Tax Accounting

BY JAMES E. SALLES

The regulations require taxpayers that sell merchandise to accrue their purchases and sales. Thirty years ago, the court in *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970), required a funeral home to accrue all its purchases and sales because, although its main business was providing funeral services, the caskets it sometimes provided as part of the package were merchandise. The years since have produced periodic litigation but little real guidance from either the courts or the IRS on the limits, if any, on the application of the *Wilkinson-Beane* holding and the regulations.

Suddenly, the question of when a taxpayer that provides goods in connection with services is selling merchandise has been the subject of three Tax Court decisions in four months. The issue has also hit the IRS's and Congress's radar screen—although largely because of unrelated developments—and is now the subject of both a regulatory project in the current IRS business plan and pending bills before the House and Senate.

BACKGROUND

The Regulations and *Wilkinson-Beane*

The regulations provide that inventories must be kept "[i]n all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor." Treas. Reg. §§ 1.446-1(a)(4)(i), 1.471-1(a)(1). Ordinarily, "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales." Treas. Reg. § 1.446-1(c)(2)(i).

A perennially troublesome area has been in what circumstances the requirement to keep inventories and the associated requirement for accrual accounting apply to taxpayers that provide, or utilize, tangible goods in conjunction with the provision of services. In the seminal case of *Wilkinson-Beane*, the court required an undertaker to inventory its caskets, even though the caskets could not be purchased separately. The court noted that the cost of the caskets was 15 percent of the taxpayer's gross receipts, and held that they were an "income-producing factor" within the meaning of the regulations. The court then held that the taxpayer had to adopt accrual accounting unless it could demonstrate "substantial identity of results" using its method. Wilkinson-Beane, 420 F.2d at 356.

Later Court Cases

In evaluating whether the taxpayer could demonstrate a substantial identity of results using its method, the *Wilkinson-Beane* court naturally considered not only fluctuations in inventory but also accounts receivable and payable. Later courts have followed the same approach and have consistently been willing to enforce the regulations' requirement to use the accrual method of accounting even though taxpayers' actual inventory balances were insignificant. Thus, for example, in *Asphalt Products Co. v. Commissioner*, 796 F.2d 843 (6th Cir. 1986), *rev'd per curiam on another issue*, 482 U.S. 1117 (1987), a taxpayer that sold emulsified asphalt for road making was required to accrue purchases and sales, even though its year-end inventories were nugatory because roads could not be asphalted during the winter. The court likewise required the taxpayer in *Epic Metals Corp. v. Commissioner*, 48 T.C.M. (CCH) 357 (1984), to accrue purchases and sales even though its business was specialized metal decking, which it ordered for its customers from custom fabricators and to which it held title only momentarily.

IRS Considered *De Minimis* Rule

In Revenue Ruling 74-279, 1974-1 C.B. 110, the IRS ruled that an optometrist had to keep inventories and accrue purchases and sales because "although the taxpayer provides various services there is also a substantial amount of merchandise sold." General Counsel

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Memorandum 37699 (Sept. 29, 1978) considered the obvious follow-up question: What if the optometrist kept no inventory but custom-ordered the lenses and frames from the manufacturer? The memorandum concluded that the taxpayer was required to keep inventories, and therefore to accrue purchases and sales, and approved a proposed revenue ruling amplifying Revenue Ruling 74-279. A later general counsel memorandum, however, noted that "the Service may allow the use of the cash method despite the fact that taxpayer may furnish some tangible product in the course of rendering professional services," and approved withholding the proposed revenue ruling "pending development of guidelines in this area." The IRS National Office was apparently contemplating either amending the regulations themselves or issuing a revenue procedure; however, neither the ruling nor the guidance has ever appeared.

RECENT TAX COURT CASES REVIVE INTEREST

Instead, after some delay, and evidently encouraged by a favorable judicial climate,[1] the IRS went on the litigation warpath. The Tax Court has had occasion to consider the *Wilkinson-Beane* holding in no less than three recent cases, handing two victories to taxpayers and the third to the IRS.

Osteopathic Medical

In *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999), a reviewed opinion decided in November 1999, the Tax Court held that a cancer clinic's chemotherapy drugs were not merchandise within the meaning of the regulations. The clinic could not, and did not, sell the drugs as such to patients. The court held that the drugs were provided as "an integral, indispensable, and inseparable part of the rendering of medical services," and were not merchandise, but supplies consumed in the process of providing services.

Inventory accounting is confined to merchandise held for sale to customers and raw materials that will "physically become a part of" merchandise. Treas. Reg. § 1.471-1(a)(1). Supplies, whether used in producing goods or providing services, are not inventoried, although taxpayers may be required to keep records of supplies on hand and consumption if necessary to clearly reflect income. Treas. Reg. § 1.162-3. Thus, the *Osteopathic* court's holding that the drugs were not merchandise meant that the regulations' requirement to use accrual accounting in conjunction with inventories did not apply either.[2]

RACMP Enterprises

In *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. No. 16 (2000), decided in March and also a reviewed opinion, the taxpayer was a construction subcontractor that specialized in foundations and flatwork—concrete driveways and walkways. In its activities it naturally used concrete, sand and rock, and assorted steel hardware. Again, the IRS contended that these materials were inventories and therefore the taxpayer had to adopt accrual accounting. The Tax Court framed the issue as "whether petitioner is in the business of selling merchandise to customers in addition to providing services or whether the material provided by petitioner is a supply that is incidental to the provision of the contracted service."

The Tax Court held that the contractor was "inherently a service provider," noting that in various nontax contexts "the courts have invariably found construction contracts that provide for the furnishing of labor and materials to constitute agreements for work, labor and services rather than the sale of goods." The court concluded that the concrete, sand and rock, and hardware used were "indispensable and inseparable from the service provided" and were consequently not merchandise. The taxpayer could continue to use the cash method.

Von Euw Trucking

Judge Vazquez, who joined in the majority opinion in *RACMP*, reached the opposite result in a memorandum case decided the following day. *Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner*, T.C. Memo. 2000-114, involved a trucking firm that supplied sand and gravel to building sites. Some customers already owned the sand and gravel they contracted with the taxpayer to transport, but others expected the taxpayer to acquire the material as well as transport it to the site.

The Tax Court held that the taxpayer was at least partly in the business of selling sand and gravel. The record showed that the taxpayer reaped a greater profit when it both acquired and transported the sand and gravel than when it merely provided transportation services. On these facts, the court held that the sand and gravel were

merchandise and an income-producing factor, and therefore the taxpayer had to use accrual accounting.

IRS AND CONGRESSIONAL INITIATIVES

In the meantime, the whole issue has suddenly attained prominence at a policy level, thanks in large part to the fallout from a controversial congressional attempt to raise revenue and the efforts of two legislators from Missouri.

Change to Installment Sales Rules

As a revenue-raiser in the extenders bill enacted late in 1999, Congress enacted a seemingly simple provision that made taxpayers using accrual accounting for tax purposes ineligible to use the installment sales method.[3] The apparent intent was to target large, liquid, publicly traded corporations that used the installment sales provisions to defer tax on large, isolated capital transactions. Nevertheless, the bill is having a larger-than-expected impact on small businesses, particularly in situations in which a long-term owner wants to sell out. Individual shareholders generally are on the cash method, of course, but small business corporations frequently report on an accrual basis, often precisely because of the regulations' requirement concerning sellers of merchandise. If, instead of the shareholder of an accrual-method corporation selling stock, the corporation itself sells assets (or is deemed to sell assets, e.g., because of an election under Code Section 338), the new prohibition on use of the installment method will apply. See generally Notice 2000-26, 2000-17 I.R.B 1.

The resulting outcry has spawned pressure on Capitol Hill to repeal the offending provision outright or tweak it so that "small business," as variously defined, is not affected. The rise to prominence of the installment sales issue has also stimulated Congress and the Treasury to take a second look at the circumstances under which accrual accounting is required, because cash-method taxpayers are not affected by the new installment sales provision at all.

Regulatory Initiative

Partially in an attempt to head off the pressure to repeal the rule on installment sales, Treasury officials have discussed the possibility of some kind of regulatory safe harbor from the requirement to use an accrual method that would be applicable to taxpayers with less than $1 million in gross receipts. The IRS's business plan for 2000 lists both "guidance under sections 446 and 471 regarding the cash method of accounting" and "revenue procedure under sections 446 and 471 excepting certain small taxpayers from the inventory and accrual method requirements" among forthcoming projects.[4] The idea seems to be to couple regulatory guidance on when inventories are a material income-producing factor with a special election out of accrual accounting for small taxpayers.

Treasury's proposals have been attacked on Capitol Hill as inadequate.[5] At an April 5 hearing before the House Small Business Committee, panel members pointed out that Code Section 448—which generally requires C corporations to use accrual accounting—draws the line at $5 million of receipts for purposes of its own exception for small taxpayers. Chairman James Talent also argued that Code Section 448 implies a presumption that taxpayers below the $5 million threshold can use the cash method. Tax Legislative Counsel Joseph Mikrut disputed this.[6] The general rule that taxpayers' accounting methods clearly reflect income, and the regulatory requirement for inventory accounting and use of accrual accounting, date from long before Code Section 448 was enacted in 1986. On a plain reading, Code Section 448 does not guarantee the right to use the cash method to anybody; it *prohibits* use of the cash method by taxpayers that do not fall under an exception to its application.

Legislative Proposals

Treasury's expressed willingness to except small taxpayers from the mandate to use accrual accounting has not prevented a plethora of legislative proposals to repeal or modify the installment sales provision,[7] and a repeal was included in the minimum wage and small business bill that recently passed the House.[8]

A couple of legislative proposals focus on the *Wilkinson-Beane* doctrine rather than, or in addition to, directly addressing the installment sales method. Last summer—before passage of the extenders bill and the controversy about the installment method—Chairman Talent had already introduced a bill to amend Code Section 446 to provide that taxpayers with less than $5 million in revenues "shall not be required to use an accrual method of accounting for any taxable year by

reason of using merchandise or inventory."[9] In March of this year, his fellow Republican from Missouri, Sen. Christopher Bond, introduced the Small Business Tax Accounting Simplification Act of 2000. The Bond bill incorporates the Talent proposal and proposes to replace the "income-producing factor" standard of the regulations with a bright-line rule providing that service providers are not required to use inventories as long as sales of merchandise account for less than 50 percent of their gross receipts.[10] Both bills are presently in committee but may well wind up as part of a compromise fix of the installment sales provision in the minimum wage legislation or in another tax bill later this year.

1. E.g., Asphalt Prods., Co. v. Commissioner, 796 F.2d 843 (6th Cir. 1986), *rev'd per curiam on another issue*, 482 U.S. 1117 (1987); see also, e.g., American Fletcher Corp. v. United States, 832 F.2d 436 (7th Cir. 1987).
2. *Osteopathic Medical* was the subject of a detailed article published in the February issue. Robert Feinschreiber & Margaret Kent, "How Supplies Are Taxed and How They Should Be Taxed," 1(5) *Corp. Bus. Tax'n Monthly* 11 (Feb. 2000).
3. P.L. 106-170, § 536(a)(1), *codified at* I.R.C. § 453(a)(2).
4. 2000 Priority Guidance Plan, "Tax Accounting," Items 12 and 13, *reprinted in* 86 *Tax Notes* 1819, 1824 (Mar. 27, 2000).
5. See, e.g., "Treasury, Lawmakers Agree Installment Method Repeal Needs Fix," TNT Doc. 2000-6142 (Feb. 29, 2000), describing a hearing before the House Ways & Means Oversight Subcommittee.
6. News Story, TNT Doc. 2000-10301 (Apr. 5, 2000); "Mikrut Says Treasury Needs Time to Assess Cases Before Issuing Cash Method Guidance," *Daily Tax Rep.*, Apr. 6, 2000, at G-7.
7. E.g., H.R. 3568, 106th Cong., (2000), by Mr. Kleczka.
8. H.R. 3081, Small Business Tax Fairness Act of 2000, § 107.
9. H.R. 2273, 106th Cong. (1999), by Messrs. Talent and English.
10. S. 2246, 106th Cong. (2000), by Sens. Bond and Grassley.