

TaxClinic

PRACTICAL ADVICE ON CURRENT ISSUES

In This Department

ACCOUNTING METHODS & PERIODS

- IRS continues to challenge deferral of revenue from gift cards; p. 350.
- Recognizing unbilled revenue; p. 352.
- Tax Court addresses claim of offset against deferred payments; p. 354.
- To capitalize or to expense: How Sec. 263A treats royalties; p. 355.

EXPENSES

- Unit of property for network assets; p. 357.

GAINS & LOSSES

- Customs valuation: A concern for unsuspecting tax practitioners; p. 358.
- Sec. 1245 recapture rules can apply to stock; p. 362.

Unless otherwise noted, contributors are members of or associated with KPMG LLP.

This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

© 2009 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

For additional information about these items, contact Ms. Van Leuven at (202) 533-4750 or mvanleuven@kpmg.com.

GROSS INCOME

- Electric utility refunds qualify for Sec. 1341 tax mitigation; p. 364.

PARTNERS & PARTNERSHIPS

- Allocating liabilities among related partners: Determining the impact of *IPO II*; p. 365.

PROCEDURE & ADMINISTRATION

- IRS announces procedures for tax return preparer penalties; p. 367.

S CORPORATIONS

- Recent amendment to Sec. 1374 provides limited opportunity for S corps.; p. 369.

ACCOUNTING METHODS & PERIODS

IRS Continues to Challenge Deferral of Revenue from Gift Cards

In recent years, due to the increasing use of gift cards and the disparity between the federal tax accounting and financial accounting treatment of advance payments, there has been inconsistency among taxpayers and confusion as to the proper timing of recognizing income from gift cards. One specific issue that has arisen is the treatment of gift card income when a taxpayer maintains a separate gift card company that is responsible for selling the cards and operating the gift card program for it and other related entities but does not itself sell or provide the goods for which the cards can be used. The IRS recently addressed this issue in Technical Advice Memorandum (TAM) 200849015.

Summary of TAM 200849015

In the TAM, Taxpayer, a C corporation, uses the overall accrual method and is a subsidiary of Parent and part of Parent's consolidated group. Parent formed Taxpayer to manage Parent's gift card program and oversee the entire gift card program for the Parent consolidated group in exchange for a management fee. Taxpayer issues and sells all gift cards used in stores operated by Parent and related entities and in certain stores operated by an unrelated entity. The gift cards can be redeemed for goods (or limited services integral to those goods) from retailers operated by other taxpayers within

the consolidated group (the retailers) and from the unrelated entity.

Under the gift card program agreement, the retailers agree to sell and reload Taxpayer's gift cards in their stores, remit all amounts paid to Taxpayer, and redeem the cards in exchange for merchandise. After the cards are redeemed, Taxpayer pays the retailers amounts equal to the amounts of the redeemed cards. Taxpayer is solely liable and obligated to the purchasers and holders of the gift cards—except the retailers are liable to Taxpayer to accept the balance on a gift card as payment for goods and services. Under the retailers' business practices, gift card holders can receive cash refunds for card balances under a certain amount. If a cardholder returns a purchase made with a gift card, the retailer will increase the balance on the gift card by the amount of the return; however, for returns below a certain amount the retailer will issue a cash refund.

The TAM addresses three issues related to the amounts received by Taxpayer on its sale of the gift cards (gift card receipts):

1. Are the gift card receipts includible in Taxpayer's gross income (i.e., are they considered income or deposits)?
2. Are the gift card receipts "advance payments" within the meaning of either Regs. Sec. 1.451-5 or Rev. Proc. 2004-34 (and therefore eligible for deferral)?
3. If the gift card receipts are includible in income upon receipt, may the Taxpayer take an immediate deduction for the liability to pay the amount to a retailer?

Income or deposits: The TAM concludes that the gift card receipts are payments over which Taxpayer exercises complete dominion and control and over which it holds a claim of right unless, and until, a subsequent event occurs that would require it to transfer amounts to retailers or refund amounts to a customer; therefore, the gift card receipts are income and not deposits.

Taxpayer had argued that the gift card receipts are not income but are instead nontaxable deposits because the gift card holders may request and obtain a full cash refund at any time under state law. In

refuting this argument, the IRS first sets forth the Sec. 61 general rule that gross income includes all income from whatever sources derived, including "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" (citing *Glenshaw Glass Co.*, 346 U.S. 426 (1955)). It then goes on to say that the taxpayer has a claim of right to the amounts upon receipt, since whether and to what extent Taxpayer will be required to reimburse a retailer is subject to the contingency that the customer will redeem the card for goods or services or obtain a refund. Further, the IRS distinguishes the gift card receipts from the receipts in *Indianapolis Power and Light Co.*, 493 U.S. 203 (1990), in which the Supreme Court held that amounts received by a utility from customers constituted deposits because the right to refund was based on the customers' actions (making timely payment for several months), and therefore the taxpayer did not have "complete dominion" over the funds. In the case of Taxpayer's gift card receipts, the IRS places great weight on the fact that, under state law, a customer who buys a gift card cannot demand a full cash refund for the initial value of the card (except in limited circumstances in which the gift card is below a certain amount), and thus any refund is dependent on the subsequent action of the customer and requires an affirmative action of the customer to obtain goods and request a refund (i.e., it is a condition subsequent).

Advance payments: The IRS concludes that the gift card receipts do not fall within the scope of either Regs. Sec. 1.451-5 or Rev. Proc. 2004-34 and therefore are not eligible for deferral under either provision. In general, Sec. 451 and the regulations require accrual-method taxpayers to include an item in gross income when the all-events test is met or, as interpreted by the courts, at the earliest of when it is received, due, or earned (see *Schlude*, 372 U.S. 128 (1963)). Thus, when a taxpayer receives a payment for goods or services prior to the goods or services being provided (advance payments), the payment must generally be included on the receipt; however, Regs. Sec. 1.451-5 and Rev. Proc. 2004-34 provide limited

exceptions to the general rule whereby a taxpayer may defer advance payments.

As noted in the TAM, Regs. Sec. 1.451-5 defines advance payment, in relevant part, as "any amount which is received . . . pursuant to, and to be applied against, an agreement . . . [f]or the sale or other disposition in a future taxable year of goods held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business." For this purpose, an agreement includes a gift certificate that can be redeemed for goods. If the regulation applies to a payment received on the sale of a gift card, the related income can generally be deferred until the earlier of when a cardholder uses the card or the second tax year following the year of purchase. Rev. Proc. 2004-34 defines advance payment differently than the regulation. Under the revenue procedure, a payment is considered an advance payment if:

- Including the payment in gross income for the year of receipt is a permissible method;
- The payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent tax year; and
- The payment is for services or the sale of goods (except where the taxpayer uses the Regs. Sec. 1.451-5 deferral method).

Under the revenue procedure, the advance payment may be deferred in the year of receipt to the extent deferred for financial statement purposes, but it must be included in gross income in the next succeeding tax year.

The TAM concludes that the gift card receipts are not advance payments within the meaning of the regulation because Taxpayer is not the party that provides the goods, and its assertion that it is contractually obligated to provide goods to customers does not reflect either the form or substance of its agreement with the retailers. With respect to Rev. Proc. 2004-34, the TAM acknowledges that unlike the regulation, the revenue procedure does not explicitly require that the payment be for goods "held for sale by the taxpayer." However, it goes on to say, with no further analysis or explanation, that the IRS National Office agrees with the examination

team's interpretation of the revenue procedure in that it should not be interpreted broadly to apply to situations in which goods are provided by a party other than the taxpayer. As discussed in more detail below, the TAM is silent as to why Taxpayer's advance payment is not considered an advance payment for services to which the deferral provisions of Rev. Proc. 2004-34 could potentially apply.

Liability to retailer: The TAM concludes that Taxpayer's liability to the retailer is not deductible in the year of purchase because the liability is contingent and not fixed at the end of the year. According to the TAM, the liability does not become fixed (and therefore deductible) until the customer redeems the gift card at the retail location because the redemption is a condition precedent to the fixing of the liability.

Implications of TAM 200849015

The rationale and conclusions in TAM 200849015 underscore the continuing disparities between the financial accounting and tax accounting treatment of advance payments. Absent further official guidance, controversies will continue to arise in this context because of the ever-increasing incidence of gift card programs and the gaps in the existing guidance addressing the tax accounting rules for advance payments, which cause continuing uncertainties.

The IRS has long sought to limit the amount of deferral permitted for the recognition of advance payments as a result of Supreme Court decisions requiring current recognition of advance payments for tax purposes. However, the existing rules appear to be out of step with business realities associated with the operation of gift card programs. Specifically, in the TAM Taxpayer was not permitted to use the deferral method in Regs. Sec. 1.451-5 because it did not sell inventory, even though an affiliate or franchisee of Taxpayer would redeem the gift cards for inventory. This is a harsh result when compared with the treatment of a business that sells inventory from the same entity that operates the gift card program. Further, this raises the question of whether Taxpayer in the TAM would have avoided the challenge if it had actually sold some inventory that could have been used

to satisfy its gift card obligations, even if the majority of the cards were redeemed from other sources. The result is similarly harsh when compared with a business that happens to operate in a state where the gift card management company can operate in the disregarded entity structure and its owner sells the inventory.

Taxpayer's deposit argument appeared to fail, at least in part, because Taxpayer was not able to prove to the IRS that gift card holders could obtain a cash refund upon demand. If a taxpayer in another case could show that its customers are contractually entitled to redeem the card for cash equal to its face value, the IRS could have great difficulty overcoming the Supreme Court's ruling in *Indianapolis Power*, notwithstanding the fact that the cards are not considered deposits by the customer and do not function as security for payment of any kind. From the standpoint of deferral, this fact pattern might be beneficial in that it could permit a taxpayer to use a method that mirrors its financial reporting method, without the deferral limits in the existing guidance. Although there is some overlap in the eligibility requirements for advance payments under Regs. Sec. 1.451-5 and Rev. Proc. 2004-34, taxpayers who are eligible for Regs. Sec. 1.451-5 generally prefer to use those rules over Rev. Proc. 2004-34 because the regulatory method permits a longer period of deferral.

While Regs. Sec. 1.451-5 indicates that it applies only to advance payments related to "goods held by the taxpayer primarily for sale to customers," the wording in Rev. Proc. 2004-34 is not as limiting because it applies to advance payments, including gift cards, that involve the sale of goods and/or services. If the gift card management company is not responsible for selling the goods, it would clearly seem to be engaged in providing management services, which fits squarely into the requirements for the Rev. Proc. 2004-34 deferral method. The IRS in the TAM offers no rationale for why the gift card management company's advance payments should not be considered to be payments for services under an arrangement whereby it earns a contingent management fee through the breakage (i.e., the amount of gift cards

sold but never redeemed) in the program over time.

In contrast, the IRS implied in recent Field Attorney Advice 20082801F that Rev. Proc. 2004-34 would be available to a gift card management company that sells no inventory, provided that the taxpayer tracked its gift card redemptions on a card-by-card basis, such that it could tell when the revenue from a gift card has been "recognized as revenues in its applicable financial statements for the tax year of receipt" as required by §5.02(1)(b)(i) of the revenue procedure. Conversely, in the TAM the IRS does not suggest that a taxpayer who actually sells inventory from the same company that issues gift cards would be disqualified because the taxpayer allowed customers to redeem the cards, at their option, for either goods or services.

While the IRS may be justified in limiting the amount of deferral for advance payments overall, the rules arguably should not operate in such a form-driven fashion for gift card programs when some taxpayers are permitted to use one deferral method and others a different but more restrictive method, while leaving some taxpayers no choice but to recognize gift card revenue upon receipt. Given that the IRS issued Rev. Proc. 2004-34 to make the deferral rules less restrictive than they had previously been, it would seem incumbent on the IRS to issue administrative guidance that makes some form of a deferral method available equally to all gift card programs.

From Cathy Fitzpatrick, CPA, MST, and Carol Conjura, J.D., CPA, Washington, DC

Recognizing Unbilled Revenue

In Technical Advice Memorandum (TAM) 200903079, the IRS applied the all-events test for income recognition to service contracts that were subject to the Federal Acquisition Regulations (FAR), 48 CFR Chapter 1. This article discusses the IRS's interpretation and application of the Sec. 451 rules for determining the event establishing the taxpayer's right to income. Although the TAM does not seem to reflect any new IRS positions, it does apply the income recognition rules to a wide variety of FAR contractual arrangements.

Contract Types and Terms

In the TAM, the taxpayer's contracts with the U.S. government were fixed price, cost plus, and time and materials. Those contracts were subject to the FAR, under which different types of contracts have different rights to bill.

- *Fixed-price contracts with milestones (specific tasks the taxpayer must perform):* Right to bill conditioned on completion of the milestone and acceptance by the customer.
- *Nonmilestone fixed-price contracts:* Right to bill monthly, regardless of completion of performance.
- *Cost-plus contracts (both fixed and variable fee terms):* Right to bill allowable costs every two weeks as work progresses.
- *Time-and-materials contracts:* Time portion of contract payable at least monthly on submission of a voucher, and materials portion of contract billable every two weeks as work progresses.

Fixed Right to Income

Regs. Sec. 1.451-1(a) includes income in gross income under an accrual method of accounting when (1) all the events have occurred that fix the right to receive the income and (2) the amount can be determined with reasonable accuracy.

Satisfaction of the test for determining when the right to income is fixed occurs upon the earliest of:

- The date payment is made to the taxpayer;
- The date the taxpayer's required performance occurs (i.e., the amount is earned); or
- The date the payment to the taxpayer is due (*Schlude*, 372 U.S. 128 (1963); Rev. Rul. 2004-52; Rev. Rul. 2003-10; and Rev. Rul. 84-31).

The terms of a contract are relevant in determining when the all-events test is satisfied (*Decision, Inc.*, 47 T.C. 58 (1966), *acq.* 1967-2 C.B. 2).

The main issue in the TAM was whether the taxpayer's method of accounting for unbilled receivables complied with Sec. 451. The taxpayer asserted that its right to income for the unbilled receivables was not fixed until the government

paid those amounts. The IRS pointed out that although acceptance of the invoice is a prerequisite to payment, "[i]f income for the unbilled receivables is 'earned' or 'due' prior to being 'paid,' then the event that first occurs [either performance or payment due] fixes the taxpayer's right to receive income." The IRS considered whether the taxpayer should have recognized its unbilled receivables before receiving payment either because of the taxpayer's performance or because the taxpayer was due payment.

Performance

With respect to performance as the event that establishes the taxpayer's right to income under Sec. 451, the IRS differentiates contracts that require performance of severable services from contracts that do not have severable services. For nonseverable-services contracts, income "generally accrues when performance is complete, not as the taxpayer engages in the activity." For severable-services contracts, performance occurs "as each severable portion of the contracts is performed . . . and Taxpayer's right to receive income from those services is fixed under §451 no later than such performance." The right to income is not deferred until the government accepts each milestone, as the taxpayer argued; instead the taxpayer earns the right to income through performance of the severable service.

Payment Due

With respect to payment due as the event that establishes the taxpayer's right to income under Sec. 451, the IRS notes that the FAR rules allow the taxpayer to submit invoices at specified intervals—e.g., every two weeks or once a month. The taxpayer's failure to bill as frequently as allowed does not delay the right to the income. In this instance, the IRS appears to equate the submission of an invoice with a minor or ministerial act that does not delay accrual. However, when the government's acceptance of a milestone is a condition precedent to the right to bill (as in the case of nonseverable, milestone contracts), the right to the income is fixed when the condition precedent is satisfied and the right to bill arises. With contracts that are nonseverable, and severable

contracts when amounts are due before the performance is complete, the right to income is fixed no later than when payment is due, the IRS asserts.

TAM Conclusions and Application to Contract Terms

The IRS concluded that:

- "[F]or Taxpayer's severable contracts, the amounts allocable to each severable portion of a contract are fixed no later than when performance of the severable portion is complete";
- "[F]or Taxpayer's contracts that are not severable, amounts under the contracts are fixed no later than when due"; and
- "[I]n the case of fixed-price contracts with milestones that must be accepted by the Government prior to billing, the amounts with respect to those milestones are not fixed until acceptance by the Government (i.e., when Taxpayer's right to bill occurs)."

In addition, the TAM specifies that general provisions relating to all the taxpayer's FAR contracts at issue—such as the government's acceptance of the billed amounts before payment is made, invoice audits that may change the amounts due, or other subsequent modifications of the contract—are not conditions precedent or substantial contingencies to the establishment of the taxpayer's right to income under such contracts.

Commentary

The interpretation and application of the Sec. 451 rules for determining the event that establishes the taxpayer's right to income in the TAM do not seem to reflect any new IRS positions. The TAM is instructive because it provides a very detailed application of the income recognition rules to a wide variety of FAR contractual arrangements and makes explicit the IRS's views on several issues.

For nonseverable-service contracts the completed performance likely occurs later than the taxpayer's right to bill arises (no less than once a month as work progresses on the contracts), and the right to the invoice amount due for such billing period (whether or not the invoice was actually submitted) is fixed when payment for

that billing period is due. For severable contracts, if performance of the severable portion is complete before the right to bill arises, then the taxpayer's right to income for such service is fixed upon completion of performance of the severable portion.

If the right to bill arises before the performance of the severable portion is complete, the right to the invoice amount due for such billing period (whether or not the invoice was actually submitted) is fixed when payment for that billing period is due. If a contract contains milestones that the taxpayer must achieve and the government must approve before the taxpayer can bill, its right to income related to the achievement of the milestone is fixed upon the approval of the milestone.

The TAM does not consider whether any particular contract addressed in the TAM was for severable services, which was an area of disagreement between the IRS and the taxpayer. The identification of contracts as containing severable services, milestones, or other intervening events, and the contingencies that attach to such provisions, will likely be an area of ongoing debate between taxpayers and the IRS. As such, a practical operational implication of the TAM for taxpayers providing services to the government subject to the FAR is to have in place processes and controls to identify contracts (and their payment terms and other relevant conditions) as service contracts or nonservice contracts. Service contracts should further be classified as severable or nonseverable and then as fixed-price, cost-plus, and time and materials contracts. Having a well-thought-out framework in place should provide a good starting point to begin analyzing service contracts for the earliest occurrence of events that fix a taxpayer's right to income for tax purposes.

From Tim Zuber, CPA, New York, NY, and Alexa Claybon, J.D., LL.M., Tysons Corner, VA

Tax Court Addresses Claim of Offset Against Deferred Payments

In a Tax Court case published on January 28, 2009, *Trinity Industries, Inc.*, 132 T.C. No. 2, the court required the

taxpayer to accrue in income, in the year it is earned, the total contract price for the sale of barges—including amounts withheld by customers against deferred payments because of a commercial contract dispute. The taxpayer (Trinity) treated the withheld amounts as nonaccruable. In addition, the Tax Court denied Trinity's deduction of the withheld amount as a Sec. 461(f) contested liability because Trinity failed to transfer money for the satisfaction of the liability.

Facts

Trinity, an accrual-method taxpayer, entered into a series of contracts with two customers in the late 1990s to provide barges. Trinity generally recognized revenue upon the delivery date of the barges. In 2000, Trinity entered into a second contract with the customers to provide additional barges for a contract price of \$1.29 million: \$1 million was due upon acceptance of the barge and the remainder was due within 18 months of delivery. Trinity delivered the barges under the second contract in 2001 and 2002.

After execution of the second contract, the customers complained to Trinity that the coatings of the first barges were defective and caused the barges to rust. Trinity denied any liability. Starting in 2002, the customers filed lawsuits, including petitions to exercise their common law right of offset by deducting damages from the first contract barges against deferred amounts owed for the second contract barges. Trinity ultimately entered into settlement agreements with both customers.

For barges delivered in 2001, Trinity recognized as income the full amount of the sales, including the deferred payments. For barges delivered in 2002, Trinity recognized only the amounts received in 2002, excluding the deferred payments against which the two customers asserted rights of offset.

Issue

The primary issue was: Is Trinity, an accrual-method taxpayer, required to accrue in 2002 deferred payments for barges it delivered in 2002 under the second contract and for which the customers claimed

rights of offset for damages arising from the barges previously purchased under the first contract? A secondary issue was: Could Trinity deduct in 2002 the payments withheld by the customers as Sec. 461(f) contested liabilities?

Analysis

The IRS contended that Trinity's delivery of the barges under the second contract unconditionally fixed its right to receive the full contract price and thus satisfied the requirements for recognition of income for accrual-method taxpayers. Under Regs. Sec. 1.451-1(a), an accrual-method taxpayer generally recognizes income in the tax year in which:

- All the events have occurred that fix the right to receive the income; and
- The amount of the income can be determined with reasonable accuracy.

Absent the claim of offset by its customers, the IRS argued that the income would be recognized when the barges were delivered, regardless of receipt of payment.

Trinity cited numerous cases supporting its position that, because of the customer's assertion of claims of rights to offset deferred payments, the seller defers income as disputed income until the dispute is settled. Essentially, the prior case law it cited stands for the proposition that an amount of income is not fixed if the obligor disputes the validity and/or the amount of the claim. The Tax Court, however, distinguished Trinity's factual situation from the cases cited because Trinity's customers did not dispute the fact or the amount of their obligations to Trinity. The court stated:

By contrast, insofar as the record shows, neither [customer] ever disputed the fact or amount of its obligation to Trinity under the second contract. To the contrary, their filings in the commercial litigation expressly acknowledged their obligations to Trinity under the second contract and indicated that they were setting the withheld amounts aside in "escrow" or as "collateral security" to offset whatever damages Trinity might ultimately be determined to owe them with respect to their claims under the first contracts.

The Tax Court indicated its corresponding view that Trinity “effectively received the withheld amounts when, pursuant to the settlement agreement, they were applied in compromise of [the customers’] claims.” The court further commented that the required event causing accrual, i.e., delivery, had occurred and that collectibility was not doubtful by reason of the customers’ financial conditions.

The secondary issue discussed in the case was whether Trinity was entitled to deduct in 2002 the amount it considered transferred to the customers to settle their disputed claims for damages to the barges from the first contract. Sec. 461(f) allows a deduction if:

- The taxpayer contests an asserted liability;
- The taxpayer transfers money or property to satisfy such liability;
- The contest exists after the transfer; and
- But for the existence of the contest, a deduction would be allowed.

If the Sec. 461(f) requirements are satisfied, then the transferred amount is deductible in the tax year of the transfer. Trinity contended that the customers’ act of withholding payment as an offset for damages satisfied the Sec. 461(f) transfer requirement. The IRS successfully argued, however, that Sec. 461(f) did not apply to the withheld amounts because the withholding did not represent a transfer of money or property beyond Trinity’s control, inasmuch as Trinity never had possession of the money at issue. Even if it did, the amounts could not have been transferred until the underlying deferred payments became due, i.e., after 2002.

Taxpayer Effect

Deferral of income, including contingent or contested revenue, has been a regular point of contention between taxpayers and the IRS. In certain circumstances, the courts and the IRS have permitted the deferral of such income until the dispute has been resolved, under the rationale that in the instance of a contested claim, income is generally not fixed until the claim is determined or settled (see, e.g., *Reading & Bates Corp.*, 40 Fed. Cl. 737 (1998); Letter Ruling 9434013).

Rev. Rul. 2003-10 provides some insight. The IRS ruled that in some situations, an accrual-method taxpayer does not accrue income in the tax year of sale if it shipped the incorrect goods and the customer disputes its liability to the taxpayer. In contrast, Trinity’s customers did not dispute their liability for the sales price of the second set of barges, but instead claimed a right of offset by deducting damages from the first contract barges against deferred amounts owed for the second contract barges. The installment method under Sec. 453 would have provided some relief had it been applicable, but presumably the barges constituted inventory in Trinity’s hands and thus would have been ineligible for installment sale treatment.

The Tax Court’s secondary holding, that Trinity could not deduct in 2002 the amount withheld by the customers as a Sec. 461(f) contested liability, also appears consistent with prior guidance because there was no actual transfer in 2002, per Regs. Sec. 1.461-2(c)(1). In theory, a deduction could have been available, but Trinity presumably would have needed to affirmatively transfer money or property as required in Regs. Sec. 1.461-2. That is, money may need to have changed hands in both directions.

Conclusion

The *Trinity Industries* decision illustrates the importance of analyzing the facts in the context of contract disputes, including determining what amount is being disputed, whether a holdback or claim of offset is asserted, and when the dispute arises. It further demonstrates that authorities that on the surface may appear applicable (here, concerning disputed revenue and contested liabilities) may not in fact provide the taxpayer’s desired relief.

From Kurt R. Hanway, CPA, and Scott W. Vance, J.D., LL.M., Washington, DC

To Capitalize or to Expense: How Sec. 263A Treats Royalties

The tax treatment of royalty payments—to capitalize or to expense—depends on the terms of the royalty agreements and, in some situations, the Sec. 263A uniform

capitalization rules. This item reviews certain authorities on the treatment of royalty payments, including the Tax Court’s recent decision in *Robinson Knife Manufacturing Co.*

Overview

Regardless of the industry, manufacturers frequently enter into licensing agreements with third parties to obtain various rights for the production, sale, marketing, and distribution of goods. Whether it is a drug manufacturer licensing the rights to a patented compound or a producer of retail goods obtaining the right to use another company’s trademark, licensing agreements appear to be standard in the world of production. What does not appear to be standard is the tax treatment of royalty payments made under the licensing agreements for purposes of Sec. 263A.

UNICAP Rules

The Sec. 263A uniform capitalization (UNICAP) rules require that all direct costs and certain indirect costs allocable to certain property be either (1) included in inventory costs or (2) capitalized, if the property is not inventory. Regs. Sec. 1.263A-1(e)(1) requires taxpayers subject to Sec. 263A to capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. Direct costs include direct material costs and direct labor costs for a producer and acquisition costs for a reseller (see Regs. Sec. 1.263A-1(e)(2)).

Taxpayers must capitalize indirect costs to the extent they are properly allocable to property produced or property acquired for resale. Regs. Sec. 1.263A-1(e)(3)(i) defines indirect costs as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred due to the performance of production or resale activities. Indirect costs may be allocable to both production and resale activities as well as to other activities not subject to Sec. 263A.

In the case of royalty expenses, tax treatment has been dependent on the nature and terms of the royalty paid as well as the method used to allocate the Sec. 263A costs. For example, if the taxpayer determines that the royalty payment is related solely to the right to sell, market, and distribute a particular product, the royalty payment would be excluded from capitalization under Regs. Secs. 1.263A-1(e)(3)(iii)(A), (4)(ii)(B), and/or (4)(iv)(N). These Treasury regulations allow a deduction for costs relating to selling, marketing, and distribution.

However, if the taxpayer determines that the royalty expense paid either directly benefits or was incurred because of production-related activities, such payment would be capitalized under Regs. Sec. 1.263A-1(e)(3)(ii)(U). This Treasury regulation characterizes licensing and franchise costs as indirect costs that are capitalized to inventory.

Many taxpayers allocate royalty expenses between deductible and capitalizable indirect costs. Such allocation is specifically permitted (and required) by Regs. Sec. 1.263A-1(c)(1).

Plastics Engineering

The IRS has disputed a taxpayer's allocation of royalty expenses between deductible and capitalizable indirect costs under Sec. 263A-1(c)(1) in several situations. Most notable is the Tax Court's decision in *Plastics Engineering & Technical Services*, T.C. Memo. 2001-324. The sole issue for determination by the Tax Court in this case was whether Sec. 263A required a taxpayer who used the simplified production method (see Regs. Sec. 1.263A-2(b)) to capitalize certain royalties it paid as the exclusive licensee of a patent.

The taxpayer entered into a licensing agreement with a related third party whereby the taxpayer was granted an exclusive and nontransferable license to manufacture and sell products that make use of a certain production process that was the subject of the third party's patent. In exchange for this license, the taxpayer agreed to pay a contingent royalty equal to 10% of the net sales price of all products manufactured through use of the patented technology.

The Tax Court agreed with the IRS and rejected the taxpayer's argument that the contingent royalty took the cost out of the realm of Regs. Sec. 1.263A-1(e)(3)(ii)(U). It held that because the royalty payment was for the right to use a certain production process, that payment was indeed an includible indirect cost under Regs. Sec. 1.263A-1(e)(3)(ii)(U) and was required to be capitalized to inventory and relieved through cost of goods sold. Further, due to the mechanics of the simplified production method used by the taxpayer, these royalty costs were allocated to ending inventory even though the costs were not incurred until the goods were sold.

Letter Ruling 200630019

The IRS followed the *Plastics Engineering* decision in Letter Ruling 200630019, which it issued on March 31, 2006. The taxpayer in the letter ruling owned nearly all the stock of a subsidiary. The subsidiary acquired the right to manufacture goods for sale to the taxpayer. The royalties paid were based on the rights described in an agreement between the taxpayer and the subsidiary; however, the amount of royalty was calculated based on the number of products sold to the taxpayer each month. The subsidiary did not include any portion of the royalty expense as an indirect cost allocable to inventory.

Citing *Plastics Engineering*, the IRS ruled that the royalties paid by the subsidiary for the rights under the licensing agreement constituted licensing and franchise costs within the scope of Regs. Sec. 1.263A-1(e)(3)(ii)(U). Further, the IRS ruled that the rights acquired directly benefited the subsidiary's production activities, and as such the royalties were indirect costs properly allocable to property produced that must be capitalized under Sec. 263A. However, in this instance the taxpayer used a facts-and-circumstances approach to allocate costs to ending inventory. Under this method, the royalty costs would not be allocated to ending inventory because they were not incurred until the goods were sold. Due to insufficient facts, the IRS could not rule on whether such a facts-and-circumstances method was appropriate.

Industry Directive

Seeing a trend of inconsistent treatment by both taxpayers and IRS exam personnel, on May 7, 2007, the IRS issued an industry directive that elevated treatment of royalties (among other costs) to a Tier II issue. Tier II issues are defined in Internal Revenue Manual Section 4.51.5.1 as those that involve areas of potential high noncompliance and/or significant risk to the Large and Mid-Size Business Division or a particular industry. They include emerging issues where the law is fairly well established, but there is need for further development, clarification, direction, and guidance on the IRS position.

Although the directive deals specifically with the pharmaceuticals industry, its scope is applicable to other industries as well. The directive clearly identifies the issue of whether or not royalties paid by a taxpayer represent a capital expenditure under Sec. 263A.

In issuing the directive, the IRS intended to provide a uniform format and approach for examiners to evaluate potential compliance risk related to the treatment of royalties (among other costs) under Sec. 263A, to outline the issue management and oversight process that had been established, and to introduce an initial set of audit guidelines. The overall effect of the directive was to increase the level of scrutiny for taxpayers subject to Sec. 263A that incur royalty expenses.

Robinson Knife

Following the issuance of the directive, recent guidance relating to the treatment of royalties under Sec. 263A can be found in the Tax Court's decision in *Robinson Knife Manufacturing Co.*, T.C. Memo. 2009-9. Like *Plastics Engineering*, the issue before the Tax Court in *Robinson Knife* was whether a taxpayer using the simplified production method was required to capitalize royalties incurred in connection with certain trademark licensing agreements under Sec. 263A.

The taxpayer was engaged in the business of designing, developing, manufacturing, marketing, and selling kitchen tools and gadgets. The taxpayer entered into two separate licensing agreements for

the right to use trademarks in connection with kitchen tools it produces and sells. In return for the rights granted, the taxpayer agreed to pay a royalty in an amount equal to 8% of the net wholesale selling price of the kitchen tools sold under one licensing agreement and to pay an amount equal to 11% of net sales up to \$1 million and 8% on net sales exceeding \$1 million under the other licensing agreement.

For tax purposes, the taxpayer treated the royalty payments associated with both licensing agreements as excludible costs, which are not required to be capitalized, after making the determination that the royalties were in the nature of marketing, selling, and advertising costs that were not subject to capitalization. However, the Tax Court reached the opposite conclusion because the taxpayer could not have legally manufactured the products without the rights it was granted under the licensing agreements. As such, the Tax Court held that the royalty expenses were includible indirect costs under Regs. Sec. 1.263A-1(e)(3)(ii)(U). Further, as in the case of *Plastics Engineering*, due to the mechanics of the simplified production method, the Tax Court held that the taxpayer should allocate the royalty costs to ending inventory even though the taxpayer did not incur the costs until the goods were sold.

Because the royalty payments in question were for the right both to manufacture and to distribute and sell, it is interesting that an allocation was not made between those capitalizable and non-capitalizable elements. Perhaps the result would be different in cases in which the royalty was strictly for the right to distribute and sell a product.

Conclusion

Although the language contained in the Treasury regulations supporting Sec. 263A is relatively clear as to the tax treatment of licensing costs and royalties, royalty agreements can be highly factual in nature, and the actual tax treatment will depend on the nature and terms of the costs incurred and the methodology used to allocate those costs. Regs. Sec. 1.263A-1(e)(3)(ii)(U) should be carefully considered, and a separate analysis should

be conducted to determine the nature and terms of the royalty paid and how such costs should be allocated to ending inventory.

From John Suttora, CPA, and Damon Bender, J.D., LL.M., Washington, DC

EXPENSES

Unit of Property for Network Assets

In March 2008, Treasury issued proposed regulations under Secs. 162 and 263(a) providing guidance on the capitalization and deduction of costs relating to tangible property (REG-168745-03). Included in these regulations are the “repair regulations,” a comprehensive set of rules for determining whether costs incurred for tangible property are deductible repairs or capital improvements. While these regulations offer extensive guidance on determining the unit of property for repair purposes, they do not define the unit of property for network assets.

Network assets are generally defined in the proposed regulations as railroad tracks, oil and gas pipelines, water and sewer pipelines, power transmission and distribution lines, and telephone and cable lines (Prop. Regs. Sec. 1.263(a)-3(d)(2)(iii)(C)). The IRS and Treasury have indicated that network asset guidance should be addressed industry by industry under the IRS’s Industry Issue Resolution program. While they wait for the IRS to issue such guidance, taxpayers owning network assets—who frequently incur significant recurring costs for such assets—face considerable uncertainty as to the proper treatment of such assets for repair and maintenance purposes.

Technical Advice Memorandum (TAM) 200902011, which provides guidance on how a taxpayer with power transmission and distribution lines should determine “single, identifiable properties” in a casualty loss context, may have alleviated some of this uncertainty. The TAM notes the importance of the “unit of property” determination in a Sec. 165 casualty loss context because the amount of basis available to allow the deduction hinges on that definition. The importance of the unit of property definition is certainly not

limited to casualty losses; it is prevalent across the Code for interest capitalization under Sec. 263A, for depreciation under Sec. 168, and certainly for repairs under Secs. 162 and 263(a), among others.

In the second footnote of the TAM, the IRS notes that it is using the term “unit of property” in the generic sense and that this unit of property determination for casualty loss purposes is not binding upon such determinations for other Code provisions. Taxpayers are wise to heed this advice because there are different determining factors for the different Code provisions cited above. For example, in Chief Counsel Advice 200827034, the taxpayer suggested an equivalency between the unit of property determinations under Sec. 263A(f) for interest capitalization and those under Secs. 162 and 263(a) for repairs and maintenance, citing *FedEx Corp.*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), *aff’d*, 412 F.3d 617 (6th Cir. 2005). In this case, the court determined that the unit of property test involved several factors including but not limited to functional interdependence. Because the functional interdependence test under Regs. Sec. 1.263A-10 is an absolute test for determining the unit of property under Sec. 263A(f), the unit of property determined under Secs. 162 and 263(a) is “not necessarily the unit of property for purposes of § 263A(f).”

IRS disclaimers aside, the Sec. 165 casualty loss unit of property analysis in the TAM uses so many of the same factors required of a unit of property analysis for a repair deduction that this TAM may also provide a useful format for helping to determine the unit of property for repair and maintenance purposes for network property.

Several courts have considered the unit of property determination for repair purposes. Most significantly, the court in *FedEx Corp.* provided four factors that it identified from *Ingram Industries, Inc.*, T.C. Memo. 2000-323, and *Smith*, 300 F.3d 1023 (9th Cir. 2002), to be applied in identifying the appropriate unit of property for purposes of applying the repair regulations:

- Functional interdependence;

- Industry treatment for regulatory, marketing, accounting, or other purposes;
- Coextensive useful lives; and
- Maintained while affixed.

Under the TAM, in determining “single, identifiable properties” for casualty loss purposes, the IRS considers a number of factors derived from relevant casualty loss case law. However, when viewed through the lens of the *FedEx* factors, one can see how the IRS might arrive at the same conclusion in a repair context for electrical transmission and distribution “network” assets.

Functional Interdependence

In the TAM, the taxpayer made a functional interdependence argument that the entire transmission and distribution system derived its utility from functioning as a whole. The IRS, like the taxpayer, cited a need to determine “whether it is a unit whose utility derives from functioning as a whole.” However, the IRS disagreed with the taxpayer’s aggregation of the entire transmission and distribution network and instead divided the network into discrete components—in this case, lines, circuits, and substations. The IRS pointed to the fact that the utility planned extra capacity into the network to allow the discrete components to be de-energized for repair while not disrupting the rest of the network, as well as for other operational, functional, and management purposes. This policy of breaking functionally interdependent systems into discrete components is consistent with the proposed repair regulations’ definition of unit of property for plant property, as well as the discrete function test of the repair allowance regulations under Regs. Sec. 1.167(a)-11(d)(2)(vi).

Industry Treatment

The IRS states outright that some factors to consider in determining the proper unit of property for casualty loss purposes include “whether it is consistent with the taxpayer’s other tax accounting practices . . . whether it is accounted for and identifiable as a unit for non-tax accounting purposes . . . whether it is separately treated for operational and management

purposes,” and specifically “whether it is consistent with industry practice.” The TAM goes on to address all these points in reaching its conclusion.

Coextensive Useful Lives

This is the only *FedEx* factor not directly addressed, but because no one factor is determinative, the weight of the other factors appears to support a broader unit of property than an item-by-item approach.

Maintained While Affixed

The TAM states that repairs to and maintenance of the transmission and distribution assets occur while both affixed to and removed from the system. The IRS observes that the taxpayer’s objective is to minimize disruption to its customers and that to do this it must isolate the damaged portion of the network during repair. It is further noted that the “assets being repaired . . . would remain in their physical location while being repaired.” Other minor components, such as transformers, would be removed, replaced with a serviceable unit, and repaired later. The TAM further notes that it would be rare for a casualty to damage an entire system but that certain segments of the system, such as lines, circuits, or substations, would likely be repaired or replaced.

Conclusion

Ultimately, the IRS reached a relatively favorable and reasonable unit of property determination for the taxpayer, concluding that each transmission line, transmission substation, distribution line, and distribution substation was the applicable unit of property, or “single, identifiable property” in the casualty loss context. While the IRS was careful to point out multiple times in the TAM that this determination is applicable only to casualty losses, with the absence of other guidance for network assets in the repair context, the IRS’s analysis provides a framework that taxpayers with network assets may consider when determining their applicable units of property.

From Darrin W. Holley, CPA, and Lynn Afeman, CPA, Washington, DC

Customs Valuation: A Concern for Unsuspecting Tax Practitioners

A taxpayer’s basis in imported goods may depend on customs valuation determinations made by U.S. Customs and Border Protection (CBP). Customs valuation often involves issues that may be unfamiliar to a tax practitioner. Yet failure to recognize this tax-customs intersection may result in unexpected additional tax (non-duty) costs. This item explains the concern and highlights certain procedures designed to coordinate tax and customs valuation.

Sec. 1059A Limitation

Sec. 1059A generally limits taxable basis or inventory cost for imported dutiable merchandise purchased from a related party to the “customs value” of the merchandise declared by the importer of record—often the taxpayer—to CBP (the Sec. 1059A limitation). Normally, full customs value must be reported on the Entry Summary document, Customs Form 7501, which is the customs equivalent of a tax return for a single import transaction. If the taxpayer inadvertently or intentionally undervalues imported merchandise subject to *ad valorem* customs duties, the IRS may decrease the cost basis, resulting in partial disallowance of the property’s tax basis or increased taxable income.

Customs law values imported merchandise based on specified costs or value elements enumerated in the statute (19 U.S.C. Section 1401a). For instance, the statutorily preferred and most commonly used method of customs valuation—transaction value—includes, in addition to the “price actually paid or payable” for the imported merchandise:

- Packing costs;
- Selling commissions;
- Assists (i.e., production items supplied free or at reduced cost by the buyer);
- Royalty or license fees that are a condition of sale; and
- Proceeds of subsequent resale or use that accrue to the seller.

There is also a legal presumption that all payments made by the buyer of

imported merchandise to the foreign seller, or to a party related to the seller, are included in customs transaction value (e.g., research and development cost-sharing payments). See *Generra Sportswear Co.*, 905 F.2d 377 (Fed. Cir. 1990). However, these costs, payments, or value elements are often initially incorrect or omitted from Customs Form 7501 because in the normal course of business the items are not generally reflected (nor expected to be reflected) in the commercial invoices accompanying the import transaction. This in turn caps the inventory tax basis at a lower than expected amount by operation of the Sec. 1059A limitation.

For example, see the following field advice memoranda issued by the IRS:

- **Royalties:** In Field Service Advice (FSA) 200036015, the IRS concluded that the taxpayer did not timely report certain royalties to CBP. Thus, the Sec. 1059A limitation prevented the taxpayer from deducting the royalties from income. In an FSA dated April 11, 1996 (available at 1996 FSA LEXIS 62), the IRS similarly concluded that the taxpayer's tax deduction for royalties may be disallowed under Sec. 1059A.
- **Additional payments and assists:** In an FSA dated January 31, 1997 (available at 1997 FSA LEXIS 83), the foreign manufacturer invoiced the taxpayer separately from the imported merchandise for tooling used to produce the merchandise. Because the taxpayer did not declare tooling costs to CBP, the IRS used the Sec. 1059A limitation to make an upward adjustment to taxable income.
- **Exchange rate:** In an FSA dated July 9, 1997 (available at 1997 FSA LEXIS 45), the foreign exchange rate used by the taxpayer for actual payment resulted in a higher dollar amount than that quoted on the import invoice. The IRS made an adjustment because the amount actually paid for the merchandise, claimed as the tax basis, exceeded the value reported to CBP.

Sec. 482 Transfer Price Increases

Adjustments triggered by the transfer pricing rules can further complicate

Exhibit: Potential adverse tax consequences of Sec. 1059A

Final liquidated value (ceiling on inventory tax basis)	\$	100M
Retroactive price increase (or other undeclared customs value)	\$	10M
True inventory cost basis/COGS	\$	110M
Tax rate		35%
Tax cost of underdeclaring customs value	\$	3.5M

- The taxpayer cannot by operation of Sec. 1059A take a full offset for its cost of goods sold (\$110 million).
- The taxpayer may deduct only the \$100 million final customs value.
- The result is an additional tax cost or tax adjustment exposure of \$3.5 million.

the situation. Specifically, Sec. 1059A exposures are prominent when transfer prices are retroactively increased after year end with an additional payment made to the related seller under Sec. 482 to bring the taxpayer within an arm's-length range. From a customs transaction value perspective, the retroactive increase may be part of the total payment for previously imported merchandise. From a tax perspective, the taxpayer would normally expect the retroactive increase to increase the inventory cost basis; however, the Sec. 1059A limitation may disallow an increase not included in the declared customs value. The exhibit provides a financial illustration of the potential adverse tax consequence of this scenario.

The Sec. 482 adjustment may be initiated by the taxpayer or by the IRS (e.g., the IRS may initiate an adjustment via competent authority or when the IRS is a party to an advance pricing agreement). The regulations arguably support a taxpayer's position that the Sec. 1059A limitation should be increased to allow a full deduction for the cost of imported property when the retroactive transfer price increase is initiated by the IRS under Sec. 482. Regs. Sec. 1.1059A-1(c)(7) provides that Sec. 1059A does not limit the IRS's authority to adjust the claimed basis of inventory cost under Sec. 482.

Timing of Adjustments

The risk of a Sec. 1059A violation is increased if a customs value element is unknown or is undeclared when Customs Form 7501 is initially filed upon importation. However, customs law may

mitigate this risk by providing taxpayers additional—albeit limited—opportunities to increase the customs value, and the Sec. 1059A limitation, post entry.

Regs. Sec. 1.1059A-1(d) binds the taxpayer to the “finally-determined customs value” as determined under the customs laws. Under the customs law, customs value becomes final upon liquidation (19 U.S.C. Section 1503), which generally occurs 314 days post entry. However, post-entry adjustments (PEAs) must be filed 20 days prior to liquidation, effectively reducing the adjustment period to 294 days post entry. Recognizing that these deadlines may not coincide with the timing of retroactive Sec. 482 transfer price adjustments or provide adequate planning certainty, CBP also offers taxpayers an opportunity to make adjustments up to 21 months post entry if the taxpayer applies and is preapproved for CBP's Reconciliation Program.

Taxpayer Protest

Importers may file an administrative protest with CBP to challenge liquidated customs value within 180 days from liquidation, generally extending “finality” a total of 494 days post entry (19 U.S.C. Section 1514). Although the protest period would generally be sufficient to adjust all customs entries filed during the tax year for Sec. 482 adjustments, CBP has determined that it does not have the authority to allow protests for a resulting increase in value, only for a refund or remittance of customs duty. See CBP Headquarters Ruling Letters 228838 (2002), 222982 (1991), 222981 (1991), and 220678 (1989).

CBP's interpretation appears to be at odds with Regs. Sec. 1.1059A-1(d), which provides that liquidation is considered final 90 days following liquidation, "unless a protest is filed." Because an increase to the Sec. 1059A limitation requires an increase to the customs value, the regulation implies that the taxpayer may protest an entry to increase customs value. In FSA 200036015, the IRS acknowledged that the taxpayer's deficiency stemmed from failure to protest the entries to timely report the undeclared royalties. Thus, there appears to be an administrative gap that should be bridged between the two agencies—or reconsidered by CBP—to give taxpayers additional time to make year-end upward adjustments.

Enforcement and Interagency Cooperation

The IRS raises Sec. 1059A challenges primarily upon examination or audit of the taxpayer's income tax return, with CBP's cooperation and information. See, for example, the above-referenced field service advice and *Shabahang Persian Carpets, Ltd.*, 22 C.I.T. 1028 (1998). In addition, under Regs. Sec. 1.6038A-2(b)(5), certain reporting corporations must also complete Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. On the form, they must declare whether the inventory basis of the imported goods is valued greater than the customs value and explain any differences.

In the past two decades, the IRS and CBP have made frequent efforts to improve cooperation in related-party matters. In 1993, Sec. 6103(l)(14) was enacted to allow the IRS to release to the Customs Service (now CBP) information necessary to ascertain whether customs entries were correctly reported. In 1994, the IRS and CBP entered into a "Working Arrangement for Mutual Assistance and Exchange of Information Regarding International Compliance," facilitating the sharing of information, including copies of Customs Form 7501, with the IRS for Sec. 482 purposes (see 94 TNT 184-68 (9/19/94)).

This increased cooperation has been recently evidenced by CBP's participation

in advance pricing agreements and negotiations and the issuance of an informed compliance publication, *Determining the Acceptability of Transaction Value for Related Party Transactions* (2007), identifying differences between Sec. 482 and customs related-party requirements. This publication signals heightened attention by CBP to related-party matters.

Conclusion and Recommendations

The incongruities between customs valuation requirements and taxable basis could go unrecognized if tax departments do not coordinate with their company's customs function. Consequently, the potential adverse tax exposure of Sec. 1059A may be unappreciated, particularly in the context of Sec. 482 transfer price adjustments.

A reasonable understanding of CBP's regulations, valuation methods, and administrative proceedings is necessary to timely reconcile adjustments with CBP (and to properly complete Form 5472). Taxpayers should also develop internal procedures between their tax and customs functions to ensure that additional payments or other customs value issues are properly coordinated. Given the time constraints for revising customs value, absent participation in CBP's Reconciliation Program, a good practice may include instituting a periodic comparison of inventory basis to declared customs value before the end of the tax year. For instance, taxpayers could leverage current processes for calculating quarterly tax provisions and/or estimated federal income tax liabilities.

While analyzing other "book to tax" differences, the taxpayer could also look for any differences between inventory costs in the general ledger accounts and the customs value declared to CBP. If differences are identified, the taxpayer should immediately notify its internal customs department to determine whether customs value adjustments are required and to take the necessary steps to timely report the adjustments to CBP before the PEA period expires for goods imported earlier in the tax year (i.e., for customs entries less than 294 days old). If potential

customs or tax liabilities exist, taxpayers must also give careful consideration to Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, concerning financial accounting and reporting obligations for loss contingencies (i.e., for probable and reasonably estimated liabilities).

As the IRS and CBP move toward more vigorous enforcement of related-party requirements, it potentially becomes more likely that valuation errors will be discovered. The failure to internally coordinate these issues can result in a partial disallowance of tax basis for the imported property, or increased tax liability, and potential IRS and CBP penalties.

From Luis A. Abad, J.D., New York, NY

Sec. 1245 Recapture Rules Can Apply to Stock

Sec. 1245 recapture rules require a taxpayer to characterize gain on the disposition of certain depreciable property as ordinary income to the extent of previously taken depreciation deductions. But those rules can also apply to a disposition of stock. This item discusses how a reduction in a debtor's stock basis through application of the Sec. 108 attribute reduction rules can result in Sec. 1245 recapture on a disposition of that stock. It also examines how the consolidated return rules in certain circumstances eliminate, in whole or in part, the potential Sec. 1245 recapture on a disposition of stock of a subsidiary member.

Sec. 108 Attribute Reduction

If a creditor discharges a debt due from a debtor, the debtor is generally required to include the amount of the cancellation of debt (COD) in gross income (Sec. 61(a)(12)). Under certain circumstances, the debtor excludes COD income from gross income under Sec. 108. For example, COD income is excluded from the debtor's gross income if the discharge occurs when the debtor is in title 11 bankruptcy proceedings. If the debtor is insolvent, COD income is excluded from gross income to the extent of the debtor's insolvency.

There is, however, a price to be paid for excluding COD income from gross

income: The debtor must reduce certain tax attributes in a specified order, generally starting with net operating losses, with basis in assets being near the middle of the tax attribute reduction list (Sec. 108(b)(2)). Sec. 108(b)(5) allows the debtor an election to first reduce basis in depreciable property before returning to the general ordering rules of Sec. 108(b)(2) (a Sec. 108(b)(5) election). Any amount of COD income remaining after the debtor's tax attributes have been reduced as required disappears—i.e., the remaining amount is not included in income and does not reduce any future tax attributes (that amount is often referred to as “black hole” COD income).

Note: The American Recovery and Reinvestment Act of 2009, P.L. 111-5, allows taxpayers to elect to defer recognition of certain COD income from reacquisitions of certain debt instruments (Sec. 108(i)). The attribute reduction rules (and therefore the Sec. 1245 recapture rules discussed in this item) do not apply to COD income subject to this new deferral election.

Whether the debtor reduces basis in property by the general ordering rules of Sec. 108(b)(2) or a Sec. 108(b)(5) election, Sec. 1017 governs the tax treatment. Sec. 1017(d) applies the Sec. 1245 recapture rules when the property (even a capital asset) is later disposed of, resulting in ordinary income up to the amount of the basis reduction (except for property subject to the Sec. 1250 recapture rules, generally real property). Furthermore, Sec. 1017(b)(3)(D) treats stock in a subsidiary as depreciable property for purposes of the Sec. 108(b)(5) election, provided the debtor and subsidiary are members of the same consolidated group and the subsidiary consents to a corresponding reduction in basis of its depreciable property (the Sec. 1017 lookthrough rule).

Sec. 1245 Recapture

Characterization of property, including stock, as Sec. 1245 property has at least two potential results when that property is disposed of. First, the character of gain recognized is ordinary to the extent of previous prescribed reductions in the basis of the property (the Sec. 1245

recapture amount). Second, the Sec. 1245 recapture amount is generally recognized notwithstanding any other provision of subtitle A (income taxes) (Sec. 1245(a)(1) and Regs. Sec. 1.1245-6(a)). As a result, a taxpayer generally is required to recognize the Sec. 1245 recapture amount even if the disposition is in an otherwise nonrecognition transaction. An exception in Sec. 1245(b)(3) provides that “[i]f the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, [or] 361,” Sec. 1245(a) is applicable only to the extent of gain otherwise recognized in the transaction (the Sec. 1245(b)(3) exceptions).

Among the Sec. 1245(b)(3) exceptions are cases in which Sec. 1245 property is distributed by a subsidiary to its parent in a Sec. 332 liquidation, contributed by a parent to its subsidiary in a Sec. 351 transaction, or transferred by a target corporation to an acquiring corporation under Sec. 361 in a Sec. 368 asset reorganization. In each of these cases, the transferee's basis is determined by reference to the transferor's basis (see Secs. 334(b)(1), 362(a), and 362(b), respectively). The reason for the Sec. 1245(b)(3) exceptions appears to be that the Sec. 1245 recapture amount has not disappeared: The Sec. 1245 property distributed in a Sec. 332 liquidation, contributed in a Sec. 351 transaction, or transferred in a Sec. 368 reorganization continues to exist, and the Sec. 1245 recapture amount is now generally subject to recapture in the hands of the transferee (Regs. Sec. 1.1245-2(c)(2)).

Notably, a parent corporation's exchange of the stock of a subsidiary in a Sec. 332 liquidation is not covered by the Sec. 1245(b)(3) exceptions, apparently because the parent's basis in the subsidiary's stock disappears, and the Sec. 1245 recapture amount is therefore not preserved in the hands of a transferee. Thus, a liquidation to which Sec. 332 applies (that generally results in no recognition of gain or loss to the parent corporation) could result in the parent corporation's recognizing gain if:

- The basis of the subsidiary stock was reduced under Sec. 1017;

- As a result, the stock is treated as Sec. 1245 property; and
- The value of the stock at the time of the liquidation exceeds the parent's basis in the subsidiary.

However, as discussed below, if the parent and the subsidiary are part of a consolidated group, the Sec. 1245 recapture amount with respect to subsidiary stock may be eliminated in whole or in part.

Also excluded from the Sec. 1245(b)(3) exceptions is another common disposition of stock in an otherwise tax-free transaction: a Sec. 354 exchange of stock of a target corporation for stock of an acquiring corporation. For policy reasons, one might think that the Sec. 1245 recapture amount could carry over to the stock in the acquiring corporation received in a Sec. 354 exchange. Alternatively, similar to a Sec. 351 exchange of stock that is Sec. 1245 property, one might think that in the case of a Sec. 368(a)(1)(B) reorganization (a transaction in which the target stock continues to exist) the Sec. 1245 recapture amount could carry over to the acquiring corporation. The reason for the exclusion of Sec. 354 from the Sec. 1245(b)(3) exceptions may simply be that the drafters of Sec. 1245 did not focus on the application of Sec. 1245 to stock. Thus, a Sec. 354 exchange (that generally results in no recognition of gain or loss to the target shareholder) could result in the target shareholder's recognizing gain if:

- The basis of the target stock was reduced under Sec. 1017;
- As a result, the target stock is treated as Sec. 1245 property; and
- The value of the target stock at the time of the Sec. 354 exchange exceeds the target shareholder's basis in the target stock.

Consolidated Attribute Reduction

Regs. Sec. 1.1502-28 sets forth rules for the application of Sec. 108(a) and the reduction of tax attributes under Sec. 108(b) when a member of a consolidated group realizes COD income that is excluded from the member's gross income under Sec. 108(a).

There are three main consolidated attribution reduction rules:

- First, the debtor reduces its own tax attributes (the debtor-first rule).
- Second, to the extent the debtor member reduces basis in stock of a subsidiary as part of the debtor-first rule, this subsidiary reduces its tax attributes (the consolidated lookthrough rule). The subsidiary reduces basis in its depreciable property first if the Sec. 1017 lookthrough rule applies because the debtor member elects to treat stock of such subsidiary as depreciable property.
- Third, if the amount of COD income exceeds the tax attributes of the debtor member reduced under the debtor-first rule, the remaining COD income reduces certain other consolidated tax attributes (the fan-out rule).

Absent a special rule discussed below, there is a potential for “double” Sec. 1245 recapture. For example, as described above, a liquidation to which Sec. 332 applies could result in the parent corporation’s recognizing gain if:

- The basis of the subsidiary stock was reduced under Sec. 1017;
- As a result, the stock is treated as Sec. 1245 property; and
- The value of the stock at the time of the liquidation exceeds the parent’s tax basis in the subsidiary.

In addition, if the basis of the subsidiary’s assets was reduced under either of the two lookthrough rules (the Sec. 1017 lookthrough rule or the consolidated lookthrough rule), any asset of the liquidated subsidiary (in which the parent takes a carryover basis under Sec. 334(b)(1)) could be subject to Sec. 1245 recapture again in the hands of the parent.

The consolidated regulations contain a special rule to prevent double Sec. 1245 recapture when asset basis is reduced because of stock basis reduction. Regs. Sec. 1.1502-28(b)(4) prevents the potential for double recapture by providing that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation (and thus subject to Sec. 1245) only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes of the subsidiary that are reduced under the Sec. 1017 lookthrough

rule or the consolidated lookthrough rule (the no double recapture rule).

Regs. Sec. 1.1502-28 is generally effective for COD income that occurs after March 21, 2005. However, taxpayers may apply this section in whole (but not in part) to COD income that occurs after August 29, 2003. Consolidated groups may use the no-double-recapture rule for COD income that occurs on or before August 29, 2003, in cases in which the Sec. 1017 lookthrough rule applied (Regs. Sec. 1.1502-28(d)).

Conclusion

A reduction in a debtor’s basis in stock through application of the Sec. 108 attribute reduction rules generally results in the stock being treated as Sec. 1245 property. As a result, a disposition of that stock may result in all or a portion of the Sec. 1245 recapture amount being recognized (as ordinary income) to the extent there is gain in the stock, even if the disposition otherwise qualifies as a nontaxable transaction. Importantly, the consolidated return rules in certain circumstances eliminate, in whole or in part, the potential Sec. 1245 recapture on stock of a subsidiary member. Because stock treated as Sec. 1245 property generally retains the Sec. 1245 recapture “taint” until there has been a recapture event, taxpayers should take care to identify and monitor stock that is Sec. 1245 property, including as part of due diligence when acquiring a target group.

From *Alla R. Kashlinskaya, CPA, MST, and Brenda L. Zent, CPA, MST, Washington, DC*

GROSS INCOME

Electric Utility Refunds Qualify for Sec. 1341 Tax Mitigation

In a recent private letter ruling, the IRS determined that a publicly regulated utility is entitled to claim benefits under Sec. 1341 for amounts paid to a purchaser of electricity to settle claims asserted against predecessor members of the publicly regulated utility’s affiliated group. Letter Ruling 200901029 is potentially significant for all taxpayers but, as this item points out, is particularly significant to the utility industry. The ruling is interesting because

it addresses how a reorganization affects Sec. 1341 and how the Sec. 1341(b)(2) inventory exception applies to utilities whose rates are subject to the market authority of the Federal Energy Regulatory Commission (FERC) rather than formal rate proceedings.

Background

When a taxpayer receives payments without restriction under a claim of right, the payments must be included in gross income. This is true even if the taxpayer discovers in a later year that it had no right to the payments in the earlier year and is required to repay the same amount. Upon repayment, a taxpayer is generally entitled to a deduction in the year of repayment; however, the deduction’s tax benefit may be less than the tax cost of originally including the payments in gross income. That is, when subsequent repayments exceed income for the year of repayment or when the tax rate for the year of repayment on the remaining income (after subtraction of such repayments) is lower than the tax rate for the year in which the income was previously taxed, the deduction does not adequately compensate the taxpayer for the tax paid in the earlier year.

Sec. 1341 can mitigate this adverse impact of a tax overpayment when the deduction in the year of repayment of an item previously included in income does not provide as great a reduction in tax liability as the tax liability generated when the item was previously included in income. It does this by providing a special tax computation for the year of repayment in a way that gives the taxpayer the equivalent of a tax refund (without interest) for the earlier year. The benefit can also take the form of a refundable tax credit if there is no tax liability in the year of repayment.

Discussion

In Letter Ruling 200901029, the taxpayer asked the IRS to rule that it had met the specific Sec. 1341 requirements, including the requirement that sales income had been included in income based on only an apparent rather than an actual right to the income. Further, the taxpayer asked the Service to rule that currently deductible

settlement payments qualified for Sec. 1341 relief even though they settled claims asserted against successors to the members of the taxpayer's former consolidated group who had originally reported the income (the original income recipients).

The taxpayer in the ruling is engaged in the business of generating electricity and filed consolidated tax returns, which took into account the income and losses of all related entities, including those treated as partnerships or disregarded entities. Two disregarded entities owned by two members of the taxpayer's group supplied electricity to an electric utility where the electric energy industry is regulated by the state and the rates are set by the FERC.

The amounts paid to the original income recipients were subject to refund if the FERC subsequently determined the rates were excessive. In this case, the FERC found the rates to be excessive. Under a settlement agreement approved by the FERC and the bankruptcy court, the successors to the original income recipients, which included the taxpayer, transferred money, stock, and assets to the claimant.

Impact of Reorganization

The taxpayer is a successor parent to an affiliated group that had received prior letter rulings on its tax-free restructuring transactions. Throughout the internal restructurings, the group's business continued to be operated in substantially the same form. When the taxpayer's predecessor and many members of the group entered chapter 11 bankruptcy, the electric utility that had purchased the electricity filed claims against the successors to the original income recipients for overcharging the utility for power sold under rate agreements. Before terminating the bankruptcy proceedings, the consolidated group reorganized, with the original members of the group, including the disregarded entities and corporations that owned them, going out of existence.

In the absence of explicit guidance on how Sec. 1341 applies when a successor to the original income recipient repays the original income and is in a different consolidated group, the IRS determined that the Sec. 1341 tax attribute of the

disregarded entities attached to the individual members of the consolidated group and not to the group as a whole. The income from the electricity sales to the electric utility passed through those disregarded entities to the group members that owned them, and the members took the income into account in computing their separate taxable incomes, the Service reasoned. The IRS also ruled that successor entities in nontaxable reorganizations succeed to the Sec. 1341 tax attribute; however, the IRS did not rule on whether the taxpayer had satisfied the requirements under Sec. 381(a) or (c).

Inventory Exception

The IRS concluded that utilities subject to general FERC authority are considered to be regulated public utilities for purposes of the inventory exception and are therefore eligible for the benefits of Sec. 1341.

Congress provided a "public utility exception" to ensure that a regulated public utility would be able to benefit from Sec. 1341 when required by a regulatory authority to refund rate payments to its customers if the utility otherwise complied with the Sec. 1341 requirements. The relief provided by Sec. 1341 generally does not apply to deductions resulting from inventory sales or sales of stock in trade; however, under Sec. 1341(b)(2) it does apply if the deduction "arises out of [government-required] refunds or repayments with respect to rates made by a regulated public utility."

The IRS concluded that the disregarded entities qualified as regulated public utilities even though the utilities were subject to competitive ratemaking because the rates were subject to FERC jurisdiction. Consequently, the exclusion for sales of inventory did not apply, and the disregarded entities qualified for the tax benefits provided by Sec. 1341.

From Carol Conjura, J.D., CPA, and Paul K. Gibbs, CPA, Washington, DC

PARTNERS & PARTNERSHIPS

Allocating Liabilities Among Related Partners: Determining the Impact of *IPO II*

In 2004, the Tax Court released its decision in *IPO II*, 122 T.C. 295 (2004).

Five years later, *IPO II*'s impact on the allocation of liabilities among related partners has not been fully explored. This item is intended to make the reader aware of *IPO II*'s potential impact on allocating partnership liabilities under Sec. 752 and, given the decision, the unique considerations that must be taken into account in reaching a desired liability allocation among related partners.

Allocation of Liabilities

Although a full discussion of the allocation of partnership liabilities is beyond the scope of this item, some background is necessary to understand the issue addressed in *IPO II*. In relevant part, Sec. 752 treats an increase or decrease in a partner's share of partnership liabilities as a contribution or distribution, respectively, of money by the partner to the partnership or vice versa. Because the deemed contributions and distributions affect a partner's basis in its partnership interests, a partner's share of partnership liabilities is relevant in determining the amount of partnership losses the partner may include on its tax return, the amount of gain or loss recognized if the interest is sold, and the partner's basis in property distributed by the partnership (or, if the distributed property is cash, whether the partner recognizes gain on the distribution).

The Sec. 752 regulations provide rules for determining a partner's share of the partnership's liabilities and make the "economic risk of loss" concept essential to the allocation of partnership liabilities. A partnership liability is recourse to the extent that one or more partners (or a related person) bear the economic risk of loss for the liability. In contrast, a liability is nonrecourse if no partner (or related person) bears the economic risk of loss for the liability. Under these rules, because members of a limited liability company (LLC) are not obligated to pay the debts of the LLC, debt incurred by an LLC is generally nonrecourse for purposes of Sec. 752, unless a member bears the economic risk of loss for such liability by contract (i.e., a guarantee) or the member (or related person) is the lender.

Regs. Sec. 1.752-2 allocates a partnership recourse liability to a partner if and to the extent the partner—or a related person—bears the economic risk of loss. Regs. Sec. 1.752-4 generally treats a person as related to a partner if, among other things, the person and the partner are:

- An individual and a corporation, and the individual owns more than 80% of the corporation's value; or
- Two corporations that are members of the same controlled group of corporations, which generally means that the same person holds, directly or indirectly, at least 80% of the vote or value of both corporations.

If a person is related to more than one partner, the person is treated as related only to one partner—the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership, the liability is allocated equally among those partners (Regs. Sec. 1.752-4(a)(2)).

Example 1: A owns all the stock of X and Y Corps., which own 99% and 1%, respectively, of the interests in LLC Q. Q borrows \$100 from A; neither X nor Y has a payment obligation with respect to the loan. Under the rules above, the liability is allocated equally to X and Y—\$50 each—because they are equally related to A.

Note: Some tax practitioners argue that the liability in Example 1 should be allocated \$99 to X and \$1 to Y. In the author's view, however, "equally" should be interpreted literally rather than as pro rata.

Notwithstanding the above, persons owning interests directly or indirectly in the same partnership generally are not treated as related when determining the economic risk of loss borne by each for the partnership's liabilities (the related-partner exception) (Regs. Sec. 1.752-4(b)(2)(iii)). The related-partner exception is designed to prevent an allocation of partnership liabilities to one partner solely as a result of its relationship with another partner that actually bears the economic risk of loss with respect to the liability.

Example 2: Assume the same facts as in Example 1, except that A is also a member of Q. Absent the related-partner exception, X and Y could argue that they should be allocated a portion of the \$100 liability under Sec. 752 because A, a person related to each of them, bears the economic risk of loss for the loan. However, the related-partner exception "turns off" X's and Y's relationship to A, such that all the liability is allocated to A under Sec. 752.

IPO II

In *IPO II*, the Tax Court addressed the related-partner exception in a more complex fact pattern. In that case, an individual, Mr. Forsythe, owned all the outstanding stock of Indeck Overseas, 70% of the outstanding stock of Indeck Energy, and 63% of the outstanding stock of Indeck Power. Forsythe's children owned the remaining 30% interest in Indeck Energy. Forsythe and Indeck Overseas owned all the interests in IPO II, an LLC classified as a partnership for federal tax purposes. IPO II borrowed cash from an unrelated third party (the IPO II debt).

Under state law, the partners in IPO II—Forsythe and Indeck Overseas—had no legal liability for the IPO II debt. However, Forsythe, Indeck Energy, and Indeck Power guaranteed the IPO II debt; Indeck Overseas did not guarantee it. IPO II allocated a portion of the IPO II debt to Indeck Overseas because Indeck Overseas was related to Indeck Energy—a nonpartner with economic risk of loss for the IPO II debt because of its co-guarantee. The IRS disagreed, asserting that the IPO II debt should be allocated entirely to Forsythe. The Tax Court agreed and held that the IPO II debt should be allocated solely to Forsythe and that none of the debt should be allocated to Indeck Overseas. In so holding, the Tax Court stated:

Indeck Overseas is only related to Indeck Energy via its "relationship" with Mr. Forsythe. . . . Pursuant to the related partner exception, this "relationship" between Indeck Overseas and Mr. Forsythe is severed for purposes of determining whether Indeck Overseas bears

an economic risk of loss for any of IPO II's recourse liability.

We conclude that Indeck Overseas and Indeck Energy are not related parties for purposes of determining whether Indeck Overseas bore any economic risk of loss with regard to IPO II's liability . . . because: (1) Indeck Overseas is not related to Mr. Forsythe pursuant to the related partner exception; and (2) Indeck Overseas is related to Indeck Energy only through Mr. Forsythe, and that relationship is not recognized for purposes of our determination. To hold otherwise would be to allow attribution of economic risk of loss indirectly even though it cannot be attributed directly. [*IPO II* at 304]

The quoted language seems to indicate that the Tax Court read the related-partner exception as completely turning off the relationship between partners—both for determining whether the partners themselves are related and for determining whether a partner is related to another person or entity. Under this interpretation, if one partner's relationship to a party at risk for the liability derives solely from that partner's relationship to another partner, the partner will not be treated as related to the party at risk for Sec. 752 purposes.

Given the facts of the case, it is the author's view that the Tax Court reached the correct conclusion in *IPO II*. A different interpretation would have allocated liability to Indeck Overseas (which bore no direct economic risk of loss for the liability) and away from Forsythe (who did have direct economic risk of loss)—the very type of allocation the related-partner exception was designed to prevent.

It is important to note, however, that the Tax Court did not limit its analysis to instances in which one partner directly bears the economic risk of loss for the liability. One could argue that the related-partner exception merely provides that partners will not be related for purposes of determining their economic risk of loss for a liability. However, when no partner directly bears the economic risk of loss for the liability, their relationship should continue to be acknowledged for purposes of

determining relatedness to other entities. But the court's analysis seems to suggest that the related-partner exception turns off a relationship between partners for all Sec. 752 purposes, even when no direct partner bears the actual economic risk of loss. To illustrate, consider the following example.

Example 3: A owns all the stock of both X and Y. Y, in turn, owns all the stock of Z. A and Y each own a 50% interest in Q, a partnership. Q borrows \$100 from Z; neither A nor Y guarantees the loan.

At first blush, one might argue that A and Y are each equally related to Z, so the liability should be allocated equally to each of them. But under the Tax Court's interpretation of the related-partner exception, A's relationship with Y will be turned off. Because A's relationship to Z derives solely from its relationship to Y, under the Tax Court's interpretation of the related-partner exception, A arguably should not be treated as related to Z. Thus, the entire liability could be allocated to Y, unless the parties successfully convince a court that although A's relationship to Y is ignored for purposes of determining whether A and Y are related, that relationship continues to exist for purposes of determining A's relationship to Z.

Example 4: Using the same ownership fact pattern as in Example 3, assume instead that X and Y each own a 50% interest in Q. Q borrows \$100 from Z. Neither X nor Y guarantees the loan.

Again, a tax practitioner's first thought might be to allocate the liability equally between X and Y because they are both equally related to Z. However, under the Tax Court's interpretation of the related-partner exception, X's relationship to Y arguably should be turned off for all purposes. Thus, X may not be treated as related to Z, so the entire liability would be allocated to Y.

Note that if the parties in Example 4 expected (and wanted) the liability to be allocated equally between X and Y, that allocation could potentially be accomplished. A partnership's liabilities are

allocated based on which party ultimately bears the economic risk of loss. Absent any contractual arrangements, if Z is the lender and Q is the borrower, that person would be Z. However, the parties could shift the economic risk of loss contractually. For example, if A guarantees the liability owed to Z in Example 4—and the guarantee is respected and binding when the determination is made—A (who is equally related to both X and Y) should bear the economic risk of loss for the loan. Thus, the liability should be allocated equally between X and Y. It should be noted, however, that the taxpayer's decision to guarantee an obligation should ultimately consider both the tax and nontax implications.

Unexpected results can also arise when an entity that was previously unrelated to a partner becomes related.

Example 5: Building on the earlier example, assume that X also owns 49% of the stock of U, a corporation unrelated to A, X, Y, and Z under the Sec. 752 definition of a related party. Now assume instead that Y and U are members in Q, which borrows \$100 from X. Under the *IPO II* interpretation of the related-partner exception, all \$100 of the liability initially is allocated to Y, as the only partner related to the lender, X. One year later, Y acquires the remaining 51% of U, and U becomes related to X and Y under the Sec. 752 definition.

If the related-partner exception did not apply, both Y and U would be equally related to X and the \$100 liability would be allocated equally to Y and U. For purposes of allocating the liability among Y, Z, and U, however, the related-partner exception requires us to assume that Y is unrelated to U (i.e., Y owns no stock in U). If so, U would not be equally related to X because U is only 100% related to X because of its stock owned by Y. Thus, all the liability would be allocated to Y.

If Y has taken losses against its share of Q's liability to X, the parties may prefer this result. For other reasons, however, the parties may want to have the liability allocated equally between Y and U. To reach that result, X could acquire the

remaining 51% of U directly, causing Y and U to be equally related to X. Further, if X wanted to purchase the remaining U stock directly but still wanted all Q's liability to X to be allocated to Y, Y could guarantee Q's liability to X. Assuming the guarantee is respected and binding when the determination is made, Y (a partner) should bear the economic risk of loss for the loan. Thus, there would be no need to rely on a relationship between one of the partners and the lender to determine how to allocate the liability for Sec. 752 purposes; it would all be allocated to Y.

Conclusion

For those unfamiliar with the Sec. 752 liability allocation rules, the last two examples may seem to introduce too much selectivity. While it is true that the Tax Court's interpretation of the related-partner exception in *IPO II* does appear to provide taxpayers with options in these situations, those options generally are available in virtually all situations involving the allocation of partnership liabilities. This is the most important point to remember: When related parties are involved, the Sec. 752 rules among partners can lead to some interesting (and often unexpected) allocations of partnership liabilities. When that allocation is undesirable, however, the parties involved can enter into contractual obligations to alter the allocation, subject to the contractual obligation being respected and binding when the determination is made. The key for the informed practitioner, therefore, is to identify what obligations are necessary and when those obligations need to arise to reach the desired allocation for the tax year at issue.

From Deanna Walton Harris, J.D., LL.M., Washington, DC

PROCEDURE & ADMINISTRATION

IRS Announces Procedures for Tax Return Preparer Penalties

The IRS recently issued internal memoranda setting forth procedures for tax return preparer penalties in taxpayer examinations. These include a memorandum by the Large and Mid-Size Business Division (LMSB) on its procedures for

tax return preparer penalty cases and two memoranda by the Small Business/Self-Employed Division (SB/SE) on preparer penalty procedures for excise and employment tax examinations. See LMSB-04-0308-009 (4/13/08), SBSE-04-1208-068 (12/31/08) (excise taxes), and SBSE-04-0209-008 (2/3/09) (employment taxes).

This item summarizes the guidance and highlights some areas of concern. It then describes some steps preparers can take to reduce their penalty exposure.

Summary of Guidance

The LMSB and SB/SE memoranda address preparer penalties under Secs. 6694 and 6695 in response to 2007 legislation extending these (and other) penalties to preparers of all tax returns, not merely income tax returns. See the Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28 (SBWOTA). These memoranda:

- Require examiners to consider the appropriateness of asserting preparer penalties in all taxpayer examinations involving a paid tax return preparer and to document consideration of the issue in the workpapers. The LMSB memorandum explains that “[i]nterviews of the taxpayer should serve a dual purpose: 1) to further the tax examination and 2) to identify violations by a tax return preparer.”
- Emphasize that the taxpayer examination is separate from the potential preparer penalty case and require that files for these matters be maintained separately.
- Provide that a preparer penalty generally cannot be proposed until the taxpayer examination is completed at the group level.
- Permit examiners to decide not to impose preparer penalties on their own, but require a higher level of approval to impose preparer penalties. The LMSB memorandum requires team manager approval prior to initiating a preparer penalty case, and the SB/SE memoranda for employment and excise tax examinations require manager and group approval prior to initiating such a case, respectively. Unlike the SB/SE memorandum for excise tax

examinations, the LMSB memorandum and SB/SE employment tax examination memorandum also provide that a preparer penalty case should not begin until the examiner has contacted the Return Preparer Coordinator.

- Affirm the preparer’s appeal rights—generally, pre-assessment if at least 180 days remain on the statute of limitation and post-assessment otherwise. The memoranda also note that preparer penalties are an Appeals coordinated issue.
- Mandate referral to the Office of Professional Responsibility (OPR) of penalties imposed under Secs. 6694(a), 6694(b), and 6695(f) against a practitioner (i.e., CPA, attorney, enrolled agent, enrolled actuary, or enrolled retirement plan agent) if the preparer penalty case is closed agreed by the examiner or sustained in Appeals, or closed unagreed without Appeals contact.

Preparer Precautions

Practitioners can take steps to reduce their preparer penalty exposure. Of course, the best defense is working closely with clients to produce high-quality work. However, in spite of a practitioner’s best efforts, on occasion there may be difficulties in gathering the facts or differences of opinion between or among the client, the practitioner, and the IRS as to which facts are relevant or the merits of a return position.

The recent IRS guidance may help practitioners in focusing on potential issues. For example, the LMSB memorandum includes examples of questions examiners may ask taxpayers in connection with potential preparer penalties, including:

- Are you aware of any errors, omissions, or mistakes on the return under examination?
- Did you disclose this transaction on your tax return? Why or why not?
- Were there any concerns about how the transaction was reported? What sort of process is used to address those concerns, and on what basis are decisions made?
- Was there any discussion regarding potential penalties?

These questions reinforce the importance of preparers:

- Exercising due diligence in gathering and assembling facts that are potentially relevant to a return position and in determining whether Sec. 6694 standards are satisfied. Although a preparer generally may rely in good faith without verification on information furnished by the client, the preparer must inquire further if the information appears inaccurate, inconsistent, or incomplete.
- Clearly communicating with client concerns about potential reporting positions. This would include discussions with clients about the potential taxpayer penalty consequences of a return position and the opportunity to avoid penalties by disclosure, where relevant.
- Contemporaneously documenting discussions with clients in these (and other) areas.

Practitioners also should remain alert to the fact that they may be subject to Sec. 6694 as nonsigning preparers, even if they do not sign returns as preparers. For example, tax advice may be subject to Sec. 6694 standards, even if the advice is not subject to Circular 230’s covered opinion rules.

Areas of Concern

A general area of concern about the new guidance is that it could encourage IRS examiners and their managers to open preparer penalty cases and/or assert preparer penalties when they are not warranted. This concern is reinforced by SBWOTA’s increase in penalty amounts for Sec. 6694 failures (up to 50% of the fees involved) and the shift in rationale for penalties over the past several years. As recently noted (and questioned) by the National Taxpayer Advocate, the philosophy of civil tax penalties has changed from one that had the sole purpose of encouraging voluntary compliance to one that includes a purpose of economic deterrence (National Taxpayer Advocate, *2008 Annual Report to Congress*, Vol. II, 11 (12/31/08)).

While the important role of return preparers in our voluntary compliance tax system supports imposing preparer penalties when warranted, this role may also be

undermined if the IRS imposes preparer penalties routinely or when reasonable people could disagree as to whether a violation has occurred. Accordingly, the IRS should devote additional resources to training its personnel on the specifics of the penalty rules and on monitoring implementation of the LMSB and SB/SE procedures to help ensure that it imposes penalties only in appropriate situations.

In addition, the IRS rules for administering preparer penalties should be transparent and consistent across functions. It is therefore important that the IRS formalize new procedures in the Internal Revenue Manual as soon as possible. Further, the SB/SE memorandum for excise tax examinations should better align with the other memoranda to require contact with the Return Preparer Coordinator before initiating a preparer penalty case.

Further, IRS procedures should be changed so that a Sec. 6694(a) preparer penalty, in particular, does not automatically lead to a referral to the OPR. Indeed, the mandatory referral approach in the LMSB and SB/SE memoranda for Sec. 6694(a) violations is surprising in view of Treasury's and the IRS's position in the preamble to the proposed Sec. 6694 regulations (REG-129243-07). The preamble provides that the IRS intends to modify its internal guidance so that a Sec. 6694(a) penalty generally will trigger a referral to the OPR only if the violation is willful or egregious or if there is a pattern of violations. According to the preamble, this intent is "[i]n keeping with a balanced enforcement program for tax return preparers" and is consistent with the legislative history to the 1989 legislation introducing the current framework for the return preparer penalty regime (see H.R. Conf. Rep't No. 101-386, 101st Cong., 1st Sess., 662 (1989)).

The preamble's more tempered approach to OPR referrals also makes sense given that Circular 230 disciplines only willful, reckless, or grossly incompetent violations of its return preparation provisions (Circular 230, §§10.34 and 10.52). Moreover, potential referrals should be routed through the applicable Return Preparer Coordinator before they are made to increase consistency and afford

an additional opportunity to determine whether the referral is appropriate.

From Eve Elgin, J.D., LL.M., Washington, DC

S CORPORATIONS

Recent Amendment to Sec. 1374 Provides Limited Opportunity for S Corps.

On February 17, 2009, the American Recovery and Reinvestment Act of 2009, P.L. 111-5 (ARRA), was enacted. ARRA contains numerous tax breaks for individual and corporate taxpayers. Of particular relevance to S corporations is an amendment to Sec. 1374(d) that provides a temporary exemption from the application of Sec. 1374 to sales of assets in 2009 and 2010, but only for S corporations that meet certain requirements. This item discusses the limited opportunity with regard to those S corporations and some of the nuances in its applicability.

Sec. 1374 Generally

An S corporation generally is not subject to federal tax on the income generated by its operations. Instead, that income is allocated among the S corporation's shareholders in accordance with their stock ownership. Each shareholder then includes its allocable share of the S corporation's income on its own federal income tax return and pays tax on that income accordingly. In certain situations, however, the Code provides that an S corporation is subject to a corporate-level income tax under Sec. 1374.

In the Tax Reform Act of 1986, P.L. 99-514, Congress repealed the *General Utilities* doctrine, which had allowed a C corporation to make a tax-free liquidating distribution to its shareholders prior to the sale of the company (*General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)). As a result, when a C corporation with individual shareholders distributes appreciated assets or sells them in the course of a complete liquidation, there are generally two levels of tax, a corporate level and a shareholder level.

Sec. 1374 generally is designed to prevent a C corporation from circumventing the repeal of the *General Utilities* doctrine

by converting to S corporation status before distributing appreciated assets to its shareholders or before selling appreciated assets and distributing the sale proceeds to its shareholders as part of a complete liquidation. To do so, Sec. 1374 generally provides that an S corporation is subject to tax at the highest corporate rate on any net recognized built-in gains (RBIGs) of the corporation recognized during the recognition period, which is generally defined in Sec. 1374(d)(7) as the 10-year period beginning with the first day of the tax year for which the corporation was an S corporation.

Example 1: X, a calendar-year C corporation, elected S status effective on January 1, 2009. X's recognition period begins on January 1, 2009, and ends at the close of the day on December 31, 2018.

Although a full analysis of RBIG is beyond the scope of this item, the Sec. 1374 tax generally will apply to any gain recognized on the disposition of assets by the corporation during the recognition period, except to the extent the corporation establishes that either: (1) the asset was not held at the time of the S election; or (2) the gain exceeds the built-in gain inherent in the asset at the time of the S election. Further, RBIG includes any item of income properly taken into account during the recognition period if that item would have been included in the gross income of an accrual-method taxpayer before the effective date of the S election.

The total amount subject to tax under Sec. 1374 is limited to the S corporation's net unrealized built-in gain (NUBIG). An S corporation's NUBIG generally is the amount of gain the S corporation would recognize on the conversion date if it had sold all of its assets at fair market value to an unrelated party that also assumed all its liabilities on that date.

Sec. 1374(d)(8) Transactions

Sec. 1374(d)(8) extends the application of Sec. 1374 by imposing a tax on an S corporation's net RBIG recognized during the recognition period and attributable to assets that it acquired in a carryover basis transaction from a C corporation (a

Sec. 1374(d)(8) transaction). Each acquisition of assets from a C corporation is subject to a separate determination of NUBIG and a separate 10-year recognition period beginning the day the assets are acquired.

Example 2: Assume the same facts as in Example 1, except that X also acquires the assets of Y, a C corporation, in a carryover basis transaction on January 1, 2010. X's recognition period with respect to the assets X held when it made its S election on January 1, 2009, is unaffected. However, the recognition period with regard to the assets acquired from Y in the January 1, 2010, transaction begins on the date of the acquisition and ends at the close of the day on December 31, 2019.

Because a qualified subchapter S subsidiary (QSub) election results in a deemed liquidation of a wholly owned corporate subsidiary of an S corporation, it is common for an S corporation to acquire assets in a Sec. 1374(d)(8) transaction as a result of a QSub election. Further, because a QSub election may be filed at any time during the S corporation's tax year, this may result in a 10-year recognition period with respect to the QSub's assets that affects 11 tax years of the parent S corporation.

Example 3: Assume the same facts as in Example 2, except that on July 1, 2009, X elects to treat Z, its wholly owned C corporation subsidiary, as a QSub. As a result of the election, Z is deemed to distribute all of its assets to X in liquidation at the close of the day on June 30, 2009. X's recognition period for its other assets remains unchanged. However, X's recognition period for the assets deemed distributed to X in the liquidation of Z begins on July 1, 2009, and ends on June 30, 2019. Thus, the 10-year recognition period for the QSub's assets begins in X's 2009 tax year and continues until X's 2019 tax year, thus affecting a total of 11 of the S corporation's tax years.

The New Legislation and Its Effect on S Corporations

ARRA revises the definition of the term "recognition period" for purposes

of applying Sec. 1374. The revised legislation retains the general definition of recognition period—the 10-year period beginning with the first day of the tax year for which the corporation was an S corporation. New Sec. 1374(d)(7)(B), however, creates an exception to the general rule. For any tax year of an S corporation beginning in 2009 or 2010, no tax will be imposed on the net RBIG of an S corporation if the seventh tax year in the recognition period preceded that tax year (the Sec. 1374 exception). This exception is applied separately for any asset acquired in a Sec. 1374(d)(8) transaction.

The Sec. 1374 exception is intended to provide S corporations that are well into their 10-year recognition period with a reprieve from application of Sec. 1374. The effect on S corporations in particular situations is best illustrated by examples. In each of the following, X is a calendar-year taxpayer and a former C corporation that held built-in gain assets on the date of its S election (S election assets). Y is also a C corporation, the assets of which are acquired by X in a Sec. 1374(d)(8) transaction (the acquired assets).

Example 4: X elected S status effective on January 1, 2001. Thus, by the beginning of 2009, eight tax years of X's recognition period had elapsed. The Sec. 1374 exception applies to sales of the S election assets by X during 2009 and 2010. Because X's recognition period for the S election assets ends on December 31, 2010, as of January 1, 2009, X will no longer be subject to Sec. 1374 for those assets. The same result would be reached if X had elected S status effective on January 1, 2000 (except that X would not need to rely on the Sec. 1374 exception for 2010 because its recognition period would have expired even under the general rule).

Example 5: X elected S status effective on January 1, 2002. Thus, by the beginning of 2009, seven tax years of X's recognition period had elapsed. X acquired Y's assets in a Sec. 1374(d)(8) transaction on December 31, 2002. The Sec. 1374 exception applies to sales of the S election assets by X during 2009 and

2010. However, beginning on January 1, 2011, X's sale of the S election assets arguably will again be subject to Sec. 1374 until the December 31, 2011, expiration of the general 10-year recognition period. The Sec. 1374 exception does not apply to sales of the acquired assets in 2009 because seven years had not elapsed between December 31, 2002, the date of the Sec. 1374(d)(8) transaction, and January 1, 2009. However, the Sec. 1374 exception should apply to sales of the acquired assets in 2010. Beginning on January 1, 2011, however, sales of the acquired assets arguably would again be subject to Sec. 1374 until the December 30, 2012, expiration of the 10-year recognition period.

Example 6: X elected S status effective on January 1, 2003. By the beginning of 2009, only six tax years of X's recognition period had elapsed. Thus, the Sec. 1374 exception will not apply to sales of X's S election assets during 2009. However, by the beginning of 2010, seven years of X's recognition period will have elapsed. Thus, the Sec. 1374 exception will apply to sales of X's S election assets during the 2010 calendar year. Beginning on January 1, 2011, X arguably will again be subject to Sec. 1374 on sales of its S election assets until the December 31, 2012, expiration of the general 10-year recognition period.

Note that the previous examples assume that the application of Sec. 1374 resumes in 2011. This is based on a literal interpretation of Sec. 1374(d)(7)(B) ("In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year"). However, this may not have been Congress's intent in drafting the statute. The conference report for ARRA provides that

no tax is imposed on an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year. Thus, with respect to gain that arose

prior to the conversion of a C corporation to an S corporation, no tax will be imposed under section 1374 after the seventh taxable year the S corporation election is in effect. [H.R. Conf. Rep't No. 111-16, 111th Cong., 1st Sess. 570-571 (2009)]

One could argue that this language indicates that Congress intended to draft a statute under which Sec. 1374 might never again apply to an S corporation's S election assets if seven tax years had elapsed prior to the first tax year beginning on or after January 1, 2009 (or 2010, as appropriate). If this was indeed Congress's intent, it is not apparent from the statutory language, and thus guidance from the government would be helpful.

Short Tax Years

It is interesting to note that application of the Sec. 1374 exception depends on whether seven *tax years* in the recognition period have elapsed. This raises an interesting issue for S corporations that, while C corporations, were on a fiscal year rather than a calendar year. A fiscal-year corporation generally must switch to the calendar year as a result of its S election. Thus, elections by fiscal-year corporations give rise to short first tax years as S corporations. By using the phrase "tax year" rather than "recognition year" or some other term in determining application of the Sec. 1374 exception, the legislation appears to reduce the amount of actual time that must elapse between certain S elections and January 1, 2009 (or 2010, as appropriate), for the Sec. 1374 exception to apply.

Example 7: X, a C corporation with a fiscal year ending on November 30, elected S status effective on December 1, 2002. Thus, X's recognition period begins on December 1, 2002, and ends on November 30, 2012. As a result of its S election, X must use the calendar year as its tax year. So X's first tax year as an S corporation is a short year beginning on December 1, 2002, and ending on December 31, 2002. Thus, as of January 1, 2009, seven tax years (one short year and six full years) have elapsed since the effective date of X's S election.

Accordingly, the Sec. 1374 exception could apply to sales of X's assets in 2009 and 2010, despite the fact that only six years and one month of X's recognition period have passed as of January 1, 2009.

Interestingly, however, the same is apparently not true for Sec. 1374(d)(8) transactions. Although the statute itself appears to treat Sec. 1374(d)(8) transactions similarly (albeit separately), legislative history indicates another intent. The ARRA conference report provides that in the case of built-in gain attributable to an asset received by an S corporation in a Sec. 1374(d)(8) transaction, no tax will be imposed under Sec. 1374 "if such gain is recognized after the date that is seven years following the date on which such asset was acquired" (H.R. Conf. Rep't No. 111-16, 111th Cong., 1st Sess. 571 (2009)). Thus, it appears Congress intended that seven full calendar years must elapse following a Sec. 1374(d)(8) transaction for the Sec. 1374 exception to apply.

Example 8: X elected S status on January 1, 2001. X elected QSub status for Z, its wholly owned subsidiary, effective on December 1, 2002. As discussed above, beginning on January 1, 2009, X will no longer be subject to Sec. 1374 for its S election assets. X's recognition period with respect to the assets acquired from Z begins on December 1, 2002, and ends on November 30, 2012. By January 1, 2009, only six years and one month of the recognition period for the assets acquired from Z have elapsed. Thus, X arguably will be subject to Sec. 1374 for the assets acquired from Z if they are sold prior to November 30, 2009. However, the Sec. 1374 exception will apply to the assets acquired from Z sold between December 1, 2009, and December 31, 2010.

As Example 8 illustrates, the effect of the conference report's explanation of the statute appears to shorten the period during which the Sec. 1374 exception applies to assets held by the S corporation when S status was elected in the short tax year situation described in Example 7, as

compared to certain assets acquired in Sec. 1374(d)(8) transactions. There appears to be no readily apparent reason for doing so. Hopefully, the IRS and Treasury will provide guidance on these issues.

Conclusion

Although relief from taxes is always welcome, this relief unfortunately may be too late for certain taxpayers. Given the current economic situation, the fair market value of many assets—particularly real estate or marketable securities—owned by S corporations may be substantially lower than the fair market value of those assets one year ago. Depending on the type of asset involved, the fair market value today may be even lower than it was at the time the owner of that asset elected S corporation status (or acquired the asset in a Sec. 1374(d)(8) transaction). Because Sec. 1374 applies only to net RBIGs, the statute by definition does not apply when no gain is recognized. Thus, when the value of assets has dropped below the S corporation's basis in those assets, Sec. 1374 will not apply anyway.

Further, a tax adviser should consider that it generally is economics, rather than the federal tax result, that motivates business decisions. The current economic environment may cause S corporations to "wait and see" whether their property recovers lost value. Thus, as a business matter, an S corporation may not be willing to sell property today—at a lower price than it might receive in the future—regardless of whether the law today provides a potentially better federal tax result. Tax advisers, however, should make clients aware of the potential impact of the new law so that they can consider it in making business decisions.

From Deanna Walton Harris, J.D., LL.M., and Paul Kugler, J.D., Washington, DC

TTA

EditorNotes

Mary Van Leuven is Senior Manager, Washington National Tax, at KPMG LLP in Washington, DC.