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Recent Developments in Tax Accounting

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Agenda

- Revised Accounting Method Change Procedures
- Expense Recognition
- Fines & Penalties
- Section 199
- Update on Tangible Property Regulations

Revised Accounting Method Change Procedures

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New Method Change Procedures

- Rev. Proc. 2015-13
  - Procedures for “automatic” and “non-automatic” consent method changes are now in one document.
    - Replaces Rev. Proc. 2011-14 and Rev. Proc. 97-27
  - Immediate effective date
    - New guidance applies to all Forms 3115 filed after January 16, 2015 for a year of change ending on or after May 31, 2014.
    - Transition guide - permit a taxpayer to file an automatic accounting method change under the superseded procedures in Rev. Proc. 2011-14 for a tax year ended on or after May 31, 2014, and on or before January 31, 2015.
- Rev. Proc. 2015-14
  - Contains all the available automatic changes
    - Replaces what was formerly the Appendix to Rev. Proc. 2011-14

What Has Changed?

- Shortened Section 481(a) adjustment period for certain taxpayer unfavorable method changes (“positive” adjustment).
  – General rule – 4-year spread for positive, 1-year for negative.
  – If taxpayer files method change while under IRS exam, the adjustment period is two taxable years if not filed in a window period.
  – Taxpayers may elect to take a positive adjustment of less than $50,000 into account in the year of change (previously $25,000).
  – Taxpayers may elect to take a positive adjustment into account in the year of change if change is made in the year of a “eligible acquisition transaction.”
    - Applies if transaction occurs during the year of change or before the extended due date of the federal income tax return for the year of change.
    - Election is irrevocable and applies to all changes filed for that year of change.
    - Election can be made even if taxpayer has executed Consent Agreement with a longer adjustment period.

What Has Changed? (cont'd)

- Filing method changes while under IRS exam
  - Being under IRS exam is no longer a "scope limitation."
  - However, unless an exception below applies, there is no audit protection if method change is filed while under IRS exam:
    - "Three-month window": Applies to applications filed in the period beginning on the 15th day of the 7th month of taxpayer's tax year and ends on the 15th day of the 10th month of the taxpayer's tax year.
    - "120 day window": Applies to applications filed in the 120 day period following end of an IRS exam, regardless of whether new cycle has begun.
    - Present method not before director: Applies to a change from a clearly permissible method or from an impermissible method where that method was adopted subsequent to the years under exam.
    - New member of a consolidated group: Applies to certain taxpayers in CAP.
    - Change results in a taxpayer favorable ("negative") section 481(a) adjustment: Applies if adjustment is negative in year of change and would have been in years under exam.
    - IRS has not imposed an adjustment for the item when one exam ends and it is not an issue under consideration in another ongoing cycle.

What Has Changed? (cont'd)

- Special rule for filing Form 3115 for a new member of a consolidated group in CAP
  - Applies to non-automatic method changes.
  - Form 3115 must be filed by the earlier of (i) 90 days after the new member becomes a member of the group or (ii) 30 days after the end of the tax year in which the new member becomes a member of the group.
- Foreign partnerships
  - Clarifies how to file Form 3115 for foreign partnership with no US filing requirement.
  - Any partner authorized to make elections for the partnership may file Form 3115 on behalf of the partnership.
  - Form 3115 is attached to a Form 1065 prepared for purposes of making the method change in accordance with Reg.Sec.1.6031(a)-1(b)(5).
- All copies of Form 3115 are filed at IRS Ogden, UT office (not IRS National Office).
- Updates made to an automatic filing after submitting copy to Ogden.
  - If the section 481(a) adjustment is updated after the Ogden copy is filed, must send copy of any additional correspondence to Ogden.
- Less favorable terms and conditions for CFCs.

Comparison of Procedures, Terms and Conditions

	US Domestic	CFC
120-day window for taxpayers under exam	Available after end of any exam cycle	Not available
90-day window	15th day of 7th month through 15th day of 10th month of tax year, provided under exam 12 months, and method issue not under consideration	15th day of 7th month through 15th day of 10th month of tax year, provided all controlling domestic s/hs under exam 24 months, and issue not under consideration
Issue under consideration	Taxpayer receives written notification that specific accounting method is being examined	Any controlling domestic shareholder receives notification that the treatment of a distribution, deemed distribution, or inclusion, or amount of e&p or foreign taxes deemed paid, is under consideration
Springing audit protection	After exam ends, if no proposed adjustment	After exam ends, and 90 days after all US shareholders notify examining agent, if no proposed adjustment or issue under consideration
Potential limit on audit protection		IRS reserves right to make change in earlier year if deemed paid taxes exceed 150% of average in 3 prior years

Non-Automatic Procedures

- Letter ruling issued (User fee schedule: Appendix A of Rev. Proc. 2015-1)
  - $8,600 user fee/per type of change
  - Single Form 3115 for consolidated groups
  - Members making identical changes
  - $8,600 plus $180 for each additional member
- Year of change
  - Tax year in which Form 3115 filed (may request roll forward)
  - No early applications
  - Limited 9100 relief for late applications

Expense Recognition

AmerGen Energy Co. LLC et al. v. United States

- 112 AFTR 2d 2013-6376 (Fed. Cl. 2013), aff'd, 115 AFTR 2d 2015-1056 (Fed. Cir. 2015).
- Facts
  - Taxpayer purchased three nuclear power plants.
  - The purchase price for each acquisition included cash and the buyer assumed the sellers' decommissioning liabilities.
  - Taxpayer attempted to increase the cost basis of the nuclear power plants by amount of decommissioning liabilities assumed as part of purchase price.
- Holding
  - The court held that Section 461(h) and all events test should be applied to determine when liabilities are incurred for the purpose of cost basis calculations under section 1012.
  - Decommissioning liabilities assumed by the taxpayer had not been "incurred" because economic performance requirement under section 461(h) had not been satisfied.

Mass Mutual Life Insurance Co. v. United States

- 109 AFTR 2d 2012-837 (Fed. Cl. 2012), aff'd, 115 AFTR 2d 2015-1459 (Fed. Cir. 2015).
  - Issue
    - Whether Taxpayer was entitled to a policyholder dividend deduction based on the declared guaranteed minimum dividend amount in the year of declaration.
    - The taxpayer asserted that its liability for the guaranteed amount of the policyholder dividends satisfied the requirements of the "all events test" and that it was entitled to deduct in tax years 1995, 1996, and 1997 a portion of the guaranteed minimum amount of policyholder dividends declared by the taxpayer's board of directors in 1995, 1996, and 1997.
    - The government challenged that the Taxpayer's liability for the dividends was not fixed in the year the dividends were declared, that economic performance had not occurred by year end, and that the taxpayer's dividend guarantees lacked economic substance.

Mass Mutual Life Insurance Co. v. United States

- The government argued:
  - the liability was not established in the year the dividends were guaranteed in the aggregate because the liability to pay the dividends was contingent on other events (such as a policyholder's decision to maintain his or her policy through the policy's anniversary date);
  - that the Taxpayer could not deduct their obligations until the following year because a liability must be fixed before it can be deducted; and
  - even if the liability was fixed, these payments still could not have been deducted until the year they were actually paid because the dividends did not qualify as rebates or refunds that would meet the recurring item exception to the requirement that economic performance or payment occur before a deduction may be taken.
- Holding
  - U.S. Court of Federal Claims upheld the deductibility of the Taxpayer's aggregate, declared, and guaranteed policyholder dividends, and the Federal Circuit affirmed.

Fines and Penalties

Guardian Industries Corp. v Commissioner

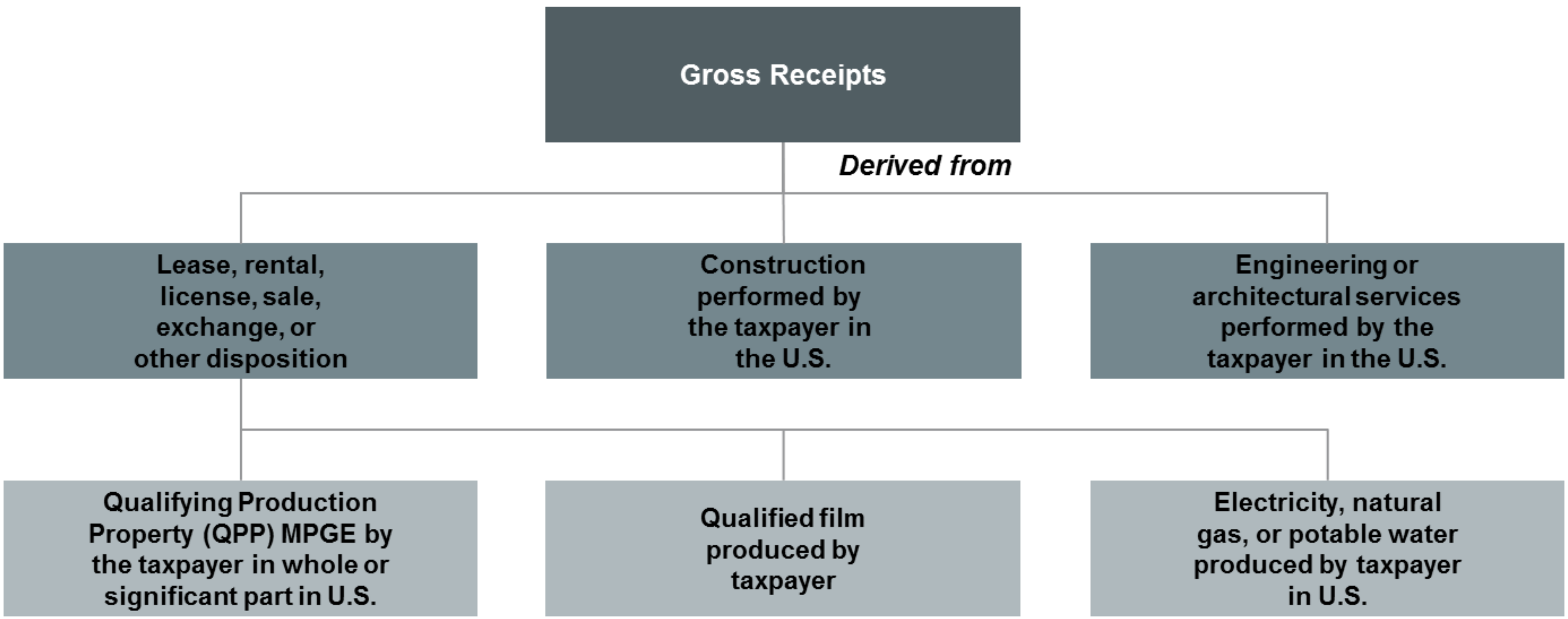
- 143 T.C. No. 1 (2014)
  - Facts
    - The European Commission (EC) determined that the Taxpayer participated in a cartel that infringed the competition provisions of the EC Treaty by fixing prices and found the Taxpayer liable for a fine of $30 million (USD).
  - Holding
    - The Tax Court held that the Taxpayer's payment to the EC was not deductible pursuant to IRC section 162(f) because:
      - The phrase "government of a foreign country," used in Treas. Reg. § 1.162-21(a) may refer both to the government of a single foreign country and to the governments of two or more foreign countries, such as the EC.
      - The EC is an entity serving as an instrumentality of the EU Member States within the meaning of Treas. Reg. § 1.162-21(a)(2) and (3).

Fresenius Medical Care Holdings, Inc. v. United States

- 114 AFTR 2d 2014-5688 (D. Mass. 2014), aff'd, 763 F.3d 64 (1st Cir. 2014)
- Facts
  - Between 1993 and 1997, whistleblowers brought a series of civil actions against the taxpayer under the False Claims Act (FCA). The government opened civil and criminal investigations into the taxpayer's federally funded health care programs. In 2000, the taxpayer entered into a criminal plea and civil settlement agreements with the government. The taxpayer was to pay over $486 million; over $101 million was for criminal fines and the remaining $385 million was to absolve the taxpayer from civil liability.
  - It was agreed the criminal fines were not deductible and $192.5 million of the civil settlement was deductible; the taxpayer and government did not agree on the tax treatment of the remaining $192.5 million.
  - The settlement agreement stated that it didn't constitute a tax characterization for the amounts paid. It also stated that nothing in the agreement is punitive in purpose or effect (it was not clear that language had anything to do with taxes).
- The taxpayer argued that no portion of the remaining amount was punitive because of the "purpose and effect" statement.
- The government argued Fresenius had to prove the parties agreed that the damages were compensatory when they signed the settlement agreement.
- Holding
  - A jury found that $95 million of the $192.5 million in dispute was deductible and the First Circuit affirmed.
  - In determining the tax treatment of a FCA civil settlement, a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party.

Section 199

Definition of DPGR



Is "Packaging" a Qualifying MPGE Activity?

- *U.S. v. Timothy Dean, et. al.,* 112 AFTR 2d 2013-5592.
  - Taxpayer incorporated packaged food items into gift baskets or "gift towers" and claimed a section 199 deduction related to such activities.
  - IRS exam team disagreed, pointing out that qualified manufacturing activities do not include packaging, repackaging, labeling, or minor assembly of QPP, if those are the taxpayer's only activities with respect to that QPP.
  - U.S. district court held that Taxpayer was entitled to benefits claimed under section 199, finding that they engaged in a qualified production activity by combining several products into a new product.
    - The court agreed with Taxpayer that Taxpayer's production process "chang[es] the form of an article" within the meaning of Treasury Regulation § 1.199-3(e)(1) and explained that rather than merely enhancing an existing product or combining items, taxpayer creates a new one with a different demand.
    - The court reasoned that designing a gift basket involves decisions as to sizing and colors, selecting materials, and ensuring quality controls and that the creation of the gift basket or tower is a "complex process" using assembly line workers and machines and produces a final product distinct in form and purpose from the individual items inside.

Is “Packaging” a Qualifying MPGE Activity?

- *Precision Dose, Inc. v. U.S. (N.D. IL 9/24/2015).*
  - Taxpayer buys drugs in bulk and sells them in single doses. It claimed a section 199 deduction related to such activities.
  - IRS exam team disagreed, pointing out that qualified manufacturing activities do not include packaging, repackaging, labeling, or minor assembly of QPP, if those are the taxpayer's only activities with respect to that QPP.
  - U.S. district court held that Taxpayer was entitled to benefits claimed under section 199, finding that it engaged in a qualified production activity by creating a “unit doses,” a new product.
    - The court agreed with Taxpayer that Taxpayer’s production process “is a complex production process that results in a distinct final product,” citing *Dean*.

LB&I Directive – Definition of MPGE

- The IRS released a directive on certain activities that, when performed at a retail level, do not meet the definition of manufactured, produced, grown or extracted under Treas. Reg. § 1.199-3(e).
  - Cutting blank keys to a customer's specification;
  - Mixing base paint and a paint coloring agent;
  - Applying garnishments to cake that is not baked where sold;
  - Applying gas to agricultural products to slow or expedite fruit ripening;
  - Storing agricultural products in a controlled environment to extend shelf life; and
  - Maintaining plants and seedlings.

Can a Programming Package be a Qualified Film? TAM 201049029

- Facts:
  - Taxpayer operated cable networks, broadcast television networks, and owned and operated television stations. Programming packages included programs produced by the taxpayer, 3rd party programs, advertisements, and interstitials.
  - IRS challenged that gross receipts from 3rd party programs included in the programming package could be DPGR
- Result: Gross receipts from licensing content in programming packages can be DPGR
  - Programming package offered in the normal course of business treated as a single “item”.
  - Programming package must still be “produced” by the taxpayer to qualify. Taxpayer’s activities must be substantial in nature.

Open question:

- The memo did not address whether the taxpayer’s Broadcast Network’s affiliation agreements are licenses of programming packages or of individual programs

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Can Distribution of Subscription Packages be Production? CCA 201446022: Issue #1

- Facts:
  - Taxpayer is a multichannel video programming distributor. Taxpayer creates subscription packages of multiple channels of video programming. The subscription packages may include licensed programming and self-produced programming.
- Result: Taxpayer's gross receipts from distribution of subscription packages do not qualify as DPGR
  - Taxpayer did not provide evidence showing that the subscription packages met the 50% compensation test to be qualified films.
  - Even if the subscription packages were qualified films, taxpayer was not the producer of the packages. Taxpayer's production activities were not substantial.
    - The Taxpayer had 5 types of distribution activities which did not relate to production. The memo also notes the limited compensation paid to production personnel.
  - However, Taxpayer could determine that components (i.e., self-produced programming) could be a qualified film.

Can Licensing Fees be Considered Overhead for Safe-Harbour Purposes? CCA 201446022: Issue #2

- Safe harbour: taxpayer is treated as producing a qualified film if direct labour and overhead costs are 20% or more of the unadjusted depreciable basis in the film. Reg. sec. 1.199-3(g)(3)(i)
  - Overhead costs are determined by reference to costs required to be capitalized under sec. 263A, or would be capitalized if sec. 263A applied to the taxpayer
- Result: Taxpayer’s licensing fees paid to unrelated programming producers is not overhead
  - Taxpayer was subject to capitalization under sec. 263A.
  - Fees for licensed programming were not subject to sec. 263A: licensed programming was not produced by Taxpayer, and not inventory or property held for resale.

Online Computer Software: GLAM AM2014-008

- IRS concluded that taxpayer-bank's app DID NOT qualify for the 199 deduction.
- Taxpayer produced an app that was downloaded to a user's phone that allowed the user to complete certain banking transactions. Taxpayer gave away the app for free, and attempted to treat certain fees from transactions completed by the app as DPGR. IRS disagreed, citing the following reasons:
  – Although the app was downloaded to a user's phone, the IRS concluded that the app did not constitute a qualifying disposition, as the app did not function without Internet access, and was therefore found to be equivalent to online software.
  – The taxpayer did not generate DPGR, because the app was given away for free. The IRS explained that term "derived from the disposition" of qualifying property is limited to the gross receipts directly derived from the disposition.
  – The taxpayer did not meet either of the online software exceptions (i.e., the self-comparable exception or the third-party comparable exception). The taxpayer-bank did not dispose of its internal software system in a qualifying manner, so it did not satisfy the self-comparable exception. With respect to the third-party comparable exception, the GLAM described a third-party software offered to competitor banks to provide banking services to competitor banks' account holders. Although the third-party app was ultimately used by competitor banks' customers in the same manner as the taxpayer-bank's app, the IRS concluded that end users of the third-party's app were not the relevant customers for purposes of the third-party comparable exception.

Benefits and Burdens Test:
ADVO, Inc. v. Commissioner

- First Tax Court decision to address the benefits and burdens of ownership test in the context of IRC §199.
- The Tax Court examined whether a taxpayer that hired third-party contract manufacturers to print advertising material retained the benefits and burdens of ownership over the printing activity undertaken by the third parties.
- HOLDING: In holding that the taxpayer did not have the benefits and burdens of ownership over the printing activity, the Tax Court considered in its decision the factors set forth in the examples provided in the §199 regulations and *Suzy's Zoo*, as well as other guidance outside IRC §263A, such as IRC §936 and *Grodt & McKay Realty, Inc. v. Commissioner*. Some of the relevant factors identified in *ADVO* include:
  - when title passes;
  - intent of the parties based on specific contract terms within the agreement;
  - right of possession and day-to-day control over the activities;
  - active and extensive participation in the management and operations of the activities
  - The Tax Court in *ADVO* recognized that the specific factors it analyzed are not the only ones that may be considered in a benefits and burdens analysis.

Benefits and Burdens Test: LB&I Directive (04-1013-008 July 2013)

- Guidance to examiners for determining which party has benefits and burdens of ownership in contract manufacturing arrangements
- Examiners are instructed not to challenge the benefits and burdens of ownership determination if a taxpayer provides these two statements:
  - A statement explaining the basis for the taxpayer's determination that it had the benefits and burdens of ownership in the years under exam
  - Certification statements signed by the taxpayer and the counter party to the contract manufacturing arrangement
- If the statements are not provided, it is presumed that the taxpayer does not have benefits and burdens of ownership
- Supersedes prior directive - LB&I-4-0112-001
- Relevant factors if facts and circumstances test applies

1. was the taxpayer primarily responsible for insuring the work in progress (WIP);
2. did the taxpayer develop the qualifying activity process;
3. did the taxpayer conduct more than 50% of the quality control tests over the WIP;
4. was the taxpayer primarily liable under the "make-good" provisions of the contract;
5. did the taxpayer provide more than 50% of the cost of raw materials and components used to produce the property;
6. did the taxpayer have the greater opportunity for profit increase or decrease from production efficiencies and fluctuations in the cost of labor and overhead.

Update on Tangible Property Regulations

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Timeline of Guidance

January 20, 2004	Notice 2004-6 announces government's plan to develop tangibles regs
August 21, 2006	Government issues first set of proposed regulations
March 10, 2008	Government withdraws 2006 proposed regulations and issues new proposal
December 27, 2011	2008 proposed regulations withdrawn and replaced with third proposal (also issued as temporary regulations, so effective immediately)
September 19, 2013	Final regulations published for acquisition costs and for repair and maintenance costs; proposed regulations issued for dispositions
January 24, 2014	Revenue Procedure 2014-16 issued (repair and maintenance)
February 28, 2014	Revenue Procedure 2014-17 issued (dispositions)
August 18, 2014	Final disposition regulations (effective January 1, 2014)
September 18, 2014	Revenue Procedure 2014-54 issued (dispositions)
December 24, 2014	Revenue Procedure 2015-12 (cable IIR)
February 13, 2015	Revenue Procedure 2015-20 (small taxpayers)
March 5, 2015	IRS Q&A

Snapshot of Regulations

Repairs

Default rule

Deduction allowable if not an Improvement

May be allocable to inventory or self-constructed assets under section 263A

Acquisitions

Transaction costs

Materials and supplies

De minimis safe harbor

Tangible Property

Improvements

Unit of property

Capitalize if:

1. Betterment
2. Adaptation, or
3. Restoration

Dispositions

Unit of property

Default rules

General Asset Accounts

Partial dispositions

Common Method Changes and Elections

		Election		Method change	
TPR Section	Item	Election made with affirmative statement	Election made by reporting on the return	Method change with 481(a) adjustment	Method change with limited 481(a)
Acquisition costs	Book de *minimis* policy	✓			
	Materials and supplies				✓
	Election to capitalize and depreciate rotable or temporary spares		✓		
Repairs and improvements	Repairs vs. improvements			✓	
	Book conformity election	✓			
Dispositions	Partial disposition		✓		
	Late partial disposition election			✓ (2014)	
	Complete asset disposition			✓	

Highlights of Recent Developments

- Final disposition regulations published August 18, 2014
  - Rev. Proc. 2014-54 provides automatic method change procedures for final regulations
- Few changes from regulations proposed in September 2013
  - Clarify application of demolition rules under section 280B in GAAs
  - Determining the adjusted basis of a disposed of asset
    - Reasonable methods permitted if taxpayer does not have accurate information
    - Discounted cost approach for partial dispositions limited to restorations
    - Producer Price Index is allowed for discounting (Consumer Price Index is not)
- Correction of election to capitalize materials and supplies
  - Election made by capitalizing and beginning to depreciate in year placed in service
  - Election not applicable to property acquired and disposed of in same year
  - Applies to elections under temporary regulations, even though regulations withdrawn

Recent IRS Q&A

- "Because these final regulations are based primarily on prior law, if you were previously in compliance with the rules you generally will be in compliance with the final regulations and generally no action is required. If you are not in compliance or otherwise want to change your method of accounting to use the safe harbor for routine maintenance, you should file Form 3115, Application for Change in Accounting Method, and compute a section 481(a) adjustment."

Questions?