such as the taxpayer on "equal footing" with employers who purchase workers compensation insurance because employers who purchase workers compensation insurance generally are not entitled to SLL treatment for the premiums.

Let's talk

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