

Accounting Methods Spotlight

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Did you know...?

Certain 2011 tax returns will require separate disclosure of Form 1099-K gross receipts

Draft versions of 2011 Forms 1120 and 1065 recently released by the IRS reveal that taxpayers should expect to see an expanded Line 1 for business gross receipts.

The gross receipts line on Forms 1120 and 1065 will now require taxpayers to separately report gross receipts for which the taxpayer received a Form 1099-K and all other gross receipts. Form 1099-K, *Merchant Card and Third Party Payments*, is a new form created for the required reporting under §6050W, which requires credit card companies and electronic payment processors to provide annual statements to payees who receive more than \$20,000 and conduct more than 200 transactions each year. This section was implemented as part of the Housing and Economic Recovery Act of 2008.

Line 1a of Forms 1120 and 1065 now reads, “Merchant card and third-party payments.” The number on Line 1a must match the amount included on Form 1099-K for payments the taxpayer received from credit card vendors such as MasterCard, Visa, and PayPal.

A new Line 1b reports the remaining “gross receipts or sales of the company not reported on line 1a.”

Line 1d has been changed to read, “Returns and allowances plus any other adjustments.” The wording is similar to

the 2010 Line 1b, which previously read, “Less returns and allowances.”

Potential issues under final §381 regulations

In August 2011, the IRS and Treasury issued final regulations under §381 that modify the rules for determining the method of accounting that must be used by the acquiring corporation in certain corporate reorganizations or tax-free liquidations described in §381. While these regulations provide clarity on a number of issues, they also present some potential traps for taxpayers.

For example, the final regulations, among other things, provide that an acquiring corporation that has undergone a §381 transaction generally does not need to secure IRS consent to continue a carryover method or use the principal method of accounting, provided such method is a permissible method of accounting. If either the principal method or the carryover method is impermissible, the acquiring entity is required to change the method of accounting under the provisions of §446. However, the regulations only waived the scope limitation relating to the final year of a trade or business. Consequently, if the change from the impermissible method would be non-automatic under Rev. Proc. 2011-14 because of the §381 scope limitations in that revenue procedure, the taxpayer will be unable to file using the automatic consent procedures because the regulations failed to waive the §381 scope limitation of Rev. Proc. 2011-14.

In addition, the final regulations do not provide an exception for situations in which a party to a §381 transaction is under IRS exam and is required to change either a principal method or a

carryover method because it is impermissible. Therefore, if no window period is available to file the Form 3115, the only available option would be to file with director consent. Given that the change required to be filed is from an impermissible method of accounting, there is some concern that it may not be possible to secure consent to file the change and that the Examination division will propose an adjustment in a pre-transaction year based on the improper method.

Treasury Associate Tax Legislative Counsel, Brandon Carlton, speaking at a recent DC Bar Taxation Section luncheon, said that the failure to include a special waiver of the §381 scope limitation in Rev. Proc. 2011-14 in the final regulations, is “something of an oversight.” Carlton stated that the Treasury and the IRS will likely address such automatic changes in §381 acquisitions when Rev. Proc. 2011-14 is updated. In light of these comments, taxpayers should monitor any changes to the accounting method change procedures to see how or if these issues are addressed.

Certain AMT NOLs may be carried forward to offset AMTI by 100%

Recently, many taxpayers have benefitted from an election pursuant to IRC §172(b)(1)(H) to expand the carryback period of amounts attributable to net operating losses (NOLs) for tax years beginning in either 2008 or 2009. The election allowed taxpayers to carryback regular and alternative minimum tax (AMT) NOLs up to five years.

Pursuant to the election, the expanded carryback suspended the 90-percent limitation on the use of any AMT NOL deduction attributable to carrybacks of the applicable NOL for which an extended carryback period was elected. Because of the election, an AMT NOL not fully utilized after the expanded carryback remains exempt from the 90-percent limitation and may be carried forward to entirely offset alternative minimum taxable income (AMTI) in future tax years.

As a result of the adjustments to the AMT NOL deduction computation in IRC §56(d)(2), any amount of AMT NOL available for carryforward may offset AMTI prior to utilizing AMT NOL amounts attributable to tax years beginning in 2008 or 2009 for which a taxpayer made the §172(b)(1)(H) election. This unusual ordering rule for AMT NOLs may allow a taxpayer to offset 100% of its AMTI for multiple tax years.

Other Guidance...

Commitment fee for construction financing must be capitalized

In a legal memorandum, ILM 201136022, the IRS determined that a commitment fee incurred for construction financing creates an asset, the adjusted basis of which must be included in accumulated production expenditures under §1.263A-11.

The taxpayer entered into financing agreements with a lender to fund the construction of property. In connection with the financing agreements, the

taxpayer paid a commitment fee to the lender on un-borrowed amounts. Once the taxpayer borrowed these amounts, the commitment fee ceased to be paid. All borrowed amounts were used to fund construction.

The IRS stated that the purpose of including an asset's adjusted basis in accumulated production expenditures is to ensure that the interest theoretically incurred on that asset, had it been purchased with debt, is included in the interest capitalization computation.

In this case, the taxpayer incurred the commitment fee for the purpose of ensuring access to funds to produce the unit of designated property. In concluding that the commitment fee had to be included in the taxpayer's accumulated production expenditures, the IRS National Office concluded that the commitment fee created an asset for the taxpayer, which the IRS National Office believed was used in a reasonably proximate manner to the production of the unit of designated property. As such, the basis of this asset was required to be included in the taxpayer's accumulated production expenditures.

Safe harbor for electric transmission, distribution property

In Rev. Proc. 2011-43, the IRS provided a safe harbor method of accounting that taxpayers may use to determine whether expenditures to maintain, replace, or improve electric transmission and distribution property must be capitalized under §263(a). The revenue procedure also provides procedures for obtaining automatic

consent to change to the safe harbor method of accounting.

Rev. Proc. 2011-43 applies to a taxpayer that:

- 1) Has a depreciable interest in electric transmission or distribution property used primarily to transport, deliver, or sell electricity; and
- 2) Applies the transmission and distribution property safe harbor method of accounting to all of its electric transmission and distribution property. The determination of whether a taxpayer is within the scope of the revenue procedure is made by each member of a consolidated group, by a partnership, or by an S corporation.

A taxpayer using the transmission and distribution property safe harbor method must determine its units of transmission and distribution property as provided in the revenue procedure. For each replacement of a portion of a unit of linear property, the taxpayer must determine whether more than 10% of the unit of linear property is replaced. If more than 10% of the unit of linear property is replaced, the cost of the replacement must be capitalized. If 10% or less of the unit of property is replaced, the cost of the replacement is not required to be capitalized under §263(a). In general, individual replacements within a circuit are not aggregated in determining the percentage of a unit of linear property replaced. In some situations, however, aggregation is required. The safe harbor method described in Rev. Proc. 2011-43 provides the exclusive means for taxpayers using the transmission and distribution property safe harbor

method to determine whether an expenditure for linear property is deductible or must be capitalized.

Taxpayers should note that a change to the transmission and distribution property safe harbor method is a change in method of accounting. A taxpayer who wants to change to this method of accounting must use the automatic change provisions in Rev. Proc. 2011-14, or its successor, as modified by Rev. Proc. 2011-43. Rev. Proc. 2011-43 is effective for tax years ending on or after December 31, 2010.

Revocation of 2010 PLR on fringe benefits

In PLR 201135022, the IRS revoked a 2010 ruling (PLR 201005014) which concluded that the value of certain clothing items and accessories provided to employees was excludible from gross income as a de minimis fringe benefit under §132(a)(4). The taxpayer's employees received work-related articles of clothing and accessories, including tee shirts, polo shirts, sweaters, jackets, swimsuits, fanny packs, etc., which they were required to wear while performing services. The taxpayer's logo was printed on many of these items. The IRS had concluded that the items at issue were de minimis fringe benefits because the taxpayer was able to demonstrate that the items provided to the employees were of low value, that it was administratively impracticable to account for the value of the items, and that it did not provide the items to items employees too frequently.

Subsequently, the IRS advised the taxpayer that it was reconsidering the February 5, 2010 letter ruling. In response to a request from the IRS, the

taxpayer had provided additional information which contained some variations regarding the manner in which and the frequency with which the employees acquired the clothing and accessories.

As a result of those variations the IRS could no longer conclude, on a categorical basis, that the items were de minimis fringe benefits. Therefore, the IRS declined to rule on the taxpayer's request.

Recent Cases...

Amortization under §197 requires an active trade or business

In *Broz v. Commissioner*, 137 T.C. 5 (2011), the U.S. Tax Court held that the mere grant of a Federal Communications Commission (FCC) license was insufficient to begin amortization under §197 where the petitioners were not engaged in the active conduct of a trade or business.

The petitioners were shareholders in a wholly owned S corporation engaged in providing wireless cellular service. The corporation acquired wireless cellular licenses from the Federal Communications Commission and built networks to service the license areas. The petitioners formed related holding companies to hold title to the licenses and equipment. During the years at issue, none of these entities were engaged in a trade or business.

Although the petitioners and the IRS agreed that the FCC licenses were amortizable under §197, the parties

disagreed as to when the amortization should begin. The petitioners argued that §197 did not have a trade or business requirement, and as such, amortization should begin at the time the FCC licenses are granted. Finding in favor of the IRS, the Tax Court noted that the purpose of §197 was to provide taxpayers with a deduction similar to §167, which allows a depreciation deduction for property used in a trade or business. The court did not believe Congress, when enacting §197, intended to create a different result by allowing taxpayers to amortize intangible assets without regard to whether the taxpayer was in a trade or business.

The court then considered the nature of the trade or business requirement for purposes of §197. Although the taxpayer argued that the trade or business requirement of §197 should be compared to §174, the court found that the appropriate standard to be applied is that imposed by §162, which requires an active trade or business. Therefore, because the petitioners were not engaged in the active conduct of a trade or business during the years at issue, they were not entitled to amortization deductions for the FCC licenses.

Settlement proceeds for misappropriation of trade secrets taxable as ordinary income

In *Freda v. Commissioner*, 108 AFTR2d 5985 (7th Cir. Aug. 26, 2011), *affg* TC Memo 2009-191, the Seventh Circuit affirmed the Tax Court's holding that proceeds received in settlement of a trade secret misappropriation suit were taxable as ordinary income and not capital gain, finding no error in the court's conclusion that the settlement

was for lost profits and not for a sale or termination of rights to a trade secret.

In *Freda*, sausage manufacturer C&F Packing Co., Inc. ("C&F"), an S-Corporation, brought a variety of claims against its former business partner, Pizza Hut, Inc., in 1993. In 2002, C&F agreed to drop its last remaining claim—trade secret misappropriation—in exchange for a \$15.3 million payment from Pizza Hut.

C&F reported the settlement proceeds as long-term capital gain from a sale of the trade secret on its federal income tax return. On examination, the IRS concluded that the settlement income was taxable as ordinary income and issued a notice of deficiency. The shareholders challenged the determination in the Tax Court, which held on behalf of the IRS.

On appeal, the taxpayer put forth various arguments as to why the proceeds should be taxed as capital gain. First, the taxpayer alleged that the proceeds were received as compensation for damage to a capital asset. When looking to C&F's claims against Pizza Hut, however, C&F only sought payment for lost profits and not payment for damages to the trade secret.

The taxpayer then argued that the settlement resulted in a sale or exchange of the trade secret. When applying the factors of §1235, the court found that there had not been a transfer of all substantial rights to the trade secret. Moreover, the language in the settlement agreement did not support the assertion that the payment related to either the purchase or the use of the trade secret by Pizza Hut.

The court found that the taxpayer's arguments were without merit. Accordingly, the Seventh Circuit

affirmed the Tax Court's holding that the proceeds were taxable as ordinary income.

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