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The following information was taken from RIA Checkpoint from the period of December 11, 2009 through September 30, 2010.

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**Income Tax—Capitalization of Royalty Costs:** Taxpayer designs, manufactures, and sells kitchen tools, and in doing so paid and deducted license fees to use certain trademarks on its products. The Tax Court previously agreed with the IRS that the fees were capital in nature and should have been deducted over time under IRC Sec. 263A and the underlying regulations. In reversing the Tax Court, the 2nd Circuit found that the royalties were not "properly allocable to property produced" under Reg. 1.263A-1(e)(3)(i). Taxpayer's royalties were calculated as a percentage of the net sales of the kitchen tools, and were incurred only upon the sale of those tools. Had taxpayer's licensing agreements required the payment of a non-sales-based royalty (e.g., paid for each item manufactured), capitalization would have been required. *Robinson Knife Manufacturing Co. v. Comm.*, 105 AFTR 2d 2010-XXXX (2nd Cir.).

**Income Tax—Percentage-of-completion Accounting Method:** Reversing a Kansas District Court, the 10th Circuit held that a paving contractor was not entitled to use the Percentage-of-completion Method (PCM) of accounting to report \$62 million of income from the State of New Mexico for warranting a state highway would meet certain performance standards over a specified period of time. [ **Editor's Note:** To market its higher cost, longer lasting roads made of a polymer-modified asphalt, taxpayer offered extended warranties on its roads.] The 10th Circuit concluded that the PCM applies only if the "manufacture, building, installation, or construction is necessary for the taxpayer's contractual obligations to be fulfilled" under

Reg. 1.460-1(b)(2)(i) , and the PCM cannot be used to defer tax on income received under a guaranty, warranty, or maintenance agreement. *Koch Industries Inc. v. U.S.* , 105 AFTR 2d 2010-XXXX (10th Cir.).

**Income Tax—Passive Activity Losses:** [IRC Sec. 469\(c\)\(7\)](#) allows taxpayers in a real property business to treat real estate rental activities as non-passive if (1) more than half of the personal services performed during the year are in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of service in the real property trades or businesses. In this case, the Tax Court ruled against the taxpayer's claim that 105 of his "on call" hours count toward meeting the 750-hour requirement because the Code requires actual performance of services. [ **Editor's Note:** Similarly, my wife does not believe I am "on call" while on the sofa watching a football game.] In addition, the court found the taxpayer liable for accuracy related penalties. *James Moss* , [135 TC No. 18](#) (Tax Ct.).

**Procedure—Change in Accounting Method:** Taxpayer began using a particular accounting method (Method X) in Year 1. In Year 4, taxpayer requested permission to *change* (emphasis by IRS) its method of accounting to continue using Method X (i.e., a request for advance consent to make a protective change in accounting method). In emailed advice, the IRS noted that taxpayer has been using Method X since Year 1 (and so has adopted Method X by using it on two consecutive tax returns). Therefore, taxpayer's request does not involve a *change* , is outside the scope of Rev. Proc. 97-27 (1997-1 CB 680) , and should be returned to taxpayer. CCA 201033038 .

**Income Tax—Capitalized Incentive Payments:** Taxpayer is a manufacturer that enters into one of three product supply agreements with its customers, one of which requires a minimum purchase by the customer. The minimum purchase agreements may include an incentive payment or signing bonus to the customer, which vary by customer and are usually based on the volume of products taxpayer expects the customer to buy. The IRS ruled that incentive payments must be capitalized under IRC Sec. 263(a) and Reg. 1.263(a)-4(d)(6) , which requires capitalization when an agreement gives a party the "right to provide or receive services." Ltr. Rul. 201032025 .

**Income Tax—Employee's Legal Expense Deduction:** Taxpayer worked for Merrill Lynch as a financial adviser. His contracts referred to his *employment* with Merrill; Merrill paid him a salary and issued Form W-2; and taxpayer never filed a Schedule C or paid self-employment taxes on his income. Nevertheless, following the arbitration of his claim for wrongful termination and retaliatory discharge, taxpayer reported the award as wages but deducted the legal expenses on Schedule C. In a summary opinion, the Tax Court held that the expenses were deductible on Schedule A as unreimbursed employee business expenses subject to the 2% of AGI floor. After applying the employer-employee factors to the facts of this case, the Tax Court found that taxpayer incurred the legal fees as an employee, not as an independent contractor, sole proprietor, or partner. *James Purdy* , TC Summ. Op. 2010-26 (Tax Ct.).

**Employment Taxes—Severance Payments:** The "straightforward, but legally-confounding question" in this case was whether severance payments to terminated employees qualified as *wages* for FICA tax purposes. In finding that the severance payments should be viewed as wage-replacement social benefits, not taxable remuneration for services rendered, a Michigan District Court concluded that the payments meet the definition of "supplemental unemployment compensation benefits" (SUB pay) in IRC Sec. 3402(o)(2) . [ **Editor's Note:** This conclusion—that IRC Sec. 3402(o) controls the determination of whether the severance payments are taxable for FICA—may provide a refund opportunity for similarly situated employers.] SUB pay is specifically excluded from the definition of *wages* for tax withholding purposes, and there "is no justification for differing interpretations of wages under the FICA and income tax withholding statutes." *U.S. v. Quality Stores, Inc.* , 105 AFTR 2d 2010-1110 (DC Mich.).

**Income Tax—Personal Service Corporations:** A Personal Service Corporation (PSC) cannot use the graduated income tax rates otherwise available to regular C corporations, but is taxed on all taxable income under IRC Sec. 11(b)(2) at a flat 35% rate. In this case, the Tax Court held that a land surveying company was a PSC subject to the 35% tax rate. The fact that taxpayer employed no licensed engineers was not controlling because the determination of whether services qualify under IRC Sec. 448(d)(2) is based on the facts and not state licensing laws. The court then held that Temp. Reg. 1.448-1T(e)(4)(i) —which includes surveying and mapping—was a reasonable interpretation of the Code and was supported by the ordinary meaning of the word *engineering* , which encompasses surveying. *Kraatz & Craig Surveying Inc.* , 134 TC No. 8 (Tax Ct.).

**Income Tax—Real Estate Professionals:** In determining whether a person's real property activities result in passive activity losses, each interest is treated as a separate rental real estate activity unless the person elects to treat all interests in rental real estate as a single activity under IRC Sec. 469(c)(7)(A). After noting that the taxpayer "must make an explicit election with his or her original return," the Tax Court found that taxpayer did not attach a statement to any return electing to treat his rental real estate activities as a single activity. [ **Editor's Note:** At trial, taxpayer claimed he met the election requirement when "he wrote on a piece of paper that he wanted to aggregate his rental real estate and tried handing it over to (the IRS)."] The fact that taxpayer consistently aggregated the rental income and expenses from the rental properties on his Schedules E was not a *deemed election* for Section 469(c)(7)(A) purposes. *Donald William Trask*, TC Memo 2010-78 (Tax Ct.).

**Income Tax—Defective Merchandise Vendor Allowance:** Taxpayer received a *defective merchandise allowance* when it purchased merchandise from certain vendors. The allowances were a fixed percentage of total purchases and were intended to cover the estimated costs of defective merchandise bought by taxpayer. Taxpayer was not required to return the defective merchandise or notify the vendor of the amount of merchandise determined to be defective. In chief counsel advice, the IRS concluded that the allowances were not part of total sales under [Reg. 1.61-3\(a\)](#), but instead were a discount that reduced the cost of all merchandise purchased from the vendor, not just the merchandise found to be defective. Furthermore, taxpayer was not required to capitalize the acquisition cost of defective merchandise as an indirect cost of nondefective merchandise under [Reg. 1.263A-1\(e\)\(3\)\(ii\)\(Q\)](#). [CCA 200945034](#).

**Income Tax—Depreciation on Leased Aircraft:** This technical advice memo addresses the 50% business use test in [IRC Sec. 280F\(b\)\(3\)](#) and the exemption to lessors under [IRC Sec. 280F\(c\)\(1\)](#) for taxpayers who lease aircraft. A husband and wife, along with a related company, owned all of the aircraft in question and leased the aircraft solely to related entities. Because of the common ownership, the owners are not regularly engaged in the business of leasing aircraft. Therefore, two of the leased aircraft are not exempt under [IRC Sec. 280F\(c\)\(1\)](#) from the depreciation limitations imposed by [IRC Sec. 280F](#). Furthermore, a third aircraft used heavily for personal use is not predominately used in a qualified business under [IRC Sec. 280F\(d\)\(6\)](#) and so, is subject to the depreciation limitations of [IRC Secs. 280F\(b\)](#) and (d). [TAM 200945037](#).

**Income Tax—Loan Interest Paid by Government Agency:** To help small businesses experiencing immediate financial hardship, the Small Business Administration (SBA) implemented the America's Recovery Capital (ARC) Loan Program, allowing a qualified small business borrower to get a loan from an SBA-approved lender to make payments on a qualifying small business loan. Under the terms of an ARC loan, the SBA pays monthly interest to the lender, while the borrower has no obligation to pay any interest on the loan. In Chief Counsel Advice, the IRS concluded that a *qualified small business borrower doesn't have to include interest paid by the SBA to the lender in income under IRC Sec. 61*. However, the borrower cannot claim an interest deduction for the payment. [CCA 200943028](#).


**Substantiating Employees' Business Expenses:** The IRS updated the rules for when an employee's lodging, meal, and incidental expenses incurred while traveling on business will be deemed substantiated under [Reg. 1.274-5](#) when the employer (or a third party) pays the expenses with a per diem allowance under a reimbursement or other expense allowance arrangement. A revised list of high-cost localities is provided for using the high/low method—a per diem of \$258 is assigned to high-cost localities (\$65 for meal and incidental expenses), while \$163 is assigned to other localities (\$52 for meal and incidental expenses). The updated rates and rules apply to per diem allowances paid to employees on or after 10/1/09 for expenses paid or incurred for travel on or after that date, although there are transitional rules for using the high/low method for the last three months of 2009. [Rev. Proc. 2009-47, 2009-42 IRB](#).

## Change of accounting from capitalization to deduction as repairs designated Tier 1 item

### Tier I Industry Director's Directive on the Planning and Examination of Repairs vs. Capitalization Change in Accounting Method (CAM) #1 and #2

In several Industry Directives, IRS has declared the repairs vs. capitalization change of accounting method (CAM) issue to be a Tier 1 issue. Under IRS's rules of engagement for Large & Mid Size Business Division (LMSB) examinations, Tier I issues are of high strategic importance to LMSB and have a significant impact on one or more industries.

*Background.* Costs are currently deductible as a repair expense under [Code Sec. 162](#) if they are incidental in nature, and neither materially add to the value of the property nor appreciably prolong its useful life. Costs also are currently deductible if they are for materials and supplies consumed during the year. Expenses must be capitalized under [Code Sec. 263](#) if they are for permanent improvements or betterments that increase the value of the property, restore its value or use, substantially prolong its useful life, or adapt it to a new or different use.


 **RIA observation:** Current regs don't clearly address the issue of whether expenses should be deducted currently (e.g., as repairs or as materials or supplies) or capitalized. As a result, over the years the issue has spawned a host of court cases and IRS rulings dealing with questions such as how to treat environmental remediation expenses, rotatable spare parts used in repairs, and repairs undertaken during an overall plan of rehabilitation. Proposed regs issued in 2006 were an ambitious attempt to rectify the lack of guidance but were roundly criticized by practitioners and were replaced in 2008 with a new set of regs that would be effective for tax years beginning on or after the date that they are finalized (see Weekly Alert ¶ 3 03/18/2008 , Weekly Alert ¶ 4 03/18/2008 , and Weekly Alert ¶ 5 03/18/2008 ).

The 2008 proposed regs would, among other important changes, scrap the judicially developed plan of rehabilitation doctrine, under which a taxpayer must capitalize otherwise deductible repair costs if they are incurred as part of a general plan of renovation or rehabilitation. The new proposed regs would specifically provide that repairs made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, don't have to be capitalized under [Code Sec. 263\(a\)](#). The proposed regs would put in place new terms and new definitions that permit taxpayers to deduct “routine maintenance” performed on a “unit of property” and require “betterment costs” to be capitalized (see Weekly Alert ¶ 5 03/18/2008 ).

In [Rev Proc 2009-39, 2009-38 IRB](#), amending [Rev Proc 2008-52, 2008-36 IRB 587](#), IRS clarified, modified, and amplified the procedures under which a taxpayer may obtain automatic consent for a change in an accounting method.” Appendix Section 3.06 of [Rev Proc 2009-39](#) provides automatic consent for a taxpayer that changes its method of accounting from capitalizing under [Code Sec. 263\(a\)](#) to deducting the repair and maintenance costs as ordinary and necessary business expenses under [Code Sec. 162](#) and [Reg. § 1.162-4](#) (see [Weekly Alert ¶ 18 09/03/2009](#) ).

Before [Rev Proc 2009-39](#), taxpayers were requesting and being granted consent for the capitalization to repairs CAM under [Rev Proc 97-27, 1997-1 CB 680](#). Both the advance consent agreements issued pursuant to [Rev Proc 97-27](#), and Appendix Section 3.06 of revised [Rev Proc 2008-52](#), provide that the consent granted for this change is not a determination that the taxpayer is using the appropriate unit of property (UOP) in determining the deductibility of repair and maintenance costs.

*Impetus for Tier 1 designation of repairs vs improvements issue.* IRS says taxpayers are filing Forms 3115 requesting a CAM for tangible assets. This is a cross industry issue affecting all industries, with significant impact in the utilities, telecommunications, gaming, retail, restaurant and hotel industries.

 **RIA observation:** Reading between the lines of the Tier 1 designation, it seems as if taxpayers might be basing their CAM requests on the repairs vs. improvements guidelines in the proposed regs issued in 2008, rather than on the cases and rulings that apply currently.

Two IRS documents issued in connection with the Tier 1 designation offer the following guidance to Industry Directors and their staffs:

... The proposed regs issued in 2008 clearly state that when issued, the final regs will be prospective only. Thus, the proposed regs can't be cited or relied on until issued as final regs. Examination teams are told to analyze whether the expenses included in the taxpayer's [Code Sec. 481\(a\)](#) adjustment are deductible using current law principles. This will in part involve the determination of what the UOP is in the taxpayer's CAM request. IRS says the UOP determination can impact whether a project should be accounted for as a repair (and deducted) or as an improvement (and subject to

capitalization). Examination teams also are advised that current case law and other guidance are considerable and each project needs to be evaluated before the law can be properly applied.

... Neither the granting of an automatic consent under Appending Section 3.06 of [Rev Proc 2008-52](#) nor the granting of consent under [Rev Proc 97-27](#) prevents examiners from auditing the issue of whether certain expenses are deductible repair costs or costs that should be capitalized. Examiners may challenge any factual representations made by a taxpayer in auditing this issue including, but not limited to, a taxpayer's determination of a UOP. Whether a taxpayer's determination of its UOP is correct, and the determination that specific costs qualify for deduction or capitalization under current law are decisions left to field examiners. Therefore, adjustments should be considered if field examiners discover that any of the taxpayer's representations are incorrect including the taxpayer's determination of a UOP.

IRS says that the Issue Management Team (IMT) is seeking to publish guidance of the repairs vs. improvements issue through the Industry Issue Resolution (IIR) process. The IMT is currently soliciting IIR requests for this issue for entities operating in the following industries: retail and/or restaurants; utilities; and telecommunications.

### **Recharacterization of activity from nonpassive to passive wasn't accounting method change**

#### **[PLR 201035016](#)**

In a Technical Advice Memorandum (TAM), IRS has concluded that a recharacterization of a taxpayer's activities from nonpassive to passive for purposes of the [Code Sec. 469](#) passive activity loss (PAL) rules didn't result in a change in accounting method, warranting a [Code Sec. 481\(a\)](#) adjustment.

*Background on PAL rules.* Under the [Code Sec. 469](#) PAL rules, taxpayers cannot use deductions arising from passive activities to offset income from personal services, portfolio income and income from a trade or business which is not a passive activity (i.e., nonpassive income). Generally, deductions arising from passive activities may only be used to offset the income arising from passive activities. Deductions arising from a passive activity that cannot be fully used against income from passive activities may be carried forward. Passive activities include the conduct of trade or business activities in which the taxpayer doesn't materially participate and, generally, rental activities without regard to whether the taxpayer materially participates in them. ([Code Sec. 469\(c\)](#), [Reg. § 1.469-1T\(e\)\(1\)](#))

*Background on accounting method changes.* Under [Code Sec. 446\(e\)](#), a taxpayer that changes the accounting method on which it regularly keeps its books must generally secure IRS's consent before computing taxable income under a new method. Under [Reg. § 1.446-1\(e\)\(2\)\(ii\)\(a\)](#), a change in accounting methods includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of an item in income or the taking of a deduction. Under [Code Sec. 481](#), taxpayers must make an adjustment to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any change in an accounting method.

*Facts.* X owned a 1% general partner interest and X and Y (collectively, Taxpayers) owned a 99% limited partner interest, through their living trust, in **Partnership**, a limited **partnership**. **Partnership** developed a nursing home and hired a management company, Company, to operate the nursing home in exchange for a fee plus a portion of the profits. Taxpayers determined that they materially participated in the nursing home from '90 through '94, and so treated the losses flowing from **Partnership** as not being subject to the PAL rules. These losses either were carried back to prior years or offset other income in those years. Thus, Taxpayers offset their ordinary income with the losses from the nursing home on their tax returns from '90 through '94.

On audit of Taxpayers' '94 tax year, the IRS examiner questioned whether Taxpayers materially participated in the nursing home activity and so were correct in deciding that their ownership of the nursing home wasn't a passive activity in '94. The Taxpayers did not agree with the examiner's position. However, solely for purposes of the TAM, the National Office assumed

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that Taxpayers didn't materially participate in the nursing home activity in '94 and so were subject to the [Code Sec. 469](#) PAL rules in that year.

*The issue.* The examiner requested guidance on whether a recharacterization of activities from nonpassive to passive for purposes of [Code Sec. 469](#) was a change in accounting methods under [Code Sec. 446\(e\)](#), that required the computation of an adjustment under [Code Sec. 481\(a\)](#). He argued that each year that an activity changed from nonpassive to passive, or vice versa, a taxpayer must file a Form 3115, Application for Change in Accounting Method. Further, in each year of change, he must compute an adjustment under [Code Sec. 481\(a\)](#). If, for example, a taxpayer materially participated in an activity in '97, but did not in '98, the examiner contended that the taxpayer must file a Form 3115 for '98. Any amounts that were properly deducted in '97 because the activity was nonpassive, that would have been deferred had the activity been passive, would be included in the [Code Sec. 481\(a\)](#) computation.

Thus, if Taxpayers did not materially participate in '94, the examiner could bring into income in '94 any amounts that were deducted in prior years, that would not have been deductible in those years if the Taxpayers had not materially participated in those years. The examiner believed that this could be done, by virtue of [Code Sec. 481\(a\)](#), without regard to whether the taxpayers materially participated in the nursing home activity in the prior years. This was so, the examiner maintained, because if a change from determining that a taxpayer materially participated in an activity to determining that it did not materially participate in the activity was a change in accounting method, [Code Sec. 481\(a\)](#) authorizes necessary adjustments to prevent amounts from being duplicated or omitted.

*TAM's conclusion.* In the TAM, IRS concluded that a determination of whether a taxpayer materially participated in an activity isn't an accounting method. Assuming that Taxpayers didn't materially participate in the nursing home activity in '94, and that they mischaracterized their nursing home activity in '94 when they failed to treat the nursing home activity as a passive activity, Taxpayers made an error in '94, the correction of which wasn't a change in an accounting method.

The TAM reasoned that Taxpayers' determination of whether they materially participate in their nursing home activity didn't determine into which period an item of income or deduction would be placed. The Taxpayers' determination didn't involve the treatment of a "material item." Determining whether Taxpayers materially participated in their activity for purposes of classifying the activity as passive or not wasn't an "item"—it wasn't a recurring incidence of income or expense. Instead, Taxpayers' determination established the character of their activity for that year—it was either passive or it was not passive. Once the character of the activity was determined, then if the activity was passive, Taxpayers had to apply the [Code Sec. 469](#) PAL rules to any existing loss.

The TAM found the examiner's reliance on *Knight-Ridder Newspapers, Inc. v. U.S.* (CA 11 1984) [54 AFTR 2d 84-6120](#), misplaced. In that case, the taxpayer's advertising customers that met certain criteria were entitled to a rebate of a portion of their advertising payment. The taxpayer accrued advertising revenue as income and deducted an estimate of the amount that would be refunded under its rebate program. *Knight-Ridder* wasn't obligated to pay, and was therefore not entitled to deduct, the advertising rebates until the advertiser met the rebate criteria. IRS proposed to change *Knight-Ridder's* accounting method to the correct method. The court concluded that *Knight-Ridder's* reserve method of accounting would have reported excess deductions as income when it terminated its affairs, thus the proper time for the taking of deductions was at issue. In *Knight-Ridder*, unlike the present case, the treatment of an item of expense (the advertising rebates) was at issue. The present case involved no item of income or expense, but, rather the factual determination of whether the taxpayers materially participated in an activity during a given year.

The TAM also noted that although the case was decided on other grounds, the Tax Court in *St. Charles Investment Co.* (1998) [110 TC 46](#), gave some indication that it did not believe that [Code Sec. 469](#) was an accounting method provision.

**References:** For accounting method changes, see [FTC 2d/FIN ¶ G-2100](#) et seq.; [United States Tax Reporter ¶ 4464.21](#); [TaxDesk ¶ 442,400](#) et seq.; [TG ¶ 6300](#) et seq. For the tax treatment of passive activities, see [FTC 2d/FIN ¶ M-4600](#); [United States Tax Reporter ¶ 4694](#); [TaxDesk ¶ 315,500](#); [TG ¶ 17425](#).

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