Tax Accounting

BY JAMES E. SALLES

In this month's column:

- Companion Tax Court cases, *Midamerican Energy Co. v. Commissioner*[1] and *Florida Progress Corp. v. Commissioner*,[2] address several issues relating to utilities' tax accounting.
- A district court requires a taxpayer to capitalize environmental remediation costs for properties that were already contaminated on acquisition in *United Dairy Farmers, Inc. v. United States*,[3]
- The Tax Court confronts two petitions contesting the issue of whether a taxpayer is in the business of selling "merchandise" in *A.D. Wilson, Inc. v. Commissioner*[4] and *T.D. Whitton Construction, Inc. v. Commissioner*.[5]

TAX COURT ADDRESSES UTILITIES' ACCOUNTING

Last month's column noted that a utility will not recognize income merely from receiving permission to charge higher rates, because even accrual taxpayers are not taxed simply because they enter into an executory contract. The column then continued:

> Likewise, when a utility's rates are reduced to "make up for" a windfall in a prior period — without an obligation to repay a fixed amount — the utility does not accrue a liability but simply recognizes less gross income during the period while the lower rate is in effect.[6]

Since that passage was written, the Tax Court released opinions by Judge Cohen in two companion cases illustrating exactly this point: *Midamerican Energy Co. v. Commissioner*,[7] and *Florida Progress Corp. v. Commissioner*[8] Both cases also presented secondary issues relating to tax accounting methods.

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Rate Cut Does Not Create Deduction

Midamerican Energy and Florida Progress involved utilities required by state regulators to reduce their rates when federal income tax rates were cut in the Tax Reform Act of 1986 (TRA86). State regulators traditionally set rates by allowing utilities a net income representing a reasonable return on invested capital, as computed under rules prescribed for the purpose. One of the costs taken into account, naturally, is federal income tax.

Because regulatory accounting departed considerably from tax accounting, substantial deferred income tax liabilities accumulated on the utilities' regulatory balance sheets. These liabilities represented tax due on income that had been recognized for regulatory purposes but not for tax purposes, and naturally were computed by reference to the then-prevailing federal and state tax rates. When TRA86 reduced the federal income tax rates, the utilities recognized a windfall under their regulatory accounting as their deferred income tax liabilities were correspondingly reduced. State regulators required the utilities to compensate by charging lower rates than would otherwise have applied.

The utilities claimed that they were entitled to apply Code Section 1341, which provides relief for taxpayers that are compelled to return an amount that they included in income in past years because they received it under a "claim of right."[9] That provision, however, requires that "a deduction [be] allowable for the taxable year" for which relief is sought.[10] The Tax Court held Code Section 1341 inapplicable in *Midamerican Energy* and *Florida Progress* because the orders to reduce rates did not give the utilities a deduction, just less gross income while the lower rates were in effect.

Fuel "Overrecovery" Excludable

As discussed above, reducing a utility's rates to compensate for an earlier regulatory windfall will not

ordinarily entitle it to a deduction. The utility will merely have more gross income while the higher rate is in effect, followed by less gross income later. This principle applies whether the reduction in rates was contemplated from the beginning,[11] is a product of a routine reconciliation,[12] or as in *Midamerican Energy* and *Florida Progress*, stems from an unforeseen event such as TRA86's reduction in tax rates. On the other hand, if the regulatory scheme explicitly creates a liability on the part of the utility to repay a fixed amount to its customers, particularly if interest is due, the initial receipt will be treated as a loan.[13] The fact that the identities of the specific future customers to whom the aggregate liability will be made good are unknown is irrelevant.[14] *Florida Progress* provides an example of this principle as well.

In that case, federal and state regulators permitted the utility to recover certain fuel costs and energy conservation costs by means of special surcharges. The surcharges were strictly to compensate for covered outlays and included no allowance for any profit element. The surcharges were set for a six-month period based on projected expenditures, with any shortfall or excess being compensated for by "true-up" adjustments in subsequent periods. The "true-up" calculations included an interest factor, to be paid by the taxpayer if it had overcollected in the prior period or to be charged by the taxpayer if it had undercollected. On these facts, the taxpayer argued and won that the revenues were effectively a loan—akin to an advance for expenses[15]—and should not be reported at all.

The Tax Court held that the taxpayer did not change accounting methods when it correctly began excluding the surcharges from income. A change in accounting method involves a change in the *timing* of an item of income or deduction. In *Florida Progress* the change was from reporting an item as income to not reporting it at all. In *Pelton & Gunther, LLP v. Commissioner*,[16] discussed in the February 2000 issue, the court held that two permanent changes involving different items of income and deduction will not add up to a change in accounting method, even though the ultimate effect may be a timing shift. Although the *Florida Progress* court did not cite *Pelton & Gunther*, the issues—and the holdings—were similar.

Code Section 451(f)

The secondary issue in *Midamerican Energy* related to Code Section 451(f)'s prohibition on the traditional "cycle meter reading" method of accounting. The "cycle meter reading" method was a variant of accrual accounting under which utilities recognized income only as customers' meters were read. Revenue earned after the last meter reading in a given year was therefore not reported until the following year. This represented a departure from the general rule that accrual taxpayers recognize income when it is first paid, due, or earned,[17] but the IRS nonetheless sanctioned use of the method under certain conditions.[18]

In 1986, Congress enacted Code Section 451(f) to eliminate use of the "cycle meter reading" method. Code Section 451(f)(1) requires utilities on an accrual method to report income "not later than the taxable year in which [utility] services are provided." By way of belt to the suspenders, Code Section 451(f)(2)(B) provides that such year "shall not, in any manner, be determined by reference to the period in which the customers' meters are read" or the utility's billing practices. Affected taxpayers were required to change methods beginning in 1987, and the resulting cumulative adjustment under Code Section 481 was to be taken into income over four years.[19]

Midamerican changed its accounting methods when the statute required, but for reasons that the opinion leaves rather obscure, backed out unbilled gas revenues in computing 1987 income and the cumulative adjustment, effectively leaving its former method in place as to these revenues. The opinion does not lay the taxpayer's argument out in detail, but evidently Midamerican believed that because regulators permitted it to set rates based on projected gas costs, it was already on the functional equivalent of a full accrual method. The court did not agree: "Irrespective of its pricing mechanisms, petitioner is still using meter readings as proxy for utility services actually provided during the taxable year in direct contravention of section 451(f)." The IRS was upheld in requiring the taxpayer to change methods and imposing a cumulative adjustment.

RESTORATION COSTS HELD CAPITAL

Meanwhile, a district court in Ohio decided an interesting case on the capitalization of environmental remediation costs. Like *Midamerican Energy* and *Florida Progress*, *United Dairy Farmers, Inc. v. United States*[20] presented secondary accounting method issues as well.

The Facts

In the late 1980s, United Dairy Farmers (UDF) acquired numerous convenience stores, including some 60 7-Eleven's. Two of the properties had formerly been operated as gas stations and required laying out six-figure amounts to restore them to an uncontaminated state. UDF had not known of the properties' prior use when it acquired them, and the court found as a fact that it had paid more than the properties' actual value. The issue was whether the cleanup costs could be deducted or had to be capitalized as part of the properties' acquisition cost.

The Regulations

The regulations under Code Section 263 have long provided that "any amount paid out for new buildings or for permanent improvements or betterments" to property must be capitalized.[21] The regulations elaborate that "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion" is a capital expenditure, but amounts expended for "incidental repairs and maintenance" are not.[22]

Sunken Vessels Galore

Whether an expenditure directed at restoring property to its original state is a capital expenditure or a deductible "repair" is frequently disputed, and an extensive and somewhat confusing array of authorities sort themselves around these two poles. It is undisputed, however, that an expenditure that restores property beyond the condition in which the taxpayer acquired it should be added to the cost of acquisition. Two cases illustrate the distinction.

The first of the two dates from the dawn of the income tax, or at least very early in the morning. In 1916, the taxpayer in *Zimmern v. Commissioner*,[23] acquired the stripped hull of an old sailing vessel for use as a coal barge and put it into service with a minimum of reconditioning. In 1918, the barge sank in a storm. In 1920, the taxpayer had it raised, and expended approximately $25,000 to restore it to a usable state. Approximately $5,000 of this figure was attributable to completing the reconditioning that had been under way when the barge sank, but there was testimony that the remaining $20,000 was expended merely to restore the barge to the condition it had been in before it sank. The Fifth Circuit held that this $20,000 was allowable as a deduction for repairs.

In contrast, in *L.A. Wells Construction Co. v. Commissioner*,[24] a contractor specializing in marine construction bought a dredge from a salvage company. The taxpayer paid $200 for its acquisition, principally because at the time of purchase, the dredge happened to be located at the bottom of Lake Erie. It cost, in round numbers, $5,000 to raise the dredge and $2,000 more to put it in working condition. The taxpayer conceded that the $5,000 should be capitalized, but sought to deduct the $2,000 under authority of *Zimmern*. The Board of Tax Appeals disagreed:

> Clearly what the petitioner had after making the expenditures here involved was not a sunken dredge in its then useless condition, but one that was afloat and serviceable . . . . The situation here presented is entirely different from that of a taxpayer who repairs damage which has occurred to property owned and being used by him and who after such repairs has no greater asset than he originally owned.[25]

Environmental Remediation Costs

The IRS considered the treatment of asbestos removal and other kinds of environmental remediation costs in several widely publicized private rulings in the early 1990s, finally issuing a published ruling in 1994. Revenue Ruling 94-38[26] permitted a corporation to deduct the cost of cleaning up contamination caused by its own earlier activities because the expenditures merely restored the property to the condition it was in when it was acquired by the taxpayer. In contrast, the cost of adding an entirely new groundwater treatment facility had to be capitalized.

The taxpayer in *United Dairy Farmers* argued that the rationale of Revenue Ruling 94-38 should be extended to permit it to deduct amounts expended cleaning up the former gas station properties as a current expense. UDF, at least, had not known of the properties' former use, and the parties had not taken the potential contamination into account in arriving at a price. Therefore, the argument went, the expenditures merely gave the taxpayer what it had bought, or in any event paid for: uncontaminated sites. The district court, however, saw "no reason for the taxpayer's subjective belief as to the

value of the property to control the determination of whether its remediation costs are deductible or whether they must be capitalized." The cleanup costs improved the properties beyond their condition when acquired and accordingly had to be capitalized.

Professional Fees

The other issue in *United Dairy Farmers* related to a very elementary accounting question: When do liabilities stemming from the performance of services accrue? UDF wanted to make a Subchapter S election. Therefore, it created a new Subchapter S corporation and merged into it, in the process racking up some $46,300 in accounting fees. The taxpayer argued that the fees were currently deductible as tax preparation costs in connection with a Subchapter S election, but the court held that the fees had to be capitalized under the authorities relating to expenditures in connection with corporate recapitalizations and reorganizations.[27]

When Fees Are "Taken into Account"

The more interesting aspect of this portion of the *United Dairy Farmers* opinion was the court's discussion of when the invoices from the accounting firm were to be taken into account. Most of the services appear to have been performed in 1992 but were billed in 1993. Accrual taxpayers take expenditures into account—that is, either deduct them or capitalize them—when:

1. All events have occurred that establish the fact of the liability;
2. The amount of the liability can be determined with reasonable accuracy; and
3. Economic performance has occurred with respect to the liability.[28]

The first two requirements comprise the traditional "all events" test; the third requirement, "economic performance," dates from the advent of Code Section 461(h) in 1984.

A liability generally becomes "established" for purposes of the "all events" test when performance takes place if the amount neither is paid nor becomes due first.[29] Economic performance as to payments for services likewise takes place when the services are performed.[30]

When the services contracted for have been performed must be determined in light of the agreement between the parties. If the contract provides for the performance of distinct services, performance will take place, and the income item or expenditure accrues, as each "severable" portion of the agreement is performed.[31] This might well mean on an hourly basis if that is how the services were billed. Although the Tax Court in *Hudlow v. Commissioner*,[32] refused to permit accruing a deduction for accountants' fees on an hourly basis, in that case the court was not convinced that the parties intended that the liability become fixed before the services "were concluded in their entirety."[33] If the parties had expressly agreed that the taxpayer would pay for ongoing services on an hourly basis, the fact of the liability would probably have been considered "established" under the first prong of the "all events" test.

The court in *United Dairy Farmers* held that the accountants' fees could not be taken into account until the invoices were rendered in 1993, not because of the absence of an "established liability," but for another reason. The second prong of the "all events" test requires that "the amount of [the] liability can be determined with reasonable accuracy."[34] The general principle is that accruals are to be based on the facts known or reasonably knowable as of the end of the year.[35] The court found that regardless of when the services were performed, the taxpayer could not estimate its liability with reasonable accuracy until the hours of services provided were tabulated and the services itemized, and the invoices "clearly establish[ed]" that this did not happen until 1993. Therefore, the fees could not be taken into account until that year.

TAX COURT TO FACE "MERCHANDISE" ISSUE AGAIN

In the June 2000 issue, this column discussed the requirement that taxpayers keep inventories and accrue their purchases and sales if "the production, purchase, or sale of merchandise . . . is an income-producing factor" in their business.[36] When the taxpayer sells goods in conjunction with services, the IRS traditionally approaches the question of whether merchandise is an "income-producing factor" by examining whether the cost of goods is material in relation to total revenues. Following its decision in *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*,[37] however, in which it held a cancer clinic's supplies of drugs not to be "merchandise," the Tax Court appears to be shifting the focus to whether the

goods are "integral" to the service provided. Under this approach, physical goods provided in conjunction with services will not be merchandise if, realistically, the service cannot be provided without them.

Two Petitions Filed

The Tax Court may get another shot or two at this issue in the near future. On May 11, an excavation contractor filed a petition before the Tax Court protesting the IRS's forcing it onto an accrual method on the grounds that it was selling merchandise. *A.D. Wilson, Inc. v. Commissioner*.[38] On May 26, a similar petition was filed by a paving contractor. *T.D. Whitton Construction, Inc. v. Commissioner*[39]

A Hole is a Hole is a . . .

An excavation contractor basically digs big holes in which to put things, in this case including concrete "vaults," cement, and asphalt. The Wilson firm bought the vaults "F.O.B. bottom of hole": the seller installed them, and title passed immediately to the ultimate customer. The cement and asphalt were likewise delivered by the suppliers directly to the site. The "useful pliable life" of these substances was measured in hours, and the taxpayer naturally did not keep an inventory. The facts in the *Whitton* case are essentially similar. The asphalt had to be laid within a few hours of when the taxpayer's driver picked it up at the plant, or else it would harden and become worthless. Thus, the taxpayer did not maintain any inventory, even overnight.

If a taxpayer sells inventoriable merchandise, it does not matter that it does not actually keep any inventory. The taxpayer in *Epic Metals Corp. v. Commissioner*[40] sold custom-ordered metal decking, which it had the fabricators ship directly to its customers. Title to the decking passed to the ultimate customers "virtually immediately" after it passed to Epic, so Epic never actually had any inventory. Nonetheless, the Tax Court held that the taxpayer had to use an accrual method.

The potentially critical difference in these cases is that Epic Metals was selling metal decking, but these taxpayers are contractors selling services. The Wilson firm's basic argument is evidently that the product that it was selling was a hole, dug to specification, and containing certain installations, such as the concrete vaults. Its customers were not buying so much cement, or so much asphalt, but rather a result. The Whitton firm likewise characterizes the asphalt it used as a supply "consumed in the process of providing . . . asphalt paving services."[41] If these cases make it to trial, they may provide the Tax Court with an opportunity to refine further its institutional view of the issue and the evolving "integral part" test.

1. 114 T.C. No. 35 (June 30, 2000).
2. 114 T.C. No. 36 (June 30, 2000).
3. 2000-1 U.S. Tax Cas. (CCH) ¶ 50,538 (S.D. Ohio 2000).
4. No. 5495-00 (T.C. filed May 11, 2000).
5. No. 5994-00 (T.C. filed May 26, 2000).
6. James E. Salles, "Tax Accounting," 1(11) Corp. Bus. Tax'n Monthly 26, 32 (Aug. 2000) (citations omitted).
7. 114 T.C. No. 35 (June 30, 2000).
8. 114 T.C. No. 36 (June 30, 2000).
9. See North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).
10. I.R.C. § 1341(a)(2).
11. Iowa S. Util. Co. v. United States, 841 F.2d 1108 (Fed. Cir. 1988).
12. Roanoke Gas Co. v. United States, 977 F.2d 131 (4th Cir. 1992); Southwestern Energy Co. v. Commissioner, 100 T.C. 500, 501-07 (1993).
13. Houston Indus., Inc. v. United States, 125 F.3d 1442 (Fed. Cir. 1997); Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir.1986).
14. Cf. United States v. Hughes Properties, Inc., 476 U.S. 593 (1986).
15. See, e.g., Drew v. Commissioner, 31 T.C.M. (CCH) 143, 164-66 (1972); cf. Treas. Reg. § 1.62-2(c)(4) (excluding employer payments under "accountable plans").
16. 78 T.C.M. (CCH) 578 (1999).
17. Rev. Rul. 74-607, 1974-2 C.B. 149.
18. See Rev. Rul. 72-114, 1972-1 C.B. 124.
19. TRA86, Pub. L. No. 99-514, § 821(b)(2).
20. 2000-1 U.S. Tax Cas. (CCH) ¶ 50,538 (S.D. Ohio 2000).
21. Treas. Reg. § 1.263(a)-1(a)(1).
22. Treas. Reg. § 1.263(a)-1(a)(2), (b).
23. 28 F.2d 769 (5th Cir. 1928).
24. 46 B.T.A. 302 (1942), aff'd per curiam, 134 F.2d 623 (6th Cir.), cert. denied, 319 U.S. 771 (1943).
25. Id. at 308.
26. 1994-1 C.B. 35.
27. See, e.g., Rev. Rul. 70-241, 1970-2 C.B. 84.
28. Treas. Reg. § 1.446-1(c)(1)(ii).
29. See G.C.M. 38901 (Feb. 12, 1982); cf., e.g., Rev. Rul. 74-607, 1974-2 C.B. 149 (same rule under counterpart "all events" test on the income side).
30. I.R.C. § 461(h)(2)(A)(i); Treas. Reg. § 1.461-4(d)(2)(i).
31. E.g., Rev. Rul. 79-195, 1979-1 C.B. 177 (Correspondence school's performance occurs as each lesson is completed).
32. 30 T.C.M. (CCH) 894 (1971).
33. Id. at 924-25.
34. I.R.C. § 461(h)(4); Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2)(i).
35. See, e.g., United Control Corp. v. Commissioner, 38 T.C. 957, 971 (1962), acq. 1966-1 C.B. 3.
36. Treas.Reg. § 1.446-1(a)(4)(i).
37. 113 T.C. 376 (1999)
38. No. 5495-00 (T.C. filed May 11, 2000) (petition available as Tax Analysts Doc. No. 2000-15698).
39. No. 5994-00 (T.C. filed May 26, 2000) (petition available as Tax Analysts Doc. No. 2000-15699).
40. 48 T.C.M. (CCH) 357 (1984).
41. Cf. Galeridge Constr., Inc. v. Commissioner, 73 T.C.M. (CCH) 2838 (1997); RACMP Enters., Inc. v. Commissioner, 114 T.C. 211 (2000) (discussed in the June, 2000 issue).