Tax Accounting

BY JAMES E. SALLES

This month's tax accounting column highlights two recent Tax Court decisions:

1. *Suzy's Zoo v. Commissioner*, 114 T.C. No. 1 (2000), held that an artist's company was the "producer" of greeting cards, stationery, and other paper products using images she developed, and therefore was subject to the uniform capitalization (UNICAP) rules.
2. *USFreightways Corporation v. Commissioner*, 113 T.C. No. 23 (1999), held that the so-called one-year rule—under which cash-basis taxpayers have been allowed a current deduction for some expenditures that extend into the following taxable year—has no application to taxpayers on an accrual method of accounting.

SCOPE OF THE UNICAP RULES

Suzy's Zoo illustrates the types of issues that can arise in determining whether a taxpayer is subject to the UNICAP rules.

The UNICAP Rules

The UNICAP rules, enacted in 1986, systematized the rules requiring capitalization of overhead costs and interest that had previously applied to manufacturers' inventory and self-constructed property, and extended the overhead capitalization rules to large resellers. Slightly different UNICAP regimes apply to:

1. Property *produced* by the taxpayer (the producer rules); and
2. Property acquired by the taxpayer for resale if the taxpayer's volume exceeds $10 million annually (the reseller rules).

I.R.C. § 263A(b).

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Special Rules for Writers and Artists

A film, sound recording, videotape, book, or similar property is property potentially subject to the UNICAP rules. I.R.C. § 263A(b). Code Section 263A(h) provides a special exception, however, for "qualified creative expenses" incurred by individual writers, photographers, and artists. This exception applies only to the individual artist or a corporation substantially all of which is owned by the artist. Qualified creative expenses do not include expenses relating to printing, photographic plates, films, and so forth. Therefore, although an individual artist—or his or her corporation—can deduct the expense involved in writing a book, or creating a work of art, the production and distribution of copies of the work, whether done by the artist or someone else, are subject to the UNICAP rules.

The Facts of *Suzy's Zoo*

Suzy's Zoo was in the business of producing stationery, greeting cards, and similar products featuring proprietary cartoon characters. Most of the artwork was done by Suzy Spafford, the 84 percent owner, assisted by a few other individuals. Suzy's Zoo contracted out the actual production to outside printers and a bindery. The printers owned the paper stock used in production but had no rights to the greeting cards or other products produced and had to deliver them immediately to Suzy's Zoo.

The Holding

Suzy's Zoo's principal argument was that it was a reseller, not a producer, and it was therefore not subject to the UNICAP rules because its sales did not meet the $10 million threshold. The taxpayer pointed out that the printers owned all the paper stock and bore the risk of loss until actual delivery to Suzy's Zoo. Thus, it argued, it was in the business of buying greeting cards, stationery, and other paper products and selling them to the public.

The regulations provide that although in general "a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles," ownership is to be determined "based on all of the facts and circumstances." A taxpayer "may be considered an owner of property produced, even though the taxpayer does not have legal title to the property." Treas. Reg. § 1.263A-2(a)(1)(ii)(A).

The court reasoned that the printers' "reproduction of petitioner's characters onto ordinary paper" was merely one step in the production process. The printers obtained no rights to the images and could not sell the stationery or greeting cards. Thus, Suzy's Zoo was not buying products from the printer for resale. If Suzy's Zoo was buying anything, it was buying the blank paper consumed in the production process. The fact that the printers bore the risk of loss was not controlling. "The identification of the owner of property for purposes of the UNICAP rules does not necessarily rest on who bears the risk of loss when the product is fabricated or assembled, or, for that matter, on who actually turns the screws or hammers the nails." Thus, Suzy's Zoo, not the printers, was the producer of the final products.

Suzy's Zoo might still have been eligible to deduct its creative expenses, although not the overhead relating to the actual production, under the artists' exception in Code Section 263A(h), but the corporation failed to meet the ownership requirement. Only 84 percent of its stock was owned by Ms. Spafford; the other 16 percent was owned by unrelated parties. The court held that *substantially all the stock* meant at least 95 percent, in keeping with the legislative history of the provision and the interpretation of the same phrase in other Code sections.

A Pointer for the Future

Suzy's Zoo provides a good illustration of the analysis to be performed in determining whether a taxpayer, under all of the facts and circumstances, is a producer of property. The regulations specifically provide for attribution of the activities of contract manufacturers,[1] but the principle sweeps more broadly than that. A court—or a practitioner seeking to guess what a court will do—must first determine what product is being produced and then proceed to determine which party is the owner of the *property*—-not the raw materials that make it up—during the production process.

ACCRUAL TAXPAYERS AND THE ONE-YEAR RULE

Almost all authorities addressing whether a taxpayer should be permitted a current deduction for prepayments involve cash-basis taxpayers. *USFreightways* is one of the exceptions. The issue in that case was whether the one-year rule, under which cash-basis taxpayers are sometimes permitted deductions for prepayments of period costs extending into the following year, can ever apply to accrual-basis taxpayers. According to the Tax Court, there is a clear answer: It cannot.

Cash-Basis Taxpayers

Accrual- and cash-basis taxpayers alike are subject to the regulations' requirement that an expenditure be capitalized if it "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year."[2] Courts and the IRS have shown some flexibility, however, when the expenditure is a recurring period cost not otherwise associated with a capital asset and the taxpayer is a cash-basis taxpayer. Thus, for example, various revenue rulings contemplate prepayments by cash-basis taxpayers if the overall result does not materially distort income.[3]

In *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980), the court permitted a cash-basis taxpayer a deduction for one year's prepayment of rent.[4] This case is often cited as support for a rule of convenience permitting cash-basis taxpayers to currently deduct recurring expenses relating to periods ending no later than 12 months after the end of the taxable year. Even the Supreme Court cited *Zaninovich* with approval in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 384 (1983), although the example given of its application involved an advance payment of only 30 days' rent.

In certain cases, the one-year rule is preempted by a specific statutory provision. For example, Code Section 461(g) flatly prohibits the deduction of prepaid interest, except for points paid on residential home mortgages. Outside of such situations, however, the one-year rule remains widely relied on by cash-basis taxpayers.

Accrual Accounting

All that is required for a cash-basis taxpayer to take an expenditure into account—although not necessarily get a current deduction—is a payment. The rules

applicable to an accrual-basis taxpayer are a bit more complicated.

Accrual-basis taxpayers have historically been permitted to recognize an expenditure when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."[5] The Deficit Reduction Act of 1984 added to this traditional "all events" test the additional requirement that economic performance must have occurred with respect to the liability. Economic performance generally occurs as goods, services, or the use of property is provided, or, in the case of other types of liabilities, when the liability is paid.[6]

The economic performance rules include an exception for recurring items, under which taxpayers may treat economic performance as having occurred as to a liability during a given year if the economic performance actually occurs within a reasonable period no greater than eight and one-half months after the close of the taxable year concerned and either (1) the item is not material, or (2) a current deduction provides a "more proper match against income."

It has occasionally been suggested that this "recurring items exception" implicitly endorses a one-year rule—or at least an eight and one-half-month rule—for accrual taxpayers. There is, however, no real authority for this view. It would be difficult, for example, to meet the "more proper match against income" test in the case of expenses clearly attributable to a particular period, such as prepaid rent or insurance.

USFreightways

In *USFreightways*, the taxpayer sought a current deduction for the full amount of payments it made for insurance premiums and license fees in 1993, although the terms of each extended into 1994.

It is important to understand exactly what the court was deciding. As in the case of its income-side counterpart,[7] the all events test for deductions is met when the liability is paid or due, or performance occurs, whichever occurs first.[8] Moreover, both insurance premiums and license fees are among the types of liabilities for which economic performance occurs on payment.[9] Therefore, both the all events test and the economic performance requirement were met when the taxpayer paid. Accordingly, the liabilities met all the requirements to be taken into account under Code Section 461. The issue was confined to whether the liabilities would be taken into account as current deductions or capitalized.[10] The whole case therefore turned on capitalization principles in general, and the one-year rule in particular.

The court noted that neither *Zaninovich* nor the other authorities permitting deductions for prepayments involved accrual-basis taxpayers. Indeed, *Zaninovich* expressly distinguished an early Board of Tax Appeals case involving an accrual-basis taxpayer on the grounds that "[t]he accrual basis of accounting, unlike the cash basis method, aims to allocate to the taxable year expenses attributable to income realized in that year."[11] Evidently relying on this distinction, as well as capitalization principles as illustrated by *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), and similar cases, the court held that the one-year rule has no application to accrual-basis taxpayers. Such taxpayers are confined to deducting "expenses which are more than incidental and allocable to future tax years only in the taxable periods to which they relate."

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1. Treas. Reg. § 1.263A-2(a)(1)(ii)(B).
2. Treas. Reg. § 1.461-1(a)(1) (cash), (2) (accrual); see also Treas. Reg. § 1.263(a)-2(a).
3. See, e.g., Rev. Rul. 79-292, 1979-2 C.B. 210.
4. See also, e.g., Kauai Terminal, Ltd. v. Comm'r, 36 B.T.A. 893 (1937) (insurance).
5. I.R.C. § 461(h)(4).
6. See generally I.R.C. § 461(h); Treas. Reg. § 1.461-4.
7. See Rev. Rul. 74-607, 1974-2 C.B. 149.
8. See G.C.M. 38901 (Feb. 12, 1982).
9. Treas. Reg. § 1.461-4(g)(5) (insurance), (6)(ii) (licensing fees).
10. See Treas. Reg. § 1.461-1(a)(2) (expenditure may be taken into account through capitalization).
11. 616 F.2d at 431 n.5.