

Recent IRS developments and court rulings provide guidance on tax accounting issues



In this month's Accounting Methods Spotlight our readers receive brief highlights on the recently released final tangible property 'repair' regulations, the refundable AMT credit, and the 2013-2014 IRS Priority Guidance Plan. This month's issue also discusses a recent industry director directive on the Section 199 'benefits and burdens' test, IRS' Action on Decision not to acquiesce in a Tax Court ruling on forbearance payments, a field attorney advice on the abandonment loss deduction, and a revenue procedure clarifying income deferral rules for gift cards. In addition, this month's issue takes a look at a court decision on whether there was a transfer of goodwill in a radio station like-kind exchange and a taxpayer's petition to the Tax Court for redetermination of a tax deficiency related to the issuance of warrants.

Did you know..?

IRS releases long-awaited final tangible property 'repair' regulations

The IRS released final tangible property 'repair' regulations under Sections 162(a) and 263(a), regarding the deduction and capitalization of expenditures related to tangible property. The final regulations

replace temporary regulations that were issued in December 2011. Also released were proposed regulations under Section 168 regarding dispositions of tangible depreciable property. Collectively, these regulations will affect every taxpayer that acquires, produces, improves, or disposes of tangible property, especially those that previously filed a related accounting method change.

With the release of the final repair regulations, taxpayers should reevaluate their current methods of accounting related to tangible property to determine if they are in compliance with the new rules. While certain aspects of the final regulations may yield favorable results, other aspects could yield less favorable results. It is expected that the IRS will issue revenue procedures in the coming weeks that will describe how taxpayers may change their methods of accounting to implement the final regulations.

Refundable AMT credit reduced due to sequester

On August 12, the IRS unexpectedly announced on its website that the refundable corporate alternative minimum tax (AMT) credit under Section 168(k)(4) would be reduced by 38 percent as part of required spending cuts due to the sequester. The reduction is effective for original or amended returns filed between August 13 and September 30 (the end of the government's fiscal year). A Section 168(k)(4) election can be made to accelerate the use of prior-year AMT credits in lieu of taking bonus depreciation. Corporations making the Section 168(k)(4) election to claim a refund of prior-year AMT credits will be notified by the IRS that a portion of their refund will be reduced by the sequester amount. These companies should consider the financial accounting implications of the reduction in the refundable credit. Going forward, companies also should consider whether they want to make a Section 168(k)(4) election or elect out of Section 168(k)(4) for Round 3 extension property in light of the recent reduction. The sequestration rate, and related cut in refundable AMT credit, is subject to change after September 30 depending on congressional action.

Treasury and IRS publish 2013-2014 Priority Guidance Plan

On August 9, 2013, the IRS released its 2013-2014 Priority Guidance Plan, which includes 22 tax accounting projects that are priorities for the plan year ending June 2014. This year's plan addresses a variety of tax accounting issues, including a few projects unique to specific industries.

While most of these items have been carried over from previous business plans, some of the more significant guidance plan projects include:

- Final regulations under Section 263A regarding the inclusion of negative amounts in additional Section 263A costs. Proposed regulations were published on September 5, 2012.
- Final regulations under Sections 263A and 471 regarding sales-based royalties and sales-based vendor allowances. Proposed regulations were published on December 17, 2010.
- Regulations under Section 451 regarding advance payments received for goods and services, including amounts received in exchange for the sale or issuance of gift cards, trading stamps, and loyalty points that can be redeemed for goods or services.
- Guidance regarding the treatment of deferred revenue in taxable asset sales and acquisitions.
- Final regulations amending Section 1.471-8 regarding the treatment of vendor allowances under the retail inventory method. Proposed regulations were published on October 7, 2011.
- Regulations under Section 199 relating to computer software.

Other guidance

IRS seeks to reduce uncertainty in meeting Section 199 'benefits and burdens' test

The IRS Large Business and International Division (LB&I) recently issued an industry director directive, LB&I-04-0713-006 (the Directive) to LB&I examiners for use in determining whether a taxpayer has the benefits and burdens of ownership (B&B) of qualifying production property, qualified films, or utilities produced under a contract manufacturing arrangement for purposes of Reg. Sec. 1.199-3(f)(1). The Directive, which supersedes LB&I's 2012 directive, is intended to further simplify and

streamline what has been one of the most difficult and controversial issues under Section 199 for taxpayers and the IRS. The Directive is effective for all Section 199 open tax years.

The Directive instructs LB&I examiners to request three statements from a taxpayer, described below, for each contract. The Directive states that if a taxpayer provides all three statements, then the examiner should not challenge the taxpayer's claim that it has the B&B for purposes of Section 199 with respect to each qualifying property on which a qualifying activity is performed under the contract manufacturing arrangement. Taxpayers that do not, or cannot, meet those requirements are subject to regular audit procedures.

Under the Directive, an LB&I examiner should request the following three statements:

1. An explanation of the basis for the taxpayer's determination that it had the B&B in the year or years under examination.
2. Certification statement signed by the taxpayer.
3. Certification statement signed by the counterparty.

The B&B statement, along with the two certification statements, should be provided to the examiner within 30 days after an information document request is issued to the taxpayer with respect to the Section 199 deduction. If the B&B determination is under examination as of the release date of the Directive (July 14, 2013), then the B&B statement and the two certification statements should be provided to the examiner within 60 days of the date of the Directive.

The Directive represents another attempt by the IRS to help resolve the numerous Section 199 examinations involving B&B. By allowing the parties to a contract manufacturing agreement to designate which party is eligible for the Section 199 deduction, the Directive reduces the uncertainty underlying a Section 199 deduction involving contract manufacturing arrangements and simplifies the B&B analysis required to support a Section 199 claim. At the same time, it remains to be seen whether, and how many, taxpayers can obtain the requisite certifications to avail themselves of the Directive.

IRS won't acquiesce in Tax Court decision on forbearance payments

In Action on Decision (AOD) 2012-08, the IRS stated that it would not acquiesce to the Tax Court's decision in *Media Space, Inc. v. Commissioner*, 135 T.C. 424 (2010), *vacated*, 477 Fed. Appx. 857 (2nd Cir. 2012), which concluded that a taxpayer's forbearance payments to preferred shareholders to forgo their redemption rights were business expenses under Section 162. Instead, the IRS will hold that forbearance payments are required to be capitalized under Section 263(a) and do not qualify for the 12-month rule under Reg. Sec. 1.263(a)-4(f)(1).

In *Media Space*, the taxpayer issued shares of preferred stock shortly after its incorporation that included redemption rights for the shareholders. In 2004, the taxpayer entered into several forbearance agreements (each for 12 months or less) under which the preferred shareholders agreed to forgo their redemption rights in exchange for payments (forbearance payments). The taxpayer reported the 2004 payments as interest expense and the 2005 payments as ordinary and necessary business expenses, but the IRS disallowed both deductions. Upon bringing the issue to the Tax Court, the court first characterized the forbearance payments as Section 162 business expenses and found that the 2004 payments were not required to be capitalized. Even though the court found that the 2005 payments were required to be capitalized under Section 263(a), it concluded that the payments qualified for the 12-month rule under Reg. Sec. 1.263(a)-4(f)(1) because the terms of the forbearance agreements were 12 months or less.

When the IRS appealed the Tax Court's decision, the taxpayer conceded that the 2004 payments were required to be capitalized under Section 263(a); therefore, the Second

Circuit dismissed the appeal. Even though the taxpayer ultimately conceded the issue, the IRS issued this AOD in order to make clear that it would not acquiesce to the Tax Court's analysis. The position of the IRS is that forbearance payments must be capitalized and do not qualify for the 12-month rule because they are amounts paid to 'create' a 'financial interest.' While the Tax Court argued that the payments effected a modification rather than a creation, the IRS believes that the court read the word 'create' too narrowly; therefore, the IRS will maintain its position and continue to litigate the issue.

IRS concludes taxpayer is not entitled to abandonment loss deduction

In FAA 20133101F, the IRS concluded that a taxpayer was not entitled to an abandonment loss deduction for costs incurred as part of a proposed public stock offering because although the planned stock offering was terminated, the taxpayer did not abandon the stock offering as part of its plan of reorganization.

The taxpayer adopted a plan of reorganization pursuant to which ownership interests would be sold through a public stock offering. The taxpayer filed a Form 8-K, as well as a Form S-1, with the Securities and Exchange Commission (SEC). However, the taxpayer's board of directors subsequently suspended the stock offering, causing the taxpayer to file another Form 8-K indicating that the company had "postponed its stock offering." The taxpayer then adopted a new plan of reorganization, and a new Form 8-K and Form S-1 were filed with the SEC. The taxpayer also issued a press release stating that the new stock offering plan was structurally and formulaically similar to the first stock offering plan, with certain quantitative differences.

After adopting the second stock offering plan, the taxpayer formally terminated the first stock offering plan. The taxpayer then deducted the costs incurred in connection with the first stock offering plan, indicating that none of the expenses would have any carryover benefit and that the taxpayer would incur them again during the second stock offering plan.

The taxpayer maintained that it was entitled to a deduction under Reg. Sec. 1.165-2(a), which provides that a loss in a business transaction that is terminated "shall be allowed as a deduction under Section 165(a) for the taxable year in which the loss is actually sustained." According to the taxpayer, its actions to cancel subscriptions, return subscription funds and file a new Form 8-K demonstrated its intent to abandon the plan. In addition, the taxpayer argued that even if the first stock offering plan was deemed abandoned when it was formally terminated, the deduction was properly taken in the year the losses were sustained.

The IRS disallowed the taxpayer's deduction citing Rev. Rul. 73-580, 1973-2 CB 86, which held that restructuring costs that can otherwise be capitalized under Section 263(a) are generally deductible under Section 165(a) only when the proposed transaction is abandoned. The IRS also cited *Sibley, Lindsay, & Curr Co v. Commissioner*, 15 T.C. 106 (1950), in which the Tax Court held that if a taxpayer investigates and pursues multiple separate transactions, costs that can be properly allocated to any abandoned transactions are deductible even if some transactions are completed. However, if a taxpayer considers two or more mutually exclusive alternatives to a single transaction, no abandonment loss is proper unless the entire transaction is abandoned. Thus, the IRS concluded that the cost of pursuing any alternatives not consummated must be capitalized as part of the cost of the completed alternative, citing *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001).

The IRS concluded in the taxpayer's case that the first and second stock offering plans were mutually exclusive alternatives to a single transaction. As a result, the costs incurred in connection with the first stock offering plan must be capitalized as part of the second stock offering plan.

IRS clarifies income deferral rules for gift cards

In Rev. Proc. 2013-29, the IRS clarified that advance payments received from the sale of gift cards redeemable by unrelated entities generally qualify for deferral from gross income under the provisions of Rev. Proc. 2004-34.

Rev. Proc. 2004-34 allows taxpayers a limited deferral beyond the tax year of receipt for certain advance payments. A qualifying taxpayer generally may defer inclusion of advance payments in gross income for federal income tax purposes to the next succeeding tax year to the extent the advance payments are not recognized in revenues in its 'applicable financial statement' for the year of receipt or, if the taxpayer does not have an applicable financial statement, to the extent the revenue is earned in a subsequent tax year.

Prior to 2011, there was uncertainty as to the ability of taxpayers utilizing separate legal entities apart from the retailer to issue gift cards, operating gift card programs through franchisee networks, or belonging to a consolidated group in which one member sold gift cards could qualify for deferral under Rev. Proc. 2004-34. After receiving numerous comments on the issue, the IRS concluded that, provided the other requirements of Rev. Proc. 2004-34 are met, a taxpayer that sells gift cards redeemable through other entities should be allowed the same treatment as a taxpayer that sells gift cards that are redeemable only by itself. As a result, Rev. Proc. 2011-18 modified the provisions of Rev. Proc. 2004-34 by adding a new category of eligible advance payment ('eligible gift card sales') that allowed gift cards to be redeemable by the taxpayer or by any other entity.

While Rev. Proc. 2011-18 modified Rev. Proc. 2004-34 to include 'eligible gift card sales' as an eligible category of advance payments, it did not change the requirement under Rev. Proc. 2004-34 that the advance payment must be included in revenue in the taxpayer's applicable financial statement in a subsequent tax year, or in the case of a taxpayer without an applicable financial statement, the payment must be earned by the taxpayer in a subsequent tax year.

Rev. Proc. 2013-29 clarifies the definition of 'eligible gift card sales' provided in Rev. Proc. 2011-18 by adding that, for purposes of Section 4.01(2) of Rev. Proc. 2004-34, if a gift card is redeemable by an entity whose financial results are not included in the taxpayer's applicable financial statement, then the payment is treated as recognized by the taxpayer in revenues of its applicable financial statement to the extent the gift card is redeemed by the entity during the tax year. The same rule applies for taxpayers without an applicable financial statement. The modification is effective as of the effective date of Rev. Proc. 2011-18, which is for tax years ending on or after December 31, 2010.

Cases

Claims Court finds no transfer of goodwill in radio station like-kind exchange

In *Deseret Management Corp. v. United States*, Fed. Cl., No. 1:09-cv-00273-FMA (7/31/2013), the U.S. Court of Federal Claims held that no appreciable goodwill was transferred in an exchange of two radio stations for purposes of the like-kind exchange provisions under Section 1031.

KZLA was a Los Angeles radio station acquired by subsidiaries of Deseret Management Corporation (Deseret) in 1998. KZLA was the only country FM station in the city at the time. From 1998 to 2000, Deseret's subsidiaries owned and operated the radio station but achieved less than desirable success in the market. KZLA's revenue declined from \$17.25 million in 1998 to \$16.4 million in 2000, at a time when the Los Angeles market was experiencing an annual 12 percent increase in revenue on average.

In 2000, Deseret and Emmis Communications entered into a transaction to exchange the assets of KZLA and four St. Louis radio stations. The transaction was valued at

\$185 million, most of which consisted of the Federal Communications Commission (FCC) license (according to Deseret's valuation). Under the like-kind exchange provisions of Section 1031, a taxpayer must recognize gain to the extent of fair market value of any nonqualifying property exchanged, including goodwill. The taxpayer argued that KZLA contained no appreciable goodwill, while the IRS argued that the FCC license was overvalued and nearly \$75 million of goodwill was involved, resulting in additional tax due on the exchange.

KZLA benefitted from some competitive advantages due to its licenses. There were 40 FM radio stations licensed to be broadcast in Los Angeles, but only 14 were licensed (including KZLA) to transmit from antennas located on Mt. Wilson, which is the most elevated peak near Los Angeles and allows more broadcast coverage of FM signals. KZLA also enjoyed the advantage of being one of 17 grandfathered FM stations exempt from FCC restrictions that limit the amount of power used to broadcast signals from elevated antenna locations.

In its analysis of whether KZLA's value included goodwill, the Federal Claims Court first looked at the definition of goodwill. Because goodwill is not defined in Section 1031 or its regulations, the court looked to Section 197, which defines goodwill as "the value of a trade or business attributable to the expectancy of continued customer patronage" under Reg. Sec. 1.197-2(b)(1).

The court then considered prior case law involving broadcast stations to evaluate both the qualitative and quantitative aspects of goodwill. The court disagreed with the taxpayer that broadcast stations such as KZLA can *never* possess any goodwill. The court found a few qualitative indications that KZLA may have possessed some goodwill, although far less than other stations. For example, the court explained that there was likely to be some loyalty from listeners and advertisers because KZLA was the only country FM station in Los Angeles, even though its 'brand depth' and 'music image' were underdeveloped.

To determine whether the goodwill was appreciable, the court then looked at quantitative evidence. The court looked for whether there was "some residual cost over the fair value of the identifiable net assets acquired." While the taxpayer did not find any goodwill in KZLA, the IRS's expert used a discounted cash flow method to determine the value of the license and goodwill. However, the court was not convinced that the IRS's expert opinion was reliable because the calculations were adjusted multiple times due to errors, and the assumptions were questionable. Additionally, if the method was completely corrected for all errors, the court determined it would have yielded a value for KZLA's goodwill of below zero. In conclusion, the court found that because there was no dispute that KZLA was valued at \$185 million and that value lied almost exclusively in its FCC license, the value of any goodwill remaining would be 'negligible and insignificant.'

Taxpayer petitions Tax Court for redetermination of tax deficiency

In *Google Inc. v. Commissioner*, No. 14061-13, the taxpayer filed a petition with the Tax Court for a redetermination of the IRS's finding that the taxpayer owed an additional \$83.5 million in tax because it was not entitled to a deduction on its 2004 tax return relating a stock warrant issued to America Online, Inc. ("AOL").

The taxpayer is a U.S. corporation and parent of a consolidated group. On June 3, 2002, the taxpayer issued a stock warrant to AOL (the AOL Warrant), an independent contractor to the taxpayer. The AOL Warrant provided AOL the right to purchase a specific number of shares of the taxpayer's Series D Preferred Stock, at a certain purchase price per share. The taxpayer issued the AOL Warrant in connection with services to be performed by AOL.

According to the taxpayer, at the time of issuance of the AOL Warrant, it was unknown whether AOL would ever exercise the AOL Warrant, and it was possible that the AOL Warrant could expire and be worthless. However, AOL exercised the warrant on May 3, 2004, the point when the taxpayer claims its actual cost for issuing the AOL

Warrant became known. The taxpayer states that its actual cost for issuing the AOL Warrant was \$238,667,835, which is the spread between the amount it received from AOL to exercise the warrant and the value of the property as of May 3, 2004.

Based on these facts, the taxpayer took a deduction for the AOL Warrant on its 2004 federal income tax return. However, the IRS denied the deduction and issued a notice of deficiency. The taxpayer argues that it was entitled to a deduction pursuant to Sections 83(h) and 162 because AOL, which performed certain services and refrained from performing certain services in connection with the transfer of the AOL Warrant, was required, upon exercising the AOL Warrant, to recognize gross income equal to the spread between the amount it received from Google to exercise the warrant and the value of the property as of May 3, 2004.

The taxpayer argues that the all events test with respect to the AOL Warrant was satisfied when AOL exercised the AOL Warrant on May 3, 2004. The taxpayer also argues that it did not transfer the AOL Warrant as a capital expenditure and that the AOL Warrant expense was an ordinary and necessary expense that was incurred in carrying on its trade or business. As a result, the taxpayer argues that the requirements of Section 461 and the regulations thereunder with respect to the AOL Warrant expense were satisfied when AOL exercised the AOL Warrant.

Therefore, the taxpayer petitioned the Tax Court to determine that the IRS erred in its denial of the taxpayer's deduction and that there is no deficiency in income tax with respect to petitioner's 2004 tax year. The Tax Court has not ruled on the matter.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Adam Handler, Los Angeles
+1 (213) 356-6499
adam.handler@us.pwc.com

Jennifer Kennedy, Washington, DC
+1 (202) 414-1543
jennifer.kennedy@us.pwc.com

George Manousos, Washington, DC
+1 (202) 414-4317
george.manousos@us.pwc.com

Annette Smith, Washington, DC
+1 (202) 414-1048
annette.smith@us.pwc.com

Dennis Tingey, Phoenix
+1 (602) 364-8107
dennis.tingey@us.pwc.com

Christine Turgeon, New York
+1 (646) 471-1660
christine.turgeon@us.pwc.com

James Martin, Washington, DC
+1 (202) 414-1511
james.e.martin@us.pwc.com

© 2013 PricewaterhouseCoopers LLP. All rights reserved. In this document, PwC refers to PricewaterhouseCoopers (a Delaware limited liability partnership), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors