Tax Accounting

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This month's column presents the first of a two-part discussion of Notice 2001-76, a new IRS initiative which considerably expands small business's access to the cash method.

NOTICE 2001-76 EXPANDS APPLICATION OF CASH METHOD

The IRS released Notice 2001-76[1] in early December as part of an ongoing response to the continued controversy about small businesses' ability to use the cash method. The Notice incorporates a revenue procedure relieving certain taxpayers with gross receipts of up to $10 million from the requirement to accrue income from sales of goods. The procedure is in proposed form, but pending further guidance taxpayers may rely upon it for taxable years beginning with calendar 2001.

Taxpayers covered by the proposed procedure are permitted to elect to report income from routine receivables on the cash basis: that is, as payment is received, or constructively received. Other transactions would be covered by the rules applicable to non-inventory sales. The cost of the goods themselves would be capitalized but not subjected to formal inventory accounting. The Notice and the proposed procedure represent a very significant step in responding to the outcry about small businesses being forced to adopt accrual accounting because of the IRS' application of existing rules applicable to sellers of "merchandise."

Notice 2001-76 does not simplify the law. Indeed, it adds another step to the existing analysis. The proposed revenue procedure does not even supersede Revenue Procedure 2001-10,[2] an earlier, more limited relief provision confined to taxpayers with revenues under $1 million. Current law will continue to apply if the taxpayer does not elect to change accounting methods under the procedure. Finally, some taxpayers (notably contractors) will continue to argue that they are not selling merchandise in the first place, and therefore need not abide by the procedure's terms. Nevertheless, many taxpayers will appreciate the increased flexibility that the Notice offers.

Notice 2001-76 was issued against a complex regulatory and judicial backdrop. Evaluating its terms requires an understanding of among other things:

- the different treatment historically accorded sales of services, inventory goods, and other property;
- the controversy about when sales of merchandise are an "income-producing factor" in what is otherwise a service business; and
- the treatment of non-inventory "materials and supplies."

This month's column attempts to summarize the existing law and explain the evolution of the IRS' institutional position as to when taxpayers sell "merchandise." Next month's column will continue the treatment of recent judicial developments, and discuss the pressures that brought about issuance of the two procedures, their key terms, and their practical implications for affected taxpayers.

The Code and Regulations

Code Section 446(a) states the general rule that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," and Code Section 446(c) lists both cash and accrual accounting among "permissible methods." Code Section 446(b), however, adds the proviso that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." The Supreme Court has repeatedly emphasized the Commissioner's broad discretion in prescribing tax accounting methods and determining if a taxpayer's chosen method "clearly reflects income."[3]

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The Regulations have long required both that "[i]n all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor," inventories must be kept,[4] and that "in 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 unless otherwise authorized."[5] Taxpayers may continue to account for other items of income and deduction under the cash method unless otherwise prohibited.[6]

Origins of the Accrual Requirement

The requirement that taxpayers accrue purchases and sales when inventories are present reflects the fact that, in many cases, the real problem with the use of the cash method by sellers of goods is not with the inventories themselves but with the associated receivables and payables. One court explained: "The use of inventories in computing income results in stating the expenses of a year's operations in terms of the cost of the goods actually sold during the year. Thus, the profit from these operations will be stated accurately only if the income from all sales made during the year is taken into consideration."[7] Income likewise will be distorted if purchases on credit are not taken into account.[8]

If a taxpayer maintained inventories, but were nonetheless allowed to use the cash method, then its gross income would be reduced by the cost of goods sold on credit in the year of sale, but the revenue will not be reported until the year of collection.[9] Thus, the accrual requirement has been enforced even in cases where a large portion of the goods were routinely returned[10] or the prospects for collection were so dubious that the court approved a bad debt reserve of 50 percent of receivables.[11]

Language in some early cases suggests either that formal inventories might not be required if the balances were immaterial or else that modest inventories need not necessarily compel accrual accounting. However, the authorities that actually approved use of the cash method with inventories seem all to involve instances where *taxpayers* argued that their own methods were wrong,[12] and in many of them the "inventories" were dubious[13] or unnecessary.[14] When the *IRS* sought to enforce accrual accounting, the courts tended to apply the regulations as written.[15] A few decisions suggested that the regulations' mandate might not be absolute, but approved the IRS' imposing accrual accounting on the facts.[16]

"Substantial Identity of Result"

As a practical matter, the question was largely resolved by the First Circuit's holding in *Wilkinson-Beane, Inc. v. Commissioner* [17] that a taxpayer using a method contrary to the regulations must demonstrate a "substantial identity of result."[18] The widespread adoption of this standard[19] poses an almost impossible burden for sellers of merchandise seeking to remain on the cash method.

"Substantial identity of result" is generally determined taking into account not only actual inventories but accounts receivable and payable as well. Thus, for example, the court in *Wilkinson-Beane* compared income under the IRS' method (employing inventories and accrual accounting) with the taxpayer's previous cash method.[20] The Eleventh Circuit's decision in *Knight-Ridder Newspapers v. United States*[21] appeared to break from this pattern by framing the issue as whether there were "substantial" balances or annual fluctuations in the inventory accounts. However, the narrower analysis did not affect the outcome, and the decision has since been held not to foreclose the IRS from requiring accrual accounting in the absence of actual inventories.[22]

Other courts and the IRS have consistently considered receivables and payables balances. For example, in *Asphalt Products Co. v. Commissioner*[23] the taxpayer, a seller of emulsified asphalt, had virtually no year-end inventories because roads cannot be asphalted in low temperatures. While stating that "[i]f the temporary and rather insignificant increase in inventories of raw materials had been the only basis for the Commissioner's determination, we would have been inclined to find an abuse of discretion," the court approved the IRS' imposing accrual accounting because of the taxpayer's substantial receivables.[24]

Taxpayers have been held subject to the accrual requirement even though they had no actual inventories at all. The taxpayer in *Epic Metals Corp. v. Commissioner* [25] sold custom metal decking that the fabricator shipped directly to Epic's customers. The Tax Court held that Epic had to use an accrual method because it sold merchandise, even though title to the decking passed to the ultimate customer "virtually immediately" after it passed to Epic. Several other decisions reach the same result in similar "custom order" or "drop shipment" situations where the seller held title only momentarily.[26]

Merchandise or Something Else?

The critical inquiry, therefore, is whether the sale of "merchandise" or "stock in trade" is an income-producing factor in the taxpayer's business within the meaning of the Regulations. More is involved than simply determining whether the taxpayer is buying or selling property in connection with a business.

Inventoriable goods, or "merchandise," include only those items "which have been acquired for sale or which will physically become a part of merchandise intended for sale."[27] Taxpayers have to inventory "raw materials" even if the finished product is immediately sold.[28] On the other hand, it was early established that property employed or even consumed in production cannot be inventoried if not incorporated in the finished product.[29] The cost of such "incidental materials and supplies" on hand at year-end may have to be capitalized if that is necessary to clearly reflect income.[30] However, while stockpiles of supplies are sometimes referred to as "inventories," they are not subject to inventory accounting under the Code,[31] and do not trigger the requirement to accrue purchases and sales.[32]

The "physically become a part" requirement has been invoked to prevent taxpayers from "padding" their LIFO layers with "raw materials" not intended for actual use in production, when they are not in the business of buying and selling the raw materials themselves. A leading case, *Ingredient Technology Corp. v. United States*,[33] excluded a dubious purchase of sugar on the high seas from inventories in part on the grounds that "it was never intended that the sugar which was on board ship would be . . . an 'income-producing factor.'" Similarly, courts and the IRS have held that taxpayers may not inventory "raw materials" not intended to be actually used in production, when they are not regularly in the business of buying and selling the raw materials themselves. Thus, a mill could not inventory warehouse receipts representing raw corn that was not suitable for its milling operations,[34] and manufacturers of jewelry could not inventory gold not intended for use in production.[35]

Finally, the sale of merchandise has to be an "income-producing factor." There must therefore obviously be sales. The early case of *Spiegel, May, Stern Co. v. United States* [36] held that a mail-order house could not inventory its stock of paper used to produce its catalogs, because the catalogs were not sold. Much more recent authorities have held that computer manufacturers did not have to inventory "rotable spare parts" used to make replacements under warranty for the same reason.[37] The sales must also also be regular, not "sporadic and unusual undertakings,"[38] and be connected with a profit-making business. Miscellaneous goods that a sugar refiner sold at cost in Cuba as a convenience for local planters, that were unrelated to its ordinary business, were not its inventory.[39] By contrast, the court in *Knight-Ridder* held newspapers to be inventory because their sale was central to the taxpayer's profit-making operations, even though the proceeds of actual sales were insufficient to cover production costs.[40]

Goods Accompanying Services

The authorities discussed above involved what were clearly purchases and sales, and the question was whether what was being bought or sold was "merchandise." The issue that has provoked most recent litigation, however, has been how to treat the case where property is "sold" only together with an associated service.

The seminal case again was *Wilkinson-Beane*. The taxpayer was an undertaker that sold caskets only as part of its "package" of funeral services. Nonetheless, noting that the cost of the caskets was about 15 percent of the taxpayer's gross receipts, the court held that the sale of merchandise was an "income-producing factor" in the taxpayer's business and required it to adopt accrual accounting.[41] Similarly, in *Surtronics, Inc. v. Commissioner*,[42] the Tax Court required an electroplater to inventory metals as "raw materials" even though their cost might amount to only about 5 percent of the taxpayer's overall charge for electroplating services. Thereafter it became generally accepted that taxpayers could be treated as selling "merchandise" even if the goods were provided only as part of a package with related services and the cost was not separately stated.[43] What remained uncertain was how far this "package concept" principle extended: could a taxpayer be required to adopt accrual accounting even if the "goods" provided were incidental and of insignificant value?

The IRS evidently contemplated issuing some sort of *de minimis* "safe harbor" for such taxpayers as early as 1980,[44] but nothing along those lines was to appear for another 20 years. However, the courts in *Wilkinson-Beane* and *Surtronics* had compared the cost of goods with the taxpayer's total revenues in determining whether sales of merchandise were an income-producing factor,[45] and the IRS followed suit in various unpublished guidance. The trend was toward exempting taxpayers from inventory accounting and the accrual requirement if the volume of purchases was very small. Thus, while the IRS held that the sale of merchandise was an income-producing factor for optometrists,[46] a provider of orthopedic devices,[47] an interior designer,[48] and a maintenance contractor that replaced light bulbs as part of its services,[49] the National Office later reached the opposite result in the case of a lawn service,[50] a dentist,[51] and a medical clinic.[52]

The IRS' numerical approach was hard to apply in some situations, like software sales, although it appears to be reasonably settled that at least standardized, "shrink-wrapped" software qualifies as merchandise.[53] A more important flaw in the IRS' analysis was that it took for granted that if the transaction involved transferring title to some property, then there was a sale of merchandise, and the only remaining question was whether the sale element was sufficiently large to constitute a "material income-producing factor." There is a serious argument to be made that a property owner that pays to have a road resurfaced, or a cancer patient paying for intravenous drug therapy, is not "purchasing" merchandise at all, but a service. That logic would make the asphalt laid on the road, or the drugs administered to the patient, "material or supplies" used in the course of business operations rather than "inventory."

The IRS litigated its theory throughout the 1990s in a series of cases that mostly involved different types of contractors, reaping several early victories as courts approved its requiring a roofing contractor,[54] a heating and air conditioning contractor,[55] and an electrical contractor[56] to maintain inventories. As the decade wore on, however, the IRS began to encounter both some problems in the courts and political resistance to requiring smaller businesses that were not traditional sellers of goods to adopt accrual accounting.

1. 2001-52 I.R.B. 613.

2. 2001-2 I.R.B. 272, *modifying and superseding* Rev. Proc. 2000-22, 2000-20 I.R.B. 1008.

3. *E.g., Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *United States v. Catto*, 384 U.S. 102, 114 & n.22 (1966); *Commissioner v. Hansen*, 360 U.S. 446, 467 & n.12 (1959); *Lucas v. Kansas City Structural Steel Co.*, 281 U.S. 264, 271 (1930).

4. Reg. §§ 1.446-1(a)(4)(i), 1.471-1.

5. Reg. § 1.446-1(c)(2)(i).

6. *See* Reg. § 1.446-1(c)(1)(iv).

7. *Caldwell v. Commissioner*, 202 F.2d 112, 114 (2d Cir. 1952).

8. *See, e.g., Boynton v. Pedrick*, 136 F. Supp. 888, 891 (S.D.N.Y. 1954), *aff'd per curiam on other issues*, 228 F.2d 745 (2d Cir. 1955), *cert. denied*, 351 U.S. 938 (1956).

9. *See, e.g., Record-Wide Distributors v. Commissioner*, 682 F.2d 204 (8th Cir. 1982), *cert. denied*, 459 U.S. 1171 (1983).

10. *Record-Wide, supra.*

11. *Moore v. Commissioner*, 45 T.C.M. (CCH) 557 (1983).

12. *E.g., Simon v. Commissioner*, 176 F.2d 230 (2d Cir. 1949); *Estate of Roe v. Commissioner*, 36 T.C. 939, 952 (1961), *acq.* 1962-1 C.B. 4; *Drazen v. Commissioner*, 34 T.C. 1070 (1960); *Brookshire v. Commissioner*, 31 T.C. 1157 (1959), *aff'd*, 273 F.2d 638 (4th Cir.), *cert. denied*, 363 U.S. 827 (1960); *Beckman v. Commissioner*, 8 B.T.A. 830 (1927).

13. *E.g., Simon* (the taxpayer, a "custom jobber" who momentarily took title, would probably be treated today as selling merchandise, but the court held that he did not have inventories); *Drazen* (taxpayer, which produced films for its customers to make plates to produce maps, capitalized contract costs but was arguably selling services); *Estate of Roe* (holding a cash method contractor could use inventories "when the taxpayer is in a service business and the inventory is used in the business and not held primarily for sale").

14. *E.g., Beckman* (court upheld the IRS' putting a farmer with inventories on the unmodified cash method, which was clearly proper).

15. *E.g., Iverson's Estate v. Commissioner*, 255 F.2d 1 (8th Cir.) , leave to file petition for reh'g denied, 257 F.2d 408 (8th Cir.), cert. denied, 358 U.S. 893 (1958). *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953); *Herberger v. Commissioner*, 195 F.2d 293 (9th Cir.), cert. denied, 344 U.S. 820 (1952). *Boynton v. Pedrick*, 136 F. Supp. 888 (S.D. N.Y. 1954), *aff'd per curiam on other issues*, 228 F.2d 745 (2d Cir. 1955), *cert. denied*, 351 U.S. 938 (1956).

16. *E.g., Ezo Products Co. v. Commissioner*, 37 T.C. 385 (1961) (accrual might not be required "where inventories are so small as to be of no consequence or consist primarily of labor," *id.* at 392, but IRS action justified).

17. 420 F.2d 352 (1st Cir. 1970).

18. *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970).

19. *See, e.g., Ralston Development Corp. v. United States*, 937 F.2d 510, 513 & n.4 (10th Cir. 1991); *Asphalt Products Corp. v. Commissioner*, 796 F.2d 843, 849 (6th Cir. 1986), *rev'd per curiam on another issue*, 482 U.S. 117 (1987); *J.P. Sheahan & Assoc. v. Commissioner*, 63 T.C.M. (CCH) 2842, 2847 (1992).

20. 420 F.2d at 356; *accord, e.g., Ezo Products,* 37 T.C. at 392 (court considered inventory and receivables in concluding the cash method did not clearly reflect income).

21. 743 F.2d 781, 791 (11th Cir. 1984).

22. *Independent Contracts, Inc. v. United States*, 94-1 U.S.T.C. ¶ 50,135 (N.D. Ala.), *aff'd per curiam without published opinion*, 40 F.3d 390 (11th Cir. 1994) (summary opinion, 74 A.F.T.R.2d ¶ 94-5672).

23. 796 F.2d 843 (6th Cir. 1986), *rev'd per curiam on another issue*, 482 U.S. 117 (1987).

24. *See also, e.g.*, Gen. Couns. Mem. 37699 (Sept. 29, 1978) (optometrist selling custom-ordered eyeglasses had to accrue purchases and sales even though its actual inventories were negligible).

25. 48 T.C.M. (CCH) 357 (1984), aff'd without published opinion, 770 F.2d 1069 (3d Cir. 1985).

26. *E.g., Thomas Nelson, Inc. v. United States*, 694 F. Supp. 428 (M.D. Tenn. 1988) (publishing company's parent drop-shipped books to subsidiary's customers); *In re BKW Systems, Inc.*, 90-1 U.S.T.C. ¶ 50,139 (Bankr. E.D. N.H. 1989) (computer hardware merchandise despite insignificant inventories); *Hoffman v. Commissioner*, 57 T.C.M. (CCH) 51 (1989) (ski equipment sold in bulk to investors in year of purchase); *see also, e.g., Independent Contracts, supra; J.P. Sheahan Assocs., Inc. v. Commissioner*, 63 T.C.M. (CCH) 2842, 2844 (1992) (that there may be "a zero or minimal year-end inventory is irrelevant").

27. Reg. § 1.471-1.

28. *E.g., Knight-Ridder Newspapers v. United States*, 743 F.2d 781 (11th Cir. 1984) (newspaper had to inventory paper and ink despite virtually no inventory of finished goods); *Fame Tool & Mfg. Co. v. Commissioner*, 334 F. Supp. 23 (S.D. Oh. 1971) (inventory accounting rules applied to custom tool and die maker); *Middlebrooks v. Commissioner*, 34 T.C.M. (CCH) 1187 (1975) (printing costs of trade magazines that were immediately sold to the distributor).

29. *E.g., Pierce Arrow Motor Car Co. v. United States*, 9 F. Supp. 577 (Ct. Cl. 1935) (steel used in the manufacture of tools); *J.E. Mergott Co. v. Commissioner*, 11 T.C. 47 (1948), aff'd, 176 F.2d 860 (3d Cir.1949) ("tumbling barrels" used in polishing metal); *Burroughs Adding Machine Co. v. Commissioner*, 9 B.T.A. 938 (1927) (reviewed) (miscellaneous factory supplies).

30. *See* Reg. § 1.162-3 (current deduction permissible only "provided the taxable income is clearly reflected").

31. *E.g., Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 550-57 (1979), *aff'd on another issue*, 633 F.2d 512 (7th Cir. 1980) (utility's coal "inventories" not subject to FIFO and LIFO).

32. *See, e.g., Estate of Roe v. Commissioner*, 36 T.C. 939, 952 (1961), *acq.* 1962-1 C.B. 4 ("inventory" of a service business "not held primarily for sale" not incompatible with cash method).

33. 698 F.2d 88, 94 (2d Cir.), *cert. denied*, 462 U.S. 1131 (1983).

34. *Illinois Cereal Mills v. Commissioner*, 46 T.C.M. (CCH) 1001 (1983) *aff'd on another issue*, 789 F.2d 1234 (7th Cir.) , cert. denied, 479 U.S. 995 (1986).

35. *B.A. Ballou & Co. v. United States*, 85-1 U.S.T.C. ¶ 9290 7 Cl.Ct. 658, *aff'd without published opinion,* 785 F.2d 325 (Fed. Cir. 1985); Rev. Rul. 79-188, 1979-1 C.B. 191.

36. 37 F.2d 988 (Ct. Cl. 1930).

37. *Hewlett-Packard Co. v. United States*, 71 F.3d 398 (Fed. Cir. 1995); *Honeywell, Inc. v. Commissioner*, 64 T.C.M. (CCH) 437 (1992), *aff'd without published opinion*, 27 F.3d 571 (8th Cir. 1994).

38. *Pierce-Arrow Motor Car Co. v. United States*, 9 F. Supp. 577, 585 (Ct. Cl. 1935) (auto manufacturer could not inventory "tool steel" despite isolated attempt to sell surplus stocks).

39. *Francisco Sugar Co. v. Commissioner*, 47 F.2d 555 (2d Cir. 1931).

40. *See also, e.g.* TAM 8549002 (Aug. 8, 1985) (contractor had to inventory coal that was a by-product of its highway construction activities).

41. *Accord, e.g., Fred H. McGrath & Son, Inc. v. United States*, 549 F. Supp. 491 (S.D.N.Y. 1982); Rev. Rul. 69-537, 1969-2 C.B. 109.

42. 50 T.C.M. (CCH) 99 (1985).

43. *See, e.g., Ward Ag Products, Inc. v. Commissioner*, 75 T.C.M. (CCH) 1886, 1889-90 (1998), *aff'd without published opinion*, 216 F.3d 1090 (11th Cir. 2000 memorandum opinion at 2000-1 U.S.T.C. ¶ 50,487) .

44. *See* Gen. Couns. Mem. 38288 (Feb. 21, 1980); *cf.* Reg. § 1.263A-1(b)(11) (providing that items provided in conjunction with services that are *not* treated as inventory are to be ignored for purposes of the uniform capitalization rules).

45. *See also, e.g., Knight-Ridder*, 743 F.2d at 790 (noting cost of paper and ink exceeded 17% of total revenues in concluding newspaper sales were "income-producing factor").

46. Rev. Rul. 74-279, 1974-1 C.B. 110; Gen. Couns. Mem. 37699 (Sept. 29, 1978).

47. Rev. Rul. 73-485, 1973-2 C.B. 150.

48. FSA 1995-20 (10/13/95).

49. PLR 8744004 (July 13, 1987).

50. PLR 9808003 (Nov. 3, 1997).

51. PLR 9848001 (July 16, 1998).

52. PLR 9723006 (Feb. 21, 1997).

53. *Nemetschek North America, Inc. v. Commissioner*, 82 T.C.M. (CCH) 827 (2001); *Applied Communications v. Commissioner*, 57 T.C.M. (CCH) 1473 (1989).

54. *J.P. Sheahan Assoc. v. Commissioner*, 63 T.C.M. (CCH) 2842 (1992).

55. *Independent Contracts, Inc. v. United States*, 94-1 U.S.T.C. ¶ 50,135 (N.D. Ala. 1994), *aff'd per curiam without published opinion*, 40 F.3d 390 (11th Cir. 1994) (summary opinion at 74 A.F.T.R.2d ¶ 94-5672).

56. *Thompson Electric, Inc. v. Commissioner*, 69 T.C.M. (CCH) 3045 (1995).