New legislative developments, IRS and court rulings provide guidance on tax accounting method issues

In this month's issue, you will receive insight on recent IRS exam activity that highlights potential Section 263A issues as well as the AICPA's comments on proposed regulations relating to negative additional Section 263A costs. In addition, we have included discussions on: permanent extension of bonus depreciation approved by the House of Representatives; and an IRS determination that ceasing treatment as options constitutes a change in accounting method. This month's issue also discusses the U.S. Tax Court's recent ruling to deny a partnership's charitable contribution deduction for conservation easements.

Did you know..?

Recent IRS exam activity highlights potential Section 263A issues; AICPA comments on proposed regulations on negative additional Section 263A costs

Section 263A (or "UNICAP") generally provides that taxpayers that either (1) produce real or tangible personal property, or (2) acquire real or personal property for resale must capitalize direct and indirect costs allocable to such property. The costs required to be capitalized for federal income tax purposes rarely will match the costs required to be capitalized under the taxpayer's method of accounting for financial statement purposes, thus giving rise to book-tax differences in the determination of cost of ending inventory and the basis of self-constructed assets. Recent developments relating to Section 263A could have widespread implications for companies with respect to these book-tax differences, as well as related cash taxes and deferred taxes.

Recent IRS exam activity addresses Section 263A issues related to intercompany inventory sales

Taxpayers that transfer goods or property between members of a consolidated group must consider the impact of Section 263A in determining the intercompany profit attributable to such transfers. Corporations filing a consolidated return are subject to the consolidated return regulations under Section 1502, which provide rules for taking into account items of income, gain, deduction, and loss arising from intercompany transactions. Under the rules, intercompany gain or profit generally must be deferred at the time of the intercompany transaction and then later taken into account under the 'matching' and 'acceleration' provisions. One of the more common 'matching' events occurs when the property is sold outside the consolidated group.

The regulations provide that the seller must include related costs or expenses when determining its intercompany income, gain, deduction, or loss. Thus, when a corporation that is subject to Section 263A sells goods to a member of the same consolidated group, and those goods remain in the purchaser's inventory at the end of the tax year, the seller's capitalized additional Section 263A costs related to the goods sold must be taken into account when calculating the deferred intercompany profit on the sale of such goods. The Section 263A costs capitalized to the cost of those goods will generate a difference between the amount of intercompany profit eliminated for financial accounting purposes and the amount of deferred intercompany profit for tax purposes.

The IRS has raised questions related to the impact of Section 263A on deferred intercompany profit in recent examinations. For example, the IRS identified an issue relating to additional Section 263A costs in ending inventory as a result of intercompany purchases between a sourcing company and a related reseller. An adjustment reflecting a reduction of the deferred intercompany profit eliminated was proposed at the sourcing company, resulting in additional taxable income. On another occasion, an agent required the capitalization of additional Section 263A costs incurred at a warehousing entity to inventory sold to a related retail entity.

In light of this recent IRS examination activity, taxpayers subject to Section 263A with sales of goods or property between members of a consolidated group should review their existing method of accounting for calculating the amount of deferred intercompany profit from such sales to determine whether a change in method of accounting for intercompany transactions may be required. If necessary, such a change in method generally will be effected prospectively on a cut-off basis (that is, without a Section 481(a) adjustment). Nonetheless, a taxpayer secures audit protection upon filing Form 3115, Application for Change in Accounting Method, to change its method of accounting for intercompany profit. The IRS then is precluded from proposing an adjustment to intercompany profit for UNICAP for a tax year prior to the year of change.

AICPA comments on proposed regulations regarding negative additional Section 263A costs

The AICPA in a letter dated February 25, 2014, recommended significant changes to the proposed regulations issued under Section 263A under which a taxpayer generally would not be permitted to include "negative amounts" in additional Section 263A costs if the taxpayer uses the simplified production method (SPM).

Under the current regulations, taxpayers may use simplified methods to allocate direct and indirect costs to eligible property produced or acquired for resale. Under the simplified production method (SPM), additional costs allocable to eligible property remaining on hand at year end are computed by applying an absorption ratio to total "Section 471 costs" remaining on hand at year end. "Section 471 costs" represent the costs, other than interest, capitalized under the taxpayer's method immediately prior to the effective date of Section 263A (which typically are the costs capitalized for financial accounting purposes). Under the SPM, the absorption ratio applied to these costs is calculated by dividing the "additional Section 263A costs" incurred during the year by the Section 471 costs incurred during the year.

Additional Section 263A costs are costs, other than interest, required to be capitalized under Section 263A that were not capitalized under the taxpayer's method immediately prior to the effective date of Section 263A. Although additional Section 263A costs often are positive amounts, the AICPA highlighted several situations in which these costs may be negative. These situations include where particular costs are capitalized under Section 471 but not under Section 263A, such as pick-and-pack costs, and situations where unfavorable book-tax differences exist such as related to pensions, accrued bonuses, vacation pay, stock options, and depreciation. The broad applicability of these situations suggests that virtually every taxpayer will encounter negative additional Section 263A costs at one time or another.

Under the proposed regulations, large taxpayers are prohibited from including negative additional Section 263A costs in their calculations under the SPM. As a result, large producers may choose between the following options:

1. Continue using the SPM, but remove deductible section 471 costs from inventory using a reasonable method that approximates the manner in which the costs were originally capitalized;
2. Use a burden rate method, a standard cost method, or other reasonable facts-and circumstances method to allocate all additional section 263A costs; or
3. Use the proposed Modified Simplified Production Method (MSPM), under which the SPM formula would be split into two components: (1) a raw material turnover ratio (the preproduction absorption ratio) applied to raw materials (RM) (including the RM content of work-in-process (WIP) and finished goods (FG)), and (2) a labor and overhead turnover ratio (the production absorption ratio) applied to WIP and FG (excluding RM content). Taxpayers are permitted to include negative amounts in the numerator of both ratios.

The AICPA argued that none of these alternatives retains the simplicity that was intended in developing the SPM. They suggested that the final regulations should leave the SPM unchanged, allow taxpayers to include negative amounts in additional Section 263A costs, and permit the MSPM as an elective alternative to the SPM. However, should the IRS and Treasury conclude that negative amounts must be excluded from additional Section 263A costs, the AICPA proposed several modifications to the proposed regulations. The proposed modifications addressed various issues, the most significant of which relate to the MSPM and the definition of Section 471 costs.

With respect to the MSPM, while the AICPA agreed that the proposed MSPM generally results in fewer distortions and more accurately allocates additional Section 263A costs, they also noted that it would place a significant administrative burden on some taxpayers. There was concern that many taxpayers would not be able to use the proposed MSPM due to their inability to readily identify the RM content included in WIP and FG ending inventory. To lessen the administrative burden and ensure the MSPM is a viable option for taxpayers, the AICPA proposed that the final regulations allow taxpayers to use any reasonable method to estimate the RM content included in the respective inventory accounts.

The AICPA also proposed that a post-production absorption ratio be added to the MSPM. Under the proposed regulations, post-production costs, such as storage and handling costs for finished goods, would be considered in the production absorption ratio, which could result in distortions according to the AICPA. In addition, the MSPM, as currently proposed, could cause distortions in the allocation of additional section 263A costs to property produced under contract for a taxpayer and property purchased for resale by a taxpayer. To prevent these potential distortions, the AICPA suggested modifying the proposed MSPM by adding a post-production absorption ratio to allocate post-production additional Section 263A costs to finished goods in ending inventory. The AICPA concluded that using three ratios under the MSPM would give taxpayers the ability to more precisely allocate positive and negative amounts of additional Section 263A costs to the property benefitted by the costs within the framework of a simplified method.

With respect to the definition of Section 471 costs, the proposed regulations would modify the definition of Section 471 costs generally to be direct costs and costs, other than interest, that a taxpayer capitalizes in its financial statements. The AICPA recommended that the final regulations modify this definition by eliminating the requirement that all direct costs be treated as Section 471 costs regardless of their treatment for financial accounting purposes. In particular, the regulations should provide that only variances capitalized to ending inventory in a taxpayer's financial statements are treated as section 471 costs, and all other variances required to be capitalized under section 263A are treated as additional section 263A costs.

The AICPA believes that these proposed modifications, as well as their other suggested modifications, would help to reduce complexity and ensure consistency in the final regulations.

Legislative developments

House of Representatives approves permanent extension of bonus depreciation

On July 11, the House of Representatives voted 258 to 160 to approve a bill (H.R. 4718) to permanently extend and modify on a retroactive basis the Section 168(k) 50-percent bonus depreciation provision. H.R. 4718 also would extend the election to accelerate alternative minimum tax (AMT) credits in lieu of bonus depreciation. The Senate Finance Committee in early April approved a related 'tax extenders' bill (S. 2260) that would temporarily extend bonus depreciation and more than 50 other expired or expiring tax provisions on a retroactive basis through the end of 2015.

If enacted, H.R. 4718 would:

- Make permanent the 50-percent additional first-year depreciation deduction for qualified property. The bill also expands the definition of qualified property to include qualified retail improvement property.
- Index for inflation the $8,000 increase in the limitation on the depreciation deductions allowed with respect to certain passenger automobiles. The increase does not apply to a taxpayer who elects to accelerate AMT credits for a taxable year.
- Make permanent the special rule for the allocation of bonus depreciation to a long-term contract.
- Make permanent and modify the election to increase the AMT credit limitation in lieu of bonus depreciation.
- Provide that in the case of a partnership having a single corporate partner owning (directly or indirectly) more than 50-percent capital and profits interests in the partnership, each partner takes into account its distributive share of partnership depreciation in determining its bonus depreciation amount.
- Provide special rules for a taxpayer to claim bonus depreciation on trees or vines bearing fruits and nuts.

A July 10 White House statement said that the "Administration strongly opposes House passage of H.R. 4718," and indicated that President Obama would veto the bill if it were presented to him by Congress.

Congress must reconcile differences between the House and Senate before any final legislation can be sent to the White House for action by President Obama. It remains unclear whether Congress will include any permanent tax law changes in legislation addressing expired tax provisions. At the same time, House passage of a permanent bonus depreciation bill and Senate Finance Committee approval of a two-year temporary bonus depreciation extension increases the likelihood that the provision will be extended at least temporarily as part of any final legislation addressing expired tax provisions.

IRS guidance

IRS concludes ceasing treatment as options constitutes a change in accounting method

In CCA 201426025, the IRS concluded that a change in accounting method occurs when a taxpayer no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions. As a result, the computation and recognition of an appropriate adjustment under Section 481(a) is needed to eliminate any distortions caused by the accounting method change.

The taxpayer, a limited liability company that was treated as a partnership for federal income tax purposes, generally engaged in the daily trading of securities. A significant portion of the taxpayer's securities trading was conducted under various basket transactions in which the taxpayer would acquire a 'basket' of securities to be actively traded and managed by the taxpayer's affiliate. The transactions generally were financed by a bank, which paid 90 percent of the notional amount referenced in the transaction, with the remaining 10 percent covered by the taxpayer. The contract between the taxpayer and the bank described the taxpayer's investment as a "premium" that gave the taxpayer an "option" to receive a cash settlement amount from the bank when the contract expired or was otherwise terminated. The amount of the cash settlement was determined based on a formula that reflected the increase or decrease in the value of the securities. Under the taxpayer's established method of accounting, the transaction was treated as an option such that the recognition of any gains, losses, income, or deductions on the securities within the basket was deferred until the basket transaction expired or terminated. At that time, the taxpayer recognized gain or loss equal to the difference between the cash settlement amount and the amount of the initial 10 percent payment.

Section 446 and the corresponding regulations generally define the term "method of accounting" to include any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Case law generally has concluded that in determining whether timing is involved the relevant consideration is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the tax year in which taxable income is reported.

Under Section 446(b), the IRS has been granted broad discretion in determining whether a taxpayer's method of accounting clearly reflects income. Upon exam, an IRS agent may determine that a taxpayer's method of accounting is not permissible and propose an adjustment under Section 481(a) to make the change to a permissible method.

In the CCA, the IRS determined that the transactions lacked the necessary characteristics to be treated as options. Instead, the taxpayer was considered to have beneficial ownership in the underlying securities and should have recognized gains, losses, income and deductions as they arose as a result of trading the securities in the basket. The IRS proposed an adjustment to change the taxpayer's method of accounting for the basket transactions, claiming the change would impact the timing of taxable income, but would not change the total amount of taxable income recognized by the taxpayer over its lifetime. The new method proposed by the IRS provided for more current recognition of gains, losses, income, and deductions resulting from trading the securities, effectively eliminating any deferral under the previous method.

The taxpayer disputed the IRS's proposed adjustment, claiming that it would give rise to a permanent difference in lifetime taxable income because the taxpayer never intended to recognize the gains, losses, income, and deductions from the security transactions within the basket. The IRS refuted this argument noting that the taxpayer intended either to recognize the option gain or loss whenever a basket transaction ended, or to recognize such gain or loss inherently as part of the gains, losses, income, and deductions from trading the securities within the basket. Further, the proposed adjustment included a removal of the gain or loss recognized upon settlement of the basket transaction.

Therefore, the IRS asserted, in looking at the proposed adjustment in totality, it merely accelerated the timing of when the gains and losses were recognized, and thus was a change in method of accounting. The IRS also commented that the change in the character of the taxable income from a single gain or loss on an option transaction to several types of gains, losses, income, and deductions on individual securities transactions does not preclude the adjustment from being a change in the taxpayer's method of accounting.

Cases

Tax Court denies partnership's charitable contribution deduction for conservation easements.

In *Seventeen Seventy Sherman Street LLC et al. v. Commissioner*, T.C. Memo. 2014-124; No. 19686-11 (June 19, 2014), the US Tax Court held that a charitable contribution deduction could not be taken on contributed conservation easements where the taxpayer failed to prove that the fair market value of the easements exceeded the consideration received in the exchange.

The easements in question related to the El Jebel Shrine. In 2002, the taxpayer gained ownership of the shrine along with an adjacent lot used for parking. At that time, the shrine was a designated landmark with its primary intended use to serve as a cultural center, theater, and rental center for events. Zoning restrictions permitted the development of residential condominium units within the El Jebel Shrine but limited the commercial and residential development of the parking lot.

The taxpayer originally planned to develop the shrine's interior into condominiums. However, they later decided to build high rise condominiums on the vacant parking lot, which was restricted under the current zoning ordinance. In an effort to obtain a more favorable ordinance over the parking lot, the taxpayer sought to use the preservation of the El Jebel Shrine as leverage in negotiating with the city's development agency. An agreement was ultimately reached where the taxpayer would transfer interior and exterior conservation easements on the El Jebel Shrine to a designated charity, thus ensuring the preservation and rehabilitation of the shrine. In return, the city would approve changes to the designated use of the parking lot and provide a recommendation to the city's voting board to approve a variance allowing the taxpayer to build a structure on the parking lot up to 650 feet.

Under Section 170, a deduction is allowed for any charitable contribution for which payment is made within the taxable year. If the charitable contribution is made in the form of property other than money, the regulations prescribe that the amount of the contribution is equal to the fair market value of the property at the time of contribution. However, case law dictates that contributions of property generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return. Under the regulations, a taxpayer who receives goods or services in exchange for a contribution of property may still be entitled to a charitable contribution deduction if the taxpayer (1) makes a contribution that exceeds the fair market value of the benefit the taxpayer receives, and (2) makes the excess payment with the intention of making a gift. If these requirements are satisfied, the taxpayer is entitled to a deduction equal to the fair market value of the property transferred less the fair market value of the goods or services received.

The issue addressed was whether the taxpayer was entitled to a charitable contribution deduction for its contribution of the conservation easements on the El Jebel Shrine and, if so, what was the proper amount of the deduction. Additionally, the court addressed whether gross valuation or accuracy related penalties should apply.

In determining whether the easements should be considered a gift, the Court noted that the relevant inquiry was whether the transaction was structured as a quid pro quo exchange. The quid pro quo analysis generally requires two parts: (1) valuation of the contributed conservation easement and (2) valuation of the consideration received in the exchange. However, the Court noted that if the taxpayer failed to identify or value all of the consideration received in the transaction, then the taxpayer would have failed to comply with Section 170 and therefore would not be entitled to any charitable contribution deduction.

The taxpayer claimed that the only valuable consideration received in exchange for the contribution of the conservation easements was the approval of changes to the zoning ordinance for the designated use of the parking lot. The IRS contended that the city's recommendation to the voting board to approve the new variance that allowed the taxpayer to build a structure on the lot was also valuable consideration in the transaction. The taxpayer disputed this claim, saying that the development agreement was a divisible agreement and its obligation to contribute the easements was solely in exchange for the changes in the zoning ordinance. Further, the taxpayer noted that the approval of a variance like the one requested was exceedingly rare and there was significant doubt as to whether the city's recommendation would have any influence on the voting board.

The Court ruled in favor of the IRS, citing evidence that the taxpayer highly valued and negotiated for the city's recommendation to the voting board. They determined that the taxpayer committed to grant the easements in a quid pro quo exchange with the expectation that the city's recommendation would substantially increase the likelihood that the board would approve the new variance. Normally, in the case of a quid pro quo exchange, the taxpayer's potential deduction under the regulations is equal to the fair market value of the property transferred less the value of the consideration received in exchange. However, because the taxpayer failed to value all of the consideration it received, the court ruled they are not entitled to any charitable contribution deduction under Section 170 and the valuation of the easements is irrelevant. Finally, the Court upheld the IRS's assessment of accuracy related penalties, citing that the taxpayer acted negligently and did not make a reasonable attempt to ascertain the correctness of the charitable contribution deduction without adjusting the deduction for the total consideration received.

Let's talk

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