Current developments for capital recovery and leasing

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Current developments

1. IRS guidance

Loans to Section 501(c)(4) organizations not deductible as worthless debts

A taxpayer that made a loan to a Section 501(c)(4) organization was denied a Section 166 worthless debt deduction. The organization in question filed a Return of Organization Exempt from Income Taxation (Form 990) for each of the taxable years Year 1, Year 2, and Year 3 as an organization described in Section 501(c)(4). The organization’s purpose was to advocate for improved public education and it reported that it engaged in political campaign activity related to a candidate running for public office. Specifically, the organization spent money to support the election of the candidate. In Year 2, a taxpayer made a loan to the organization but the organization dissolved in Year 3 without repayment of the loan. Accordingly, the taxpayer took a Section 166 worthless debt deduction on its Year 3 tax return in the amount of the loan.

In CCA 201842006, the IRS concluded that although Section 166 allows deductions for worthless debts, Section 271 is the governing provision in this situation. Section 271 prohibits a Section 166 deduction for any debt that is owed by a political party. Importantly, the Section 271 definition of a political party operates independently of any other Code section or regulation. An organization, regardless of tax-exempt status, that accepts contributions or makes expenditures with the purpose of influencing an election for public office is political party under Section 271. Based on these facts, the IRS found that the taxpayer’s loan was to a Section 271 political party and therefore a Section 166 worthless debt deduction for that amount is disallowed.

No rate base reduction for public utility’s bonus depreciation timing differences

In PLR 201842001, the IRS has ruled that a utility company did not violate the normalization requirements under Section 168 and Treas. Reg. § 1.167(l)-1 by reflecting forthcoming tax refunds in its annual regulatory filings because the refunds did not decrease the utility’s rate base.

The taxpayer was a rate-regulated utility company and a wholly-owned subsidiary of the parent. Parent’s Year 1 consolidated federal tax return reported a tax overpayment so it applied the Year 1 overpayment to Year 2 estimated tax payments (including the taxpayer’s share). When the parent made the Year 2 estimated tax payments, the additional 50% first year depreciation deduction (Bonus Depreciation) did not apply to otherwise qualified property (other than long production period property). Accordingly, the taxpayer calculated its Year 2 estimated tax payment without factoring in Bonus Depreciation for qualified property placed in service in the Year 2 tax year (other than long production period property).

The Tax Increase Prevention Act (TIPA) of 2014 retroactively extended the option to elect Bonus Depreciation for all qualified property placed in service before January 1, 2014. After TIPA’s enactment, the parent elected Bonus Depreciation for the consolidated group’s Year 2 federal income tax return. This lowered the taxpayer’s Year 2 tax liability, causing a Year 2 estimated tax payment overpayment. Accordingly, the taxpayer filed a refund claim with the IRS for the Year 2 tax overpayment, but did not receive the refund before the due date of its annual regulatory filing. In its annual regulatory filings in Year 2, the taxpayer reflected the forthcoming refund without decreasing the rate base by the DTL associated with the refund amount. In Year 3, the parent made estimated tax payments without applying Bonus Depreciation prior to the Protecting Americans from Tax Hikes (PATH) Act of 2015 retroactively extended the option to elect Bonus Depreciation for all qualified property placed in service before January 1, 2016. After this, the parent elected Bonus Depreciation for Year 3 and then filed a refund claim with the IRS, which the IRS granted, but

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In the PLR, The IRS stated that a taxpayer’s reserve for deferred taxes for normalization purposes should include only amounts of tax that are actually deferred and amounts of zero-cost capital that are actually received. Since the taxpayer had not received the Year 2 and Year 3 refunds when it submitted its annual regulatory filings, decreasing the rate base by the amount of the forthcoming refunds would have violated the normalization rules. By reflecting the forthcoming tax refunds without reducing its rate base, Taxpayer complied with the normalization rules.

**IRS outlines rules on parking fringe benefits**

In Notice 2018-99, the Treasury Department and Internal Revenue Service provide interim guidance on the determination of qualified transportation fringe (QTF) parking expenses as disallowed deductions under Section 274(a)(4) or unrelated business taxable income (UBTI) under Section 512(a)(7). Both provisions were added to the Code by the Tax Cuts and Jobs Act of 2017 (TCJA). The Notice indicates that Treasury and IRS intend to publish proposed regulations on the determination of nondeductible parking expenses and other expenses for QTFs and the calculation of increased UBTI attributable to QTFs. In the meantime, taxpayers may use any reasonable method for determining the amount of nondeductible expenses under Section 274(a)(4) or the amount of the increase in UBTI under Section 512(a)(7). Taxpayers may rely on the guidance in the Notice, which sets forth a deemed reasonable method for allocating expenses and identifies certain methods as unreasonable. Notably for the Capital Recovery & Leasing committee, the Notice does not address the disallowance of commuting expenses under Section 274(l), which was also added to Section 274 by the TCJA.

2. **Regulations**

**Release of negative Section 263A regulations**

The IRS has issued final regulations on allocating costs to property produced or acquired by a taxpayer for resale. The final regulations adopt, with modifications, the proposed regulations (REG-126770-06) published in the Federal Register on September 5, 2012. The final regulations include the following provisions:

- The final regulations maintain the general restriction set out in the proposed regulations on the inclusion of negative adjustments in additional Section 263A costs and add a new consistency requirement to limit potential distortion in the simplified methods.
- The final regulations clarify that Section 471 costs, additional Section 263A costs, and any adjustments to Section 471 costs or additional Section 263A costs are classified using the narrower of: (1) the classifications used by the taxpayer in its financial statement; or (2) the classifications in Treas. Reg. § 1.263A-1(e)(2), (3) or (4). If a cost is not described in Treas. Reg. § 1.263A-1(e)(2), (3) or (4), the final regulations require the taxpayer to classify the cost by using the classification of costs used in the financial statement.
- The proposed regulations created the MSPM, which allows producers to determine the capitalizable portion of preproduction-related, additional Section 263A costs (e.g., purchase, storage and handling of raw materials) using a preproduction cost absorption ratio.
- Under the final regulations, a taxpayer using the MSPM that capitalizes mixed-service costs using the simplified service cost method under Treas. Reg. § 1.263A-1(h) may allocate capitalizable mixed-service costs to preproduction additional Section 263A costs based on: (1) unprocessed direct material costs in Section 471 costs; or (2) preproduction labor costs in total labor costs.
• The final regulations establish that additional Section 263A costs properly allocable to property produced under a contract and property acquired for resale are generally included in preproduction additional Section 263A costs under the MSPM.
• The final regulations clarify that Section 471 costs are the types of costs capitalized to property produced or property acquired for resale in the taxpayer’s financial statement.
• The final regulations clarify that, for purposes of Section 263A, “a taxpayer’s financial statement is its financial statement of the highest priority, in accordance with the list of categories of financial statements, in order of priority, provided in these final regulations.”
• The final regulations establish a de minimis direct labor cost rule to permit taxpayers using the SRM, simplified production method (SPM) or MSPM to include in additional Section 263A costs, and exclude from Section 471 costs, certain direct labor costs that are not capitalized to property produced or property acquired for resale in the taxpayer’s financial statement (uncapitalized direct labor costs).
• The final regulations establish a de minimis direct material cost rule under which taxpayers who use SRM, SPM or MSPM are allowed to include in additional Section 263A costs, and exclude from Section 471 costs, certain direct material costs that are uncapitalized financial statement costs.
• The final regulations add a safe harbor rule for taxpayers who use the SRM, SPM or MSPM to include in additional Section 263A costs, and exclude from Section 471 costs, certain variance and under- or over-applied burdens that are capitalized to property produced or property acquired for resale in the taxpayer’s financial statement (uncapitalized variances or uncapitalized under- or over-applied burdens).
• The proposed regulations allowed taxpayers with average annual gross receipts of $10 million or less for three previous tax years to include negative amounts in additional Section 263A costs under the SPM. Importantly, the final regulations increase the threshold from $10 million or less to $50 million or less.

**Release of Opportunity Zone regulations**

On October 19, 2018, the IRS released proposed regulations (REG-115420-18) providing guidance on Section 1400Z-1 qualified opportunity zones (Opportunity Zones). The proposed regulations describe and clarify the types of gains that may be deferred by investors in a Qualified Opportunity Fund (QOF), the time by which gain must be invested in a QOF, and procedures for electing to defer specified gains. In addition, the proposed regulations include rules related to QOF self-certification, valuation of QOF assets, and Qualified Opportunity Zone Businesses. Some provisions covered by the regulations include:

• The proposed regulations clarify that only capital gains are eligible for deferral under Section 1400Z-2(a)(1). The gain must be gain that would be recognized no later than December 31, 2026, if deferral under Section 1400Z-2(a)(1) were not permitted.
• The proposed regulations allow deferral under Section 1400Z-2(a)(1) only for a taxpayer’s net capital gain from Section 1256 contracts in the tax year even though technically the gains may be much greater on a gross basis.
• The proposed regulations allow a partnership to elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF.
• Any taxpayer that is a corporation or partnership for Federal income tax purposes can self-certify as a QOF, provided that the self-certifying entity is statutorily eligible to do so. The IRS will set forth the time and manner for self-certification in forthcoming guidance.
• Section 1400Z-2(d)(1) requires a QOF to hold 90% of its assets in Opportunity Zone Property. To determine whether it meets the 90% Asset Test, a QOF must average the percentage of its assets in Opportunity Zone property at six months and at the end of the QOF’s fiscal year.

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• The proposed regulations provide a working capital safe harbor for QOF investments in Qualified Opportunity Zone Businesses that acquire, construct or rehabilitate tangible business property. The safe harbor allows Qualified Opportunity Zone Businesses to apply the definition of "working capital" provided in Section 1397C(e)(1) to financial property held by the business for up to 31 months, if: (1) a written plan exists that identifies the financial property as property held for the acquisition, construction or substantial improvement of tangible property in an Opportunity Zone, (2) a written schedule consistent with the ordinary business operations of the business states that the property will be used within 31 months, and (3) the business substantially complies with the schedule.

3. Court cases

*Patients Mutual Assistance Collective Corp. v. Commissioner, 151 T.C. 11 (2018)*

Patients Mutual Assistance Collective Corp. (dba. Harborside Health Center) (“Harborside”) is a medical cannabis dispensary operating under California law, and treated as a subchapter C-corporation for U.S. federal income tax purposes. All of its customers are patients, and it maintains a “closed loop” cannabis production process. This means that Harborside only sold cannabis to its patients that was provided by its patients and handled only by its employees (all of whom were patients), and none of the cannabis was diverted to the illegal black market. Harborside enforced strict security requirements, clearing each person entering the sales floor, and requiring patients to sign a collective cultivation agreement to allow other patients to cultivate on their behalf. Harborside sold different products containing cannabis and non-cannabis containing products (like branded gear and other equipment). Harborside also provided a wide variety of therapeutic services at no additional cost to the patients, to comply with the CA requirement that it operate as a nonprofit.

The Tax Court had to decide how Section 280E applied to the taxpayer’s facts. Section 280E provides that “no deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities that comprise such trade or business) consist of trafficking in controlled substances . . . .” (emphasis added). Section 280E does not preclude a taxpayer from subtracting cost of goods sold from gross receipts. Therefore, cannabis businesses may only recover costs (for tax purposes) through cost of goods sold. In its analysis, the tax court considered several earlier tax court cases that applied Section 280E. The main technical issues addressed by the court were: (1) whether the taxpayer’s activities constituted more than one trade or business so that some expenses could be allocated to (and deducted in) the other non-cannabis related business; and (2) whether the taxpayer was permitted to make adjustments to cost of goods sold.

**Multiple trades or businesses:** The taxpayer argued that it had several lines of business and that it should be allowed to deduct expenses from the non-cannabis businesses. The business lines examined were: selling cannabis and cannabis containing products; selling products containing no cannabis; therapeutic services; and brand development. The Court held that Harborside had only a single business and all the other services were related to the cannabis business. Specifically, the Court found that because only patients could enter the sales floor, only patients could purchase the non-cannabis products, and that the therapeutic services fulfilled the state requirements for nonprofits to sell cannabis in California. Accordingly, the sale of non-cannabis products and therapeutic services were part of the business of selling cannabis. Other factors indicated the existence of only a single trade or business. Specifically, the brand development was performed in the same entity, using the same employees as the cannabis business. The two businesses were so entwined and dependent on each other that they were not in fact separate trades or businesses. Thus, the Court held that Section 280E applies to all of the taxpayer’s business activities and business expenses.

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Adjustments to cost of goods sold: The Court also held unfavorably on the inventory-related (cost of goods sold) issues. Section 280E does not prohibit taxpayers from reducing gross receipts by cost of goods sold. Accordingly, cannabis businesses generally want to increase their cost of goods sold ("COGS") since that is their only way to recover costs for tax purposes. One question was whether COGS included only costs described in Section 471 or include the broader range of costs that would be capitalized under Section 263A. As to that issue, the Court essentially adopted the analysis in a 2015 IRS memorandum, CCA 201504011, that concluded cannabis businesses cannot apply the uniform capitalization rules in Section 263A to increase their COGS. Instead cannabis businesses must calculate COGS under Section 471, which generally results in lower COGS as compared with Section 263A.

Generally, producers are required to capitalize a wider range of costs than resellers which would result in greater cost recovery through COGS. Harborside argued that it was a producer of cannabis, and therefore could apply the producer inventory rules which allow additional expenses to be treated as COGS. The Court disagreed and said that under its closed loop production process, patients produced the cannabis and were allowed to sell the cannabis to other dispensaries.

*Alternative Health Care Advocates, et. al. v. Commissioner, 151 T.C. 13 (2018)*

Three individuals were shareholders in Alternative Health Care Advocates, a C corporation, to operate a medical marijuana dispensary in California. The same individuals were also shareholders in Wellness, an S corporation, that was organized to handle daily operations for Alternative including paying employee wages and salaries, advertising and paying rent. Alternative operated a closed-circuit medical cannabis dispensary model, per California law. This means that it only purchased or sold cannabis to members of the collective. Alternative also sold products such as hash, kief, cuttings (or clones), edibles, tinctures, oils, and products that can be applied topically.

Alternative deducted sec. 162 business expenses and later adjusted COGS to include indirect expenses per sec. 263A. The IRS determined that both Alternative's and Wellness's sole trade or business was trafficking in a controlled substance and that sec. 280E precluded deducting business expenses. In light of that determination, the IRS further determined that the taxpayers had underreported their flowthrough income from Wellness. The IRS also determined that Alternative is not entitled to COGS in an amount greater than what the IRS already allowed and that Alternative is liable for sec. 6662(a) accuracy-related penalties.

The Tax court consolidated the cases of Alternative, Wellness, and the 3 shareholders to decide the common issues. Similar to the Harborside Health Center case (above), the Tax Court held against the taxpayers on all issues. The Court held that Section 280E precludes Alternative or Wellness from deducting sec. 162 business expenses, since their only business was integrated and involved trafficking in a controlled substance. The Court also found that the taxpayers underreported their flowthrough income from Wellness, due to the nondeductible expenses. The Court found that Alternative misapplied sec. 263A to increase COGS, and could not increase COGS beyond what the IRS had allowed, for the same reasons that the Court held in the Harborside case (above). Due to these holdings, the Court found Alternative liable for the sec. 6662(a) accuracy related penalties.

4. Other IRS materials

**IRS clarifies SALT-related business deduction rules**

*Scholarship fund contributions*

In correspondence (2018–0030) to a Section 501(c)(3) taxpayer, the IRS states that proposed regulations (REG-112176-18) on the federal deductibility of charitable contributions for which a taxpayer received a state or local tax (SALT) benefit do not affect business taxpayers' payments to a state tax credit program that are deductible under a

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code section other than Section 170. The correspondence explains that, under the proposed regulations, a taxpayer making a payment or transferring property to an entity described in Section 170(c) "must reduce its charitable contribution deduction by the amount of a state or local tax credit the taxpayer receives or expects to receive." Since the proposed regulations address only "whether certain amounts may be deducted as charitable contributions under Section 170 (or Section 642, if the payments are made by a trust or decedent’s estate) and [its regulations] and does not propose to change existing tax treatment under any other provisions of the Code or the Treasury Regulations," any payments that businesses make as part of the state tax credit program at issue that are not deductible as charitable contributions are not affected by the proposed regulations.

State and local tax credit programs

In a press release (IR-2018-178) issued September 5, 2018, the IRS announced the publication of a new "State and Local Income Tax FAQ." This FAQ clarifies that recently issued proposed regulations (REG-112176-18) concerning the availability of charitable contribution deductions for contributions to state and local tax credit programs do not affect business taxpayers' ability to claim business expense deductions for certain payments to charities or government entities for which taxpayers receive state and local tax (SALT) credits. The press release states "the business expense deduction is available to any business taxpayer, regardless of whether it is doing business as a sole proprietor, partnership or corporation, as long as the payment qualifies as an ordinary and necessary business expense."

Rev. Proc. 2019-8

Section 179 property

This revenue procedure provides guidance related to TCJA amendments to Section 179 and Section 168. A Section 179 election is made or revoked pursuant to Treas. Reg. § 1.179-5 for any taxable year beginning after 2002 and before 2008. Section 1.179-5(c) was promulgated in 2005 and has not been amended to reflect subsequent amendments to Section 179(c). Section 3.02 of Rev. Proc. 2017-33 provides that for a taxable year beginning after 2014, the taxpayer will be permitted to make a Section 179 election for any Section 179 property without the Commissioner's consent on an amended federal tax return for the taxable year in which the taxpayer places in service the Section 179 property. Section 3.02 of Rev. Proc. 2017-33 further provides that until Treas. Reg. § 1.179-5(c) is amended to incorporate this guidance, taxpayers may rely on such guidance.

Section 179(d) defines the term “§ 179 property”. TCJA amended Section 179(d)(1)(B) to provide that if the taxpayer elects, Section 179 property may include qualified real property as defined in Section 179(f). Prior to amendment by the TCJA, Section 179(f)(1) provided that Section 179 property included qualified real property if the taxpayer elected the application of Section 179(f) for the taxable year, and Section 179(f)(2) defined “qualified real property” as meaning qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property described in Section 168(e)(6), (7), and (8), respectively. TCJA amended Section 179(f) by defining qualified real property as (1) any qualified improvement property described in Section 168(e)(6) and (2) any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems. These amendments apply to property placed in service in taxable years beginning after December 31, 2017.

Rev. Proc. 2019-8 confirms that for property placed in service by the taxpayer in a taxable year beginning in 2017 and ending in 2018, qualified real property is qualified leasehold improvement property, qualified restaurant property, or qualified retail improvement property as described in Section 179(f)(1) and (2) as in effect on the day before the date of enactment of the TCJA. Rev. Proc. 2019-8 provides that a taxpayer may elect to expense under Section 179(a) the cost, or a portion of the cost, of qualified real property placed in service by the taxpayer during any

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taxable year beginning after 2017 by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in Treas. Reg. § 1.179-5(c)(2) and Section 3.02 of Rev. Proc. 2017-33.

**Change in Use under Section 168(g)**

Prior to amendment by the TCJA, Section 168(g)(1) provided that the depreciation deduction provided by Section 167(a) is determined under the alternative depreciation system for: (A) any tangible property that during the taxable year is used predominantly outside the United States; (B) any tax-exempt use property; (C) any tax-exempt bond financed property; (D) any imported property covered by an Executive order under Section 168(g)(6); and (E) any property to which an election under Section 168(g)(7) applies.

TCJA amended Section 168(g)(1) by requiring the depreciation deduction provided by Section 167(a) to be determined under the alternative depreciation system for the following additional property: nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business as defined in Section 163(j)(7)(B); and any property with a recovery period of 10 years or more that is held by an electing farming business as defined in Section 163(j)(7)(C). These amendments apply to taxable years beginning after December 31, 2017, without regard to when the property is or was placed in service. TCJA also amended the ADS table in Section 168(g)(2)(C) by providing that the recovery period is 30 years for residential rental property, instead of 40 years prior to TCJA. This amendment applies to property placed in service after December 31, 2017.

The procedure provides that for the first taxable year for which an electing real property trade or business or an electing farming business makes an election under Section 163(j)(7)(B) or (C), respectively, and the regulations thereunder (the “election year”), that trade or business must begin depreciating the properties described above in accordance with the alternative depreciation system in Section 168(g). This applies to such property placed in service by the trade or business in taxable years beginning before the election year (“existing property”) and such property placed in service by the trade or business in the election year and subsequent taxable years (“newly-acquired property”).

For existing property a change in use occurs under Section 168(i)(5) and Treas. Reg. § 1.168(i)-4(d) for the election year as a result of the election under Section 163(j)(7)(B) or (C), as applicable. Accordingly, depreciation for such property beginning for the election year is determined in accordance with Treas. Reg. § 1.168(i)-4(d). Pursuant to Treas. Reg. § 1.168(i)-4(f), a change in computing depreciation for the election year for such existing property is not a change in method of accounting under Section 446(e). If any such existing property was qualified property under Section 168(k) in the taxable year in which the trade or business placed the property in service, the additional first year depreciation deduction allowable for that property is not redetermined. See Treas. Reg. § 1.168(k)-1(f)(6)(iv)(A).

For newly-acquired property the taxpayer determines the depreciation in accordance with the alternative depreciation system for such property for its placed-in-service year and the subsequent taxable years. Because such newly-acquired property is required to be depreciated under the alternative depreciation system, the property is not qualified property for purposes of the additional first year depreciation deduction under Section 168(k). See Section 168(k)(2)(D). Failure to adopt these rules for existing property and newly-acquired property is an impermissible method of accounting.

Rev. Proc. 2019-8 also provides an optional table for property depreciated under the alternative depreciation system with a recovery period of 30 years and the mid-month convention.
5. **Priority Guidance Plan**

Guidance plan items relevant to the Capital Recovery and Leasing group:

1. Guidance under Sections 167 and 168 for determining whether certain assets used by a wireline telecommunication service provider are primarily used for providing one-way or two-way communication services.

2. Revenue procedure under Section 263(a) regarding the capitalization of natural gas transmission and distribution property.

6. Regulations under Section 472 regarding dollar-value last-in, first-out (LIFO) inventories, including rules for combining pools as a result of a change in method of accounting, certain corporate acquisitions, and certain nonrecognition transactions.

7. Final regulations amending §1.472-8 regarding the inventory price index computation (IPIC) method.