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# Of Merchandise, Accruals, And Administrative Grace

By James E. Salles

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Rev. Proc. 2002-28,[1] released on April 12, represents the IRS's latest and most comprehensive response to the continued controversy over small businesses' use of the cash method. The procedure relieves broad categories of taxpayers with gross receipts of up to $10 million from the general requirement to accrue income from the sale of goods. Eligible taxpayers are permitted to elect to report income from routine receivables from the sale of goods on the cash basis, that is, as payment is received, or constructively received. Other transactions would be covered by the rules applicable to noninventory sales. The cost of the goods themselves must be capitalized but taxpayers may elect to exclude them from formal inventory accounting and treat them as "materials and supplies." The IRS has thus taken a significant step toward responding to the outcry arising from the agency's application of the existing rules under section 446 governing sellers of "merchandise" to taxpayers not in traditional wholesaling and retailing businesses. In doing so, it has also provided a practical solution to a recurring issue demanding a disproportionate amount of attention on the part of the IRS and the courts in recent years.

A forerunner of Rev. Proc. 2002-28 had been released in December 2001 as part of Notice 2001-76.[2] While the procedure included with the notice was in proposed form, taxpayers had been permitted to rely on it for taxable years beginning with calendar year 2001, pending further guidance. The final procedure likewise is effective for tax years ending December 31, 2001, or later. The IRS also promises that it will not disturb accounting methods used in earlier years to the extent that their use would have been permitted under the procedure.[3]

Rev. Proc. 2002-28 does not simplify the law; indeed, it adds another step to the existing analysis. It does not

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[1]Rev. Proc. 2002-28, 2002-18 IRB 815 (Apr. 12, 2002), *Doc 2002-9029 (28 original pages), 2002 TNT 72-6.*

[2]2001-52 IRB 613, *Doc 2001-30482 (18 original pages), 2001 TNT 238-21.*

[3]Rev. Proc. 2002-28, section 9.

even supersede Rev. Proc. 2001-10,[4] an earlier relief provision confined to taxpayers with revenues less than $1 million. Current law continues to apply to taxpayers not electing to apply the procedure. Moreover, some taxpayers — notably contractors — will be able to argue, based on recent case law, that they are not selling merchandise in the first place, and therefore need not abide by the restrictions the procedure imposes on use of the cash method. Nevertheless, many small businesses will appreciate the increased flexibility that the new procedure offers.

Rev. Proc. 2002-28 must be understood in terms of the complex regulatory and judicial backdrop against which it evolved, including the different treatment historically accorded sales of services, inventory goods, and other property; the treatment of noninventory "materials and supplies"; and the long-running controversy about when sales of merchandise are an "income-producing factor" in what is otherwise a service business.

## I. Code and Regulations

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 section 446(c) lists both cash and accrual accounting among "permissible methods." 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 IRS's broad discretion in prescribing tax accounting methods and determining if a taxpayer's chosen method "clearly reflects income."[5]

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,[6] 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."[7] 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."[8] Income likewise will be distorted if purchases on credit are not taken into account.[9] 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 would not be reported until the year of collection.[10] Thus, the accrual requirement has been enforced even in cases where a large portion of the goods were routinely returned[11] or the prospects for collection were so dubious that the court approved a bad-debt reserve of 50 percent of receivables.[12]

The accrual requirement under the regulations applies only to purchases and sales of merchandise. Taxpayers may continue to account for other items of income and deduction under the cash method unless some other provision prohibits them from doing so.[13] However, a taxpayer might have to accrue receivables from both goods and associated services if the corresponding costs and revenues cannot be sorted out. Indeed, at least until recently, the IRS's position seems to have been that if the taxpayer mixes services and merchandise in a single trade or business, then all its customer revenues have to be accrued, even if the merchandise is charged for separately. A 1993 TAM concluded that a weight reduction clinic had to accrue both its counseling fees and its proceeds from the sale of food supplements and similar items because the two aspects of the business were "completely integrated."[14] The IRS National Office seemed to regard the relevant standard as being whether the two activities qualified as separate trades or businesses.[15] However, in *Hospital Corp. of America v. Commissioner* (*HCA I*),[16] the Tax Court allowed a hospital to continue with its hybrid method of accounting under which it accrued the portion of its receivables representing charges for medical supplies and reported service receivables on the cash basis. The court noted that the taxpayer's cost accounting system made it "quite feasible to accurately segregate accounts containing merchandise for which

[4] 2001-2 IRB 272, *Doc 2000-31536 (12 original pages), 2000 TNT 236-9,* modifying and superseding Rev. Proc. 2000-22, 2000-20 IRB 1008, *Doc 2000-12080 (10 original pages), 2000 TNT 83-1.*

[5] *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).

[6] Reg. sections 1.446-1(a)(4)(i), 1.471-1.

[7] Reg. sections 1.446-1(c)(2)(i).

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

[9] *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).

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

[11] *Id.*

[12] *Moore v. Commissioner,* 45 T.C.M. (CCH) 557 (1983).

[13] *See* reg. section 1.446-1(c)(1)(iv).

[14] TAM 9408003 (Nov. 10, 1993), *94 TNT 39-16.*

[15] *See* reg. section 1.446-1(d).

[16] 71 T.C.M. (CCH) 2319 (1996), *Doc 96-7070 (61 pages), 96 TNT 48-16.*

an accrual method is required from accounts which do not contain merchandise for which the cash method is appropriate."[17]

## II. 'Substantial Identity of Result'

Language in some early cases suggested 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 actually approving use of the cash method with inventories seem all to involve instances where taxpayers were arguing that their own methods failed to clearly reflect income.[18] Moreover, in many of them the presence of inventories was dubious or unnecessary. One early case involved a cash method farmer who argued that he had to use accrual accounting because he kept inventories. The IRS had resolved the conflict by putting him on the unmodified cash method, which he was clearly permitted to use. The Board of Tax Appeals upheld its action.[19] The taxpayer in *Simon v. Commissioner,*[20] a "custom jobber" who momentarily took title, might have been held today to sell merchandise,[21] but the court found that he did not have inventories. The Tax Court remarked in *Drazen v. Commissioner*[22] that "some reasonable latitude" might be allowed in determining "whether and when [the taxpayer's manufacturing activities] became substantial enough to require the use of inventories and a change to an accrual method," but the taxpayer, which produced films to make map plates, was arguably selling services rather than goods.[23] Similarly, in *Estate of Roe v. Commissioner,*[24] involving a cash method contractor, the court stated that inventories were not incompatible with the cash method "when the taxpayer is in a service business and the inventory is used in the business and not held primarily for sale."[25]

When the presence of inventories was clear and the IRS sought to enforce accrual accounting, the courts tended to apply the regulations as written.[26] A few decisions suggested that the regulations' mandate might not be absolute, but approved the IRS's imposing accrual accounting on the facts.[27] As a practical matter, the question was largely resolved by the First Circuit's holding in *Wilkinson-Beane, Inc. v. Commissioner*[28] that a taxpayer using a method contrary to the regulations must demonstrate a "substantial identity of result."[29] The widespread adoption of this standard[30] posed 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's method — employing inventories and accrual accounting — with the taxpayer's previous cash method.[31] The Eleventh Circuit's decision in *Knight-Ridder Newspapers v. United States*[32] 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 court's narrower focus 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.[33] Other courts and the IRS have consistently considered receivables and payables balances in measuring "substantial identity of result."[34] For example, in *Asphalt Products Co. v. Commissioner,*[35] the taxpayer, a seller of emulsified asphalt, had virtually

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[17] 71 T.C.M. (CCH) at 2332-34. Under the Tax Court's later decision in *Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner,* 113 T.C. 376 (1999) (reviewed), *Doc 1999-37146 (61 original pages), 1999 TNT 225-3, acq. in result* AOD 2000-5, 2000-23 IRB 2 (discussed below), *Doc 2000-12115 (3 original pages), 2000 TNT 83-9,* the supplies were probably not merchandise. The court in *Hospital Corp.* refrained from deciding the issue because the taxpayer was already using the hybrid method. The question before the court was whether — before the advent of section 448 — the taxpayer had to change to full accrual accounting.

[18] *See, e.g., Brookshire v. Commissioner,* 31 T.C. 1157 (1959), *aff'd* 273 F.2d 638 (4th Cir.), *cert. denied* 363 U.S. 827 (1960), and the cases cited immediately following.

[19] *Beckman v. Commissioner,* 8 B.T.A. 830 (1927).

[20] 176 F.2d 230 (2d Cir. 1949).

[21] *See, e.g., Epic Metals Corp. v. Commissioner, 48 T.C.M. (CCH) 357 (1984), aff'd without published opinion* 770 F.2d 1069 (3d Cir. 1985).

[22] 34 T.C. 1070 (1960).

[23] *Cf. RACMP Enterprises, Inc. v. Commissioner,* 114 T.C. 211, 225 (2000), *Doc 2000-9721 (78 original pages), 2000 TNT 63-19* (paper and ink not "inventory" to an architect).

[24] 36 T.C. 939 (1961), *acq.* 1962-1 C.B. 4.

[25] *Id.* at 952.

[26] *E.g., Iverson's Estate v. Commissioner,* 255 F.2d 1 (8th Cir. 1958), leave to file petition for rehearing denied 257 F.2d 408 (8th Cir. 1958), *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).

[27] *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).

[28] 420 F.2d 352 (1st Cir. 1970).

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

[30] *See, e.g., Ralston Development Corp. v. United States,* 937 F.2d 510, 513 & n.4 (10th Cir. 1991), *91 TNT 141-4; Asphalt Products Corp. v. Commissioner,* 796 F.2d 843, 849 (6th Cir. 1986), *86 TNT 144-74, rev'd per curiam on another issue* 482 U.S. 117 (1987), *87 TNT 106-9;* J.P. *Sheahan & Assoc. v. Commissioner,* 63 T.C.M. (CCH) 2842, 2847 (1992), *92 TNT 88-6.*

[31] 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).

[32] 743 F.2d 781, 791 (11th Cir. 1984).

[33] *Independent Contracts, Inc. v. United States,* 94-1 U.S.T.C. Par. 50,135 (N.D. Ala.), *94 TNT 51-29, aff'd per curiam without published opinion* 40 F.3d 390 (11th Cir. 1994), *94 TNT 240-7* (summary opinion, 74 AFTR2d Par. 94-5672).

[34] *E.g., Cross Oil Co. v. Commissioner,* 81 T.C.M. (CCH) 1682 (2001), *Doc 2001-15382 (17 original pages), 2001 TNT 105-6* (accrual method required despite modest and stable inventories); *see also, e.g., 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").

[35] 796 F.2d 843 (6th Cir. 1986), *rev'd per curiam on another issue* 482 U.S. 117 (1987).

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's imposing accrual accounting because of the taxpayer's substantial receivables.[36]

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*[37] sold custom metal decking that the fabricator shipped directly to its 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 itself. Several other decisions reach the same result in similar "custom order" or "drop shipment" situations where the seller held title only momentarily.[38]

### III. Merchandise or Something Else?

Under the "substantial identity of result" test, therefore, it is pretty much a given that if the regulations' "income-producing factor" standard is met, the accrual requirement will be enforced. The critical inquiry, therefore, becomes what it takes to make the sale of "merchandise" or "stock in trade" an income-producing factor in the taxpayer's business. More is involved than simply determining whether the taxpayer is buying or selling property in connection with a business.

Firstly, the property concerned must be "merchandise": that is, inventory. (As a side note, sales of noninventory property are accounted for under a different regime revolving around section 1001, which generally requires sellers to recognize the difference between the amount received and basis and, where it applies, section 453, relating to installment sales.) This means that the property must be personal property, as real estate cannot be inventoried.[39] Moreover, to be inventoriable, the goods must have been acquired for sale or to "physically become a part of merchandise intended for sale."[40] While "raw materials" must be inventoried even if the finished product is immediately sold,[41] property employed or even consumed in production cannot be inventoried if not incorporated in the finished product.[42] Reg. section 1.162-3 requires the cost of these "incidental materials and supplies" to be capitalized if that is necessary to clearly reflect income.[43] However, while stockpiles of supplies are sometimes referred to as "inventories," they are not subject to inventory accounting under the code,[44] and do not trigger the requirement to accrue purchases and sales.[45]

The "physically become a part" requirement has been invoked to prevent taxpayers from "padding" their inventory LIFO layers. A leading case, *Ingredient Technology Corp. v. United States,*[46] 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 taken the stance 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,[47] and manufacturers of jewelry could not inventory gold not intended for use in production.[48]

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*[49] held that a mail order house could not inventory paper used to produce its catalogs, because the catalogs were not sold. Much more recent authorities have held that computer manufacturers did not

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

[37] 48 T.C.M. (CCH) 357 (1984), *aff'd without published opinion* 770 F.2d 1069 (3d Cir. 1985).

[38] *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. Par. 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* note 33.

[39] *E.g., W.C. & A.N. Miller Development Co. v. Commissioner,* 81 T.C. 619 (1983); *Atlantic Coast Realty Co. v. Commissioner,* 11 B.T.A. 416 (1928).

[40] Reg. section 1.471-1.

[41] *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).

[42] *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).

[43] *See* reg. section 1.162-3 (current deduction permissible only "provided the taxable income is clearly reflected").

[44] *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).

[45] *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).

[46] 698 F.2d 88, 94 (2d Cir. 1983), *cert. denied* 462 U.S. 1131 (1983).

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

[48] *B.A. Ballou & Co. v. United States,* 7 Cl. Ct. 658 (1985), *aff'd without published opinion* 785 F.2d 325 (Fed. Cir. 1985); Rev. Rul. 79-188, 1979-1 C.B. 191.

[49] 37 F.2d 988 (Ct. Cl. 1930).

have to inventory "rotable spare parts" used to make replacements under warranty for the same reason.[50] The sales must also be regular, not "sporadic and unusual undertakings,"[51] and be connected with a profit-making business. Miscellaneous goods a sugar refiner sold at cost in Cuba as a convenience for local planters, and unrelated to its ordinary business, were not its inventory.[52] In contrast, the court in *Knight-Ridder* held newspapers to be inventory because their sale was central to the taxpayer's profitmaking operations, even though the proceeds of actual sales were insufficient to cover production costs.[53]

## IV. Goods Accompanying Services

The authorities discussed above involved what were clearly purchases and sales of goods, and the question was whether the goods concerned were "merchandise." The issue provoking 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 selling 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.[54] Similarly, in *Surtronics, Inc. v. Commissioner,*[55] 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.[56] A series of IRS rulings required optometrists,[57] a provider of orthopedic devices,[58] an interior designer,[59] and a maintenance contractor replacing light bulbs[60] to adopt accrual accounting. Questions remained, however, about how far that principle was to be taken, and when the provision of personal property in connection with services would be a "sale" of "merchandise" that was an "income-producing factor." Absent regulatory or much other guidance, these issues were still being fought out in the courts 30 years after *Wilkinson-Beane.*

### A. *De Minimis* Sales of Goods

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,[61] and the Tax Court more recently has described "comparison of the cost of the merchandise to the taxpayer's gross receipts computed under the cash method of accounting" as the "recognized standard" to be applied in determining whether sales of merchandise were a material income-producing factor in the taxpayer's business.[62] The obvious implication is that below some threshold, *de minimis* sales of goods may be ignored.

For a time, there was little guidance as to what ratio of costs to receipts might suffice to make sales of merchandise an "income-producing factor." The IRS evidently contemplated publishing some sort of safe harbor,[63] but never did. Some inferential guidance appeared in 1993 with the appearance of the final uniform capitalization (UNICAP) regulations.[64] These regulations include an exemption for "property provided incident to services" as long as the property was both "*de minimis* in amount" and "not inventory in the hands of the service provider."[65] The regulations further provide that if the "acquisition or direct material cost of the property" does not exceed 5 percent of the taxpayer's total charges, then the property will be deemed "*de minimis* in amount."

Strictly speaking, the UNICAP regulations do not address the "material income-producing factor" inquiry. Indeed, they allow for the possibility that property might be "*de minimis*" for UNICAP purposes — although not necessarily under the 5 percent safe harbor — but nonetheless still be "inventory in the hands of the service provider." However, the trend appeared to be toward exempting taxpayers from keeping inventory and the accrual requirement if their volume of purchases in relation to receipts was small. In a 1997 TAM, the IRS's National Office concluded that merchandise sales were not a "material income-producing factor" in the business of a medical clinic despite purchases totaling roughly 8 percent of

[50] *Hewlett-Packard Co. v. United States,* 71 F.3d 398 (Fed. Cir. 1995), *Doc 95-10985 (12 pages), 95 TNT 240-9; Honeywell, Inc. v. Commissioner,* 64 T.C.M. (CCH) 437 (1992), *92 TNT 164-25, aff'd without published opinion,* 27 F.3d 571 (8th Cir. 1994), *Doc 94-6514, 94 TNT 135-16.*

[51] *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).

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

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

[54] *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.

[55] 50 T.C.M. (CCH) 99 (1985).

[56] *See, e.g., Ward Ag Products, Inc. v. Commissioner,* 75 T.C.M. (CCH) 1886, 1889-90 (1998), *Doc 98-7783 (17 pages), 98 TNT 39-14, aff'd without published opinion* 216 F.3d 1090 (11th Cir. 2000), *Doc 2001-3651 (1 original page), 2001 TNT 26-8* (memorandum opinion at 2000-1 U.S.T.C. Par. 50,487).

[57] Rev. Rul. 74-279, 1974-1 C.B. 110; GCM 37699 (Sept. 29, 1978).

[58] Rev. Rul. 73-485, 1973-2 C.B. 150.

[59] FSA 1995-20 (Oct. 13, 1995), *Doc 2000-6829 (8 original pages), 2000 TNT 178-36.*

[60] LTR 8744005 (Jul. 13, 1987).

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

[62] *Cross Oil Co. v. Commissioner,* 81 T.C.M. (CCH) 1682, 1685 (2001).

[63] *See* GCM 38288 (Feb. 21, 1980).

[64] Reg. section 1.263A-1, T.D. 8482, 1993-2 C.B. 77, *superseding* reg. section 1.263A-1T, T.D. 8131, 1987-1 C.B. 98, *amended by* T.D. 8148, 1987-2 C.B. 70

[65] Reg. section 1.263A-1(b)(11).

revenues (although this figure included non-"merchandise" materials and supplies).[66] In another ruling issued later the same year, the IRS allowed a landscaper to use the cash method despite materials purchases of roughly 3 percent, 3 percent, and 6 percent of sales in the three years at issue.[67] Taking the regulations together with the rulings, practitioners and commentators began to regard the 5 percent neighborhood as relatively safe.[68]

### B. 'Ephemerality': *Galedrige Construction* and *Turin*

The IRS's 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.[69] There was, however, a more important weak spot in the IRS's analysis, which was that it largely assumed away the issue of whether the goods were merchandise in the first place. The IRS, following longstanding regulations prescribing what goods are included in inventory,[70] took the position that all property transferred — or physically incorporated into something that was transferred — in the transaction was merchandise and its sale at least potentially an "income-producing factor." Thus, the IRS classified a dentist's anesthetics, crowns, bridges, and dentures, or a medical clinic's medicine, serum, and bandages as "merchandise," although such items as syringes, gloves, and disposable towels fell under the heading of "materials and supplies."[71] However, there is a serious argument to be made that a cancer patient paying for intravenous drug therapy — or a property owner paying to have a road resurfaced, or a floor laid — is not purchasing "merchandise" at all, but a service. If so, the drugs furnished the patient, the asphalt on the road, or the tiling making up the floor are not "merchandise" but "materials or supplies" used in providing that service.

The IRS litigated its theory throughout the 1990s, reaping several early victories as courts approved its requiring a roofing contractor, [72] a heating and air conditioning contractor,[73] and an electrical contractor[74] to maintain inventories. As the decade wore on, however, and the IRS's litigation position became more aggressive, the courts began to question the assumption that any property whose ownership might pass to a customer was necessarily "merchandise."

In *Galedrige Construction, Inc. v. Commissioner,*[75] and *Jim Turin & Sons v. Commissioner,*[76] the Tax Court held that paving contractors were not required to inventory their stocks of emulsified asphalt because it was not their "merchandise." Unlike in *Asphalt Products,* the taxpayers themselves laid the asphalt, and "sold" it only as part of a finished road surface. Both the Tax Court and the Ninth Circuit emphasized that the useful life of emulsified asphalt was measured in hours — if not laid promptly when it was heated, it hardened and had to be discarded.[77]

To the Ninth Circuit in *Turin*, the asphalt's "ephemeral" status was the critical factor, because it meant that "there is no inventory that can be purchased late in one tax year and held over to the next."[78] Thus, whether or not the asphalt might be in some sense "merchandise," it was not as a practical matter an inventoriable good. This reasoning enabled the court to distinguish both the "drop shipment" authorities following *Epic Metals* and the earlier contractor cases such as *J.P. Sheahan Co.* on the grounds that they all involved goods which "were or could be stored in inventory."[79] The taxpayer in *Epic Metals,* for example, could have stored the metal decking in a warehouse while awaiting sale.

Beyond such materials as asphalt and liquid concrete,[80] the Ninth Circuit's analysis could call into question the IRS's position that electricity is "merchandise,"[81] not to mention raising interesting — but unlikely to be litigated — questions about, for example, whether fast food chains are selling goods or a service. (Few fast food chains have much in the way of receivables to worry about.) However, the "ephemerality exception" remains largely confined to these specialized situations.

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[66]TAM 9723006 (Feb. 7, 1997), *Doc 97-16506 (7 pages), 97 TNT 110-25.*

[67]TAM 9808003 (Nov. 3, 1997), *Doc 98-6703 (6 pages), 98 TNT 35-42.*

[68]*See, e.g.,* William L. Raby and Burgess J.W. Raby, "Merchandise and Cash-Basis Taxpayers," *Tax Notes,* Dec. 21, 1998, p. 1533, suggesting the critical threshold might be about 8 percent, citing TAM 9723006, *supra* note 66.

[69]*Nemetschek North America, Inc. v. Commissioner,* 82 T.C.M. (CCH) 827 (2001), *Doc 2001-27348 (14 original pages), 2001 TNT 210-11; Applied Communications v. Commissioner,* 57 T.C.M. (CCH) 1473 (1989).

[70]Reg. section 1.471-1.

[71]LTR 9848001 (July 16, 1998), *Doc 98-34191 (6 pages), 98 TNT 229-8;* TAM 9723006 (Feb. 21, 1997), *Doc 97-16506 (7 pages), 97 TNT 110-25.*

[72]*J.P. Sheahan Assoc. v. Commissioner,* 63 T.C.M. (CCH) 2842 (1992), *92 TNT 88-6.*

[73]*Independent Contracts, Inc. v. United States,* 94-1 U.S.T.C. Par. 50,135 (N.D. Ala. 1994), *94 TNT 51-29, aff'd per curiam without published opinion* 40 F.3d 390 (11th Cir. 1994), *Doc 94-10820, 94 TNT 240-7* (summary opinion at 74 AFTR2d Par. 94-5672).

[74]*Thompson Electric, Inc. v. Commissioner,* 69 T.C.M. (CCH) 3045 (1995), *Doc 95-6430, 95 TNT 126-10.*

[75]73 T.C.M. (CCH) 2838 (1997), *Doc 97-14395 (28 pages), 97 TNT 100-11.*

[76]75 T.C.M. (CCH) 2534 (1998), *Doc 98-20430 (6 pages), 98 TNT 122-16* (1998), *aff'd* 219 F.3d 1103 (9th Cir. 2000), *Doc 2000-20008 (11 original pages), 2000 TNT 144-9.*

[77]*Galedrige,* 73 T.C.M. (CCH) at 2841, 2843; *Turin,* 75 T.C.M. (CCH) at 2535-36, 219 F.3d at 1105, 1107-09.

[78]219 F.3d at 1107.

[79]219 F.3d at 1109.

[80]*See RACMP Enterprises v. Commissioner,* 114 T.C. 211, 225-27 (2000), *Doc 2000-9721 (78 original pages), 2000 TNT 63-19.*

[81]*See* Service Industry Specialization Program Coordinated Issue Paper, "Customer Deposits," 1991-95 IRS Positions Par. 175,785; LTR 9523001 (Dec. 17, 1994), *95 TNT 113-9.*

### C. The 'Triple Eye' Test: *Osteopathic Medical*

While the Ninth Circuit in *Turin* appeared to concentrate exclusively on the asphalt's "ephemeral" nature, the Tax Court was pursuing a broader distinction. Its reasoning appears most clearly in two reviewed decisions, *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner,*[82] and *RACMP Enterprises, Inc. v. Commissioner.*[83]

The question in Osteopathic was whether a cancer clinic's chemotherapy drugs were merchandise or supplies. The stage had been set in *Hospital Corp. of America v. Commissioner (HCA II),*[84] which considered whether a hospital was selling services or providing goods when it furnished drugs and other items to its patients. The accrual requirement was not at issue in *HCA II.* Through 1986, HCA had used a hybrid method under which it accrued purchases and sales. As discussed above, the IRS had unsuccessfully tried to change to full-fledged accrual accounting in *HCA I.*[85] Starting in 1987, HCA was unquestionably subject to section 448, which required it to account for all items of income and deduction on an accrual method. The issue in *HCA II* was the potential application of section 448(d)(5), which allows some taxpayers the option of avoiding accruing accounts receivable "which (on the basis of experience) will not be collected," essentially providing a more tightly constrained version of the old reserve for bad debts.[86] This "nonaccrual experience method," however, is confined to receivables from the sale of services, presenting the question whether the hospital was selling goods, services, or both.

Many hospital consumables are clearly supplies. The controversy before the court was how to classify items finding their way into, or on to, the patient in the course of medical treatment, such as casts, splints, sutures, skin staples, implants, and pacemakers as well as intravenous drugs.[87] The IRS contended that charges for these items represented proceeds from the sale of goods and were ineligible for the nonaccrual experience method. However, the court concluded that the medical supplies were "inseparably connected" to the services that HCA provided and therefore any income attributable to the supplies was still "income earned from the performance of services" qualifying for the nonaccrual experience method.

The court in *HCA II* did not have to decide whether the drugs were inventoriable "merchandise,"[88] although its reasoning strongly suggested that they were not. In *Osteopathic Medical,* however, the "merchandise" issue came squarely before the court on similar facts. The clinic's patients were buying a course of treatment, not a given quantity of drugs. The clinic did not, and indeed legally could not, furnish the drugs to the patients directly. The Tax Court held that the drugs were supplies, not merchandise, because they were "an integral, indispensable, and inseparable part of the rendering of medical services." (An earlier writer in these pages has christened this formulation the "Triple Eye"[89] test, and I shall hereafter take the liberty of following suit.)

After losing another memorandum case involving similar facts,[90] the Service formally acquiesced in *Osteopathic Medical.* The acquiescence was only "in result," indicating disagreement with some aspects of the Tax Court's reasoning. However, the IRS conceded that "prescription drugs or similar items administered by healthcare providers" were not merchandise subject to inventory accounting, although the associated costs might still have to be capitalized under the rules for supplies.[91]

### D. Contractors: *RACMP* and Its Progeny

*RACMP, Inc. v. Commissioner,*[92] a reported and indeed reviewed opinion chronologically sandwiched between the memorandum holdings in *Galedrige* and *Turin*, extended Osteopathic's "Triple Eye" approach to contractors. The taxpayer in *RACMP* was a contractor that built driveways, sidewalks, and building foundations, a process naturally requiring much sand, gravel, and poured concrete and the occasional steel bar or pipe.[93] *Galedrige* was squarely on point as far as the concrete was concerned: liquid concrete, like emulsified asphalt, has a useful life measured in hours, and much the same considerations apply. That left the question of what to do with the other construction materials, as rock and steel are not ordinarily associated with ephemeral qualities. The court held that construction contracts should be treated as contracts for services, as they are in a variety of nontax contexts. If a taxpayer is actually selling services, "that the cost of the materials is substantial is insufficient to transmute the sale of a service to the sale of merchandise and a service."[94] Thus, the construction materials were not merchandise because they were indispensable to and inseparable from the services provided.[95]

The *RACMP* court made clear that its focus was on the transaction between the taxpayer and its customer rather than on the property itself. One taxpayer's inventory may be another taxpayer's supplies. The court noted that paper and ink could not be inventory to an

[82] 113 T.C. 376 (1999) (reviewed), *Doc 1999-37146 (61 original pages), 1999 TNT 225-3, acq. in result*, AOD 2000-05 (Apr. 27, 2000), 2000-23 I.R.B. 2, *Doc 2000-12115 (3 original pages), 2000 TNT 83-9.*

[83] 114 T.C. 211 (2000) (reviewed), *Doc 2000-9721 (78 original pages), 2000 TNT 63-19.*

[84] 107 T.C. 116 (1996), *96 TNT 183-8.*

[85] *See Hospital Corp. of America v. Commissioner,* 71 T.C.M. (CCH) 2319 (1996).

[86] Former section 166(c), repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, section 805(a).

[87] 107 T.C. at 123.

[88] 107 T.C. at 143 n.18.

[89] Leo F. Nolan II, "Zen and the Cash Method," *Tax Notes,* June 26, 2000, p. 1771.

[90] *Mid-Del Therapeutic Center, Inc. v. Commissioner,* 79 T.C.M. (CCH) 1875 (2000), *Doc 2000-10782 (22 original pages), 2000 TNT 71-10.*

[91] AOD 2000-05 (April 27, 2000), *Doc 2000-12115 (3 original pages), 2000 TNT 83-9.*

[92] 114 T.C. 211 (2000) (reviewed), *supra* note 83.

[93] 114 T.C. at 212.

[94] 114 T.C. at 224.

[95] 114 T.C. at 227-31.

architect, even if the architect supplied clients with physical blueprints, because the "essence" of the architect's services is designing buildings,[96] but paper and ink is inventory to a newspaper.[97] While a contractor like RACMP might properly treat asphalt that it buys for immediate use as "supplies," asphalt is inventory to a dealer like the taxpayer in *Asphalt Products.* Similarly, while the drugs in *Osteopathic Medical* were not inventory to the clinic, they obviously were inventory to the pharmaceutical companies producing them.

This point was vividly illustrated when Judge Vazquez, who joined in the majority opinion in *RACMP,* reached the opposite result in a memorandum case released the following day. *Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner*[98] involved a trucker selling sand and gravel — which were found to be "materials" in *RACMP* — to contractors. However, in *Von Euw* the only service that the taxpayer was providing was transportation. The sand and gravel were thus its merchandise, and because it reaped larger profits when it sold sand and gravel on a delivered basis than it did when it merely transporting its customers' materials, the sale of that merchandise was a "material income-producing factor" in its business. Thus, the accrual requirement applied.[99]

Under the Tax Court's evolving view, the key factor distinguishing supplies consumed in the course of supplying a service from "merchandise" provided in conjunction with a service is that the "supply" cannot usefully be provided without the service, while "merchandise" can. For example, no one questions that automobile parts are "merchandise" to a repair shop. While normally the repair shop will install the parts in customers' cars, car owners can buy replacement parts and install them themselves, and some do. Similarly, the *Osteopathic* court explained, earlier cases requiring contractors to use the accrual method, like *J.P. Sheahan Associates v. Commissioner,*[100] had all involved situations where "customers of the taxpayer also could have personally purchased the merchandise elsewhere and either installed the merchandise themselves . . . or contracted with a third party."

In contrast, *Vandra Bros. Construction Co. v. Commissioner*[101] involved a contractor specializing in laying concrete in public sites such as city streets and sidewalks. While most of its materials cost represented liquid concrete, the taxpayer also bought stone, reinforcing steel, and other items as needed. The Tax Court found the facts essentially indistinguishable from *RACMP* and held that the taxpayer was entitled to continue to use the cash method. *Smith v. Commissioner*[102] involved a flooring contractor that would procure materials — for example, tile — to the customer's specifications. The contractor charged its customers what it paid for the materials, plus a fee. While the taxpayer did not stock flooring, the volume acquired in connection with a given job could be substantial, and several months might elapse before it received payment. It nonetheless maintained no inventories — apart from a constant capitalized amount of $15,000 — and reported income on the cash basis. Relying principally on *RACMP,* the Tax Court held that the flooring was not merchandise because its "sale" was incidental to the taxpayer's installation business. The court read *RACMP* as holding not only that the "ephemeral qualities" of liquid concrete precluded its status as merchandise, but also more broadly that materials could not be "merchandise" when they "were incorporated into the particular project to such a degree that they lost their separate identity." As in *Osteopathic Medical* and *RACMP,* the court appeared to focus not so much on what the taxpayer was selling as what its customers were buying. After the transaction, the taxpayer's customers did not have a pile of tiles; they had a floor.

## V. Rev. Procs. 2000-22 and 2001-10

After losing *Vandra Bros.* and *Smith,* the IRS threw in the institutional towel, announcing that pending further guidance it would no longer press the issue of whether "construction contractors involved in paving, painting, roofing, drywall, and landscaping" are required to use accrual accounting because they sell "merchandise."[103] Indeed, it seems to have retreated from its litigation strategy on the whole "merchandise" question generally, stipulating successively to the dismissal with no or minimal deficiencies of pending Tax Court cases involving a paving contractor,[104] excavation contractor,[105] a building contractor with an "inventory" of bricks,[106] and even a slaughterhouse.[107]

The IRS had to take into account more than merely judicial developments. In the late 1990s, pressure had begun to build both on the IRS and in Congress to exempt small contractors, and other small businesses

[96] 114 T.C. at 224-25.

[97] *See Knight-Ridder Newspapers v. United States,* 743 F.2d 781 (11th Cir. 1984).

[98] 79 T.C.M. (CCH) 1793 (2000), *Doc 2000-9827 (15 original pages), 2000 TNT 64-55.*

[99] *Osteopathic Medical,* 113 T.C. at 388.

[100] 63 T.C.M. (CCH) 2842 (1992), *supra* note 30.

[101] 80 T.C.M. (CCH) 125 (2000), *Doc 2000-20582 (12 original pages), 2000 TNT 150-10.*

[102] 80 T.C.M. (CCH) 701 (2000), *Doc 2000-29370 (14 original pages), 2000 TNT 221-6.*

[103] Chief Counsel Notice CC-2001-010 (Feb. 9, 2001), *Doc 2001-4417 (2 original pages), 2001 TNT 31-23; see also* FSA 200125001 (Jan. 18, 2001), *Doc 2001-17281 (7 original pages), 2001 TNT 122-25* (recommending IRS not attempt to change drywall installer's accounting method).

[104] *T.D. Whitton Construction, Inc. v. Commissioner,* Docket No. 5994-00 (2000), petition available as *Doc 2000-15699 (11 original pages), 2000 TNT 117-51,* judgment per stipulation, Aug. 29, 2000.

[105] *A.D. Wilson, Inc. v. Commissioner,* Docket No. 5495-00 (2000), petition available as *Doc 2000-15698 (10 original pages), 2000 TNT 117-49,* judgment per stipulation, Feb. 5, 2001.

[106] *Manor Concrete Construction Co. v. Commissioner,* Docket No. 9625-00 (Sept. 7, 2000), petition available as *Doc 2000-27270 (12 original pages), 2000 TNT 221-15,* judgment per stipulation, Apr. 23, 2001.

[107] *DeYoung v. Commissioner,* Docket No. 8734-00 (2000), judgment per stipulation, Aug. 7, 2001.

arguably selling "merchandise" along with their services, from the full rigors of accrual accounting. The issue achieved a higher profile on the Hill in part by happenstance. A revenue raiser slipped into the 1999 "extenders bill" banned accrual taxpayers from using the installment method.[108] The apparent intent was to target large, liquid, publicly traded corporations using the installment sales rules to defer tax on large, isolated capital transactions. However, the measure proved to have a larger-than-expected impact on small businesses, especially in the context of business dispositions. Many small business entities had adopted accrual accounting as an overall method because of the merchandise rule. After the 1999 amendment, if such an entity sold its assets, installment reporting would be unavailable and sellers could be taxed many years before they received the corresponding cash.[109] The problem prompted hearings, and some lawmakers expressed the view that smaller businesses should be allowed to use the cash method regardless of whether they had inventories.[110] Congress eventually repealed the installment sales provision[111] without addressing the cash method issue. However, there remained interest in a more comprehensive "fix" of the rules governing sellers of merchandise, at least so far as they affected small taxpayers.

Even before the installment sales issue had come to the fore, Rep. Jim Talent, R-Mo., chair of the House Small Business Committee, had introduced a bill to exempt sellers of merchandise with revenues under $5 million from the accrual requirement.[112] The counterpart Senate bill would also have permitted taxpayers to use the cash method if their cost of goods was less than 50 percent of revenues.[113] The Joint Committee staff simplification study included a similar proposal.[114] The legislative initiatives focused on the accrual requirement, evidently assuming that the cost of goods should be capitalized as supplies. However, the ABA Tax Section even suggested that outright expensing might be appropriate.[115]

[108]Tax Relief Extension Act of 1999, Pub. L. No. 106-170, codified at section 453(a)(2).

[109]*See* Notice 2000-26, 2000-17 IRB 954 (Apr. 10, 2000), *Doc 2000-10605 (6 original pages), 2000 TNT 70-5, modified by* Notice 2001-22, 2001-12 IRB 911, *Doc 2001-5061 (3 original pages), 2001 TNT 34-8.*

[110]*See* "Mikrut Says Treasury Needs Time to Assess Cases Before Issuing Cash Method Guidance," *DTR*, Apr. 6, 2000, at G-7; Massey, Barton, "Treasury's Interpretation of Cash Method Is Wrong, Lawmakers Charge," *Tax Notes*, Apr. 10, 2000, p. 190.

[111]Installment Tax Correction Act of 2000, Pub. L. No. 106-573, section 2(a), repealing former section 453(a)(2).

[112]H.R. 2273, 106th Cong., 1st Sess. (June 17, 1999) by Messrs. Talent and English.

[113]S. 2246, 106th Cong., 2d Sess. (Mar. 9, 2000) by Sens. Bond and Grassley.

[114]JCS-3-01 "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986," (Jt. Comm. Prt. Apr. 2001) ["2001 Simplification Study"] VII.B at 328-32.

[115]*See* Statement of Richard M. Lipton on behalf of the ABA Section of Taxation before the Senate Finance Committee, Apr. 26, 2001, reprinted at 617, 627-28 (Spring, 2001).

The initial IRS response was Rev. Proc. 2000-22,[116] later refined in Rev. Proc. 2001-10.[117] That revenue procedure generally allows taxpayers with average annual gross receipts of $1 million or less to use a modified version of the cash method, under which revenue from routine accounts receivable (due in 120 days or less) and can be deferred until the taxpayer is in receipt or constructive receipt of the cash. Other merchandise sales are reportable under section 1001. That section generally applies to sales of noninventory property.

Rev. Proc. 2001-10 also permits eligible taxpayers to opt out of inventory accounting. If inventories are not kept, then the goods that would normally be inventoried must be treated as a "non-incidental" supplies under reg. section 1.162-3, meaning that the associated costs must be capitalized. (Only "incidental" materials and supplies may sometimes be expensed.) However, conventional inventory accounting and the uniform capitalization rules for inventories will not apply.

Rev. Proc. 2001-10 applies to most taxpayers meeting the $1 million threshold (computed under the rules applicable under section 448). The revised procedure, however, added a specific exclusion for entities or arrangements constituting "tax shelters" as defined in section 448.[118] The referenced definition is broad, and can sweep in, for example, entities other than "C" corporations whose ownership interests offer limited liability and/or are registered under the securities laws.[119] As originally issued, Rev. Proc. 2000-22 also conditioned relief on compliance with a LIFO-style conformity requirement[120] that directed that income be reported to owners and creditors in the same manner as for tax. The 2001 changes, however, eliminated this condition.

## VI. Revenue Procedure 2002-28

Even after Rev. Proc. 2000-22 appeared, pressure continued for broader relief.[121] Proposals for a $5 million threshold were reintroduced in the new Congress.[122] Notice 2001-76, and now Rev. Proc. 2002-28, represents the IRS's attempt at response. With some minor wrinkles, the new procedure essentially expands the relief under Rev. Proc. 2001-10 to some taxpayers with average annual gross receipts up to $10 million, prescribing two related optional accounting methods:

[116]2000-20 IRB 1008, *supra* note 4.

[117]2001-2 IRB 272, *Doc 2000-31536 (12 original pages), 2000 TNT 236-9.*

[118]Rev. Proc. 2001-10, section 3.

[119]*See* sections 448(a)(3), 461(i)(3), and 1256(e)(3)(B).

[120]*Cf.* section 472(c).

[121]*See* letter from Rep. Donald Manzullo, R-Ill., to Joseph Mikrut, Tax Legislative Counsel (June 7, 2000), *Doc 2000-20507 (3 original pages), 2000 TNT 150-21;* W. Eugene Seago, "A New Revenue Procedure Makes the Cash Method More Available, But Does It Go Far Enough?" 93 *J. Tax'n* 12, 17 (July 2000); Massey, Barton, "Practitioners Disappointed With New Cash Basis Fix," *Tax Notes*, May 1, 2000, p. 603.

[122]Cash Accounting for Small Business Act of 2001, H.R. 656, 107th Cong., 1st Sess. (Feb. 16, 2001), by Rep. Wally Herger, R-Cal.; Cash Accounting for Small Business Act of 2001, S. 336, 107th Cong., 1st Sess. (Feb. 14, 2001), by Sen. Christopher Bond, R-Mo.

a modified version of the cash method for trade receivables, and a "quasi-supply" treatment for items that would otherwise be inventoriable "merchandise."

### A. Eligible Taxpayers

Taxpayers required to use an accrual method under section 448 — generally, C corporations with average annual gross receipts above $5 million — cannot use the proposed revenue procedure. Other taxpayers may be eligible for relief if their gross receipts fall between $1 million and $10 million. Gross receipts are computed consistently with section 448, including use of a three-year rolling average and the combination of related parties.[123] Finally, the taxpayer must meet any of several alternative rules relating to lines of business:

- A taxpayer may use the revenue procedure for any of its businesses so long as the North American Industry Classification System (NAICS) code for its principal business activity (that is, the activity accounting for the largest proportion of its gross receipts) is not one of a specified group of "ineligible codes." Ineligible codes generally indicate core production or reselling operations: mining, manufacturing, wholesale and retail trade, and "information industries."[124]
- A taxpayer may also use the revenue procedure for any of its businesses if its principal business activity consists of the provision of services or "the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications," even if that activity falls under an ineligible code.[125] A taxpayer is not considered to be engaged in "the fabrication or modification of tangible personal property upon demand" if the customer merely chooses among preselected options or the modifications are minor.[126] For example, a sofa manufacturer that upholsters to suit would not fall under this exception, but a custom toolmaker would.[127] Several commentators had inquired about the potential application of this "custom manufacturer" exception to taxpayers mass-producing assets to their customers' specifications,[128] custom fabricators and quarries,[129] and graphic designers and desktop publishers.[130] The final procedure specifically provides that the exception does not cover a taxpayer that "manufactures an item in quantities for a customer." The drafters also added an example clarifying that graphic designers do not fall under an ineligible NAICS code,[131] so that they do not have to make use of the exception.
- Even if a taxpayer is not eligible to use the revenue procedure for all of its businesses (because its principal business activity falls under an ineligible code and does not involve the provision of services or custom production), it may still use the procedure for one or more trades or businesses that standing alone, would qualify for relief.[132] For example, a taxpayer selling plumbing (ineligible) but does some installation work (the provision of services) can use the revenue procedure for the installation business if it qualifies as a separate trade or business.[133] The standard is the same as for determining whether the taxpayer has two or more "separate and distinct" trades or businesses entitled to use their own method of accounting.[134] A "complete and separable" set of books must be kept for each business.

The IRS's use of NAIC codes and the importance attached to the determination of "principal business activity" attracted a number of comments. Several writers expressed concern that short-term swings in taxpayers' business operations might affect the determination of taxpayers' "principal business activity," and suggested looking to average operating results over some period, and/or excluding isolated transactions outside the usual course of business operations, such as bulk sales or business dispositions.[135] In response to these concerns, Rev. Proc. 2002-28 permits taxpayers to determine their principal business activity based on either the prior year's results or a three-year average.[136] The procedure also makes clear that an activity may be the "principal business activity" even though it does not account for 50 percent of gross receipts.[137]

### B. Changes of Method

The procedure's two special methods may be adopted independently of one another. An eligible taxpayer can choose to combine traditional inventory accounting with the modified cash method for receivables, or

[123] Rev. Proc. 2002-28, sections 5.05-.08, *Doc 2002-9029 (28 original pages), 2002 TNT 72-6.*

[124] *Id.,* section 4.01(1)(a).

[125] *Id.,* section 4.01(1)(b)-(c).

[126] *Id.,* section 4.01(1)(c).

[127] *Id.,* section 6, Exs. 10 & 12.

[128] Comments dated January 23, 2002, by John P. Cornelius of Baune, Dosen & Co., *Doc 2002-3151 (2 original pages), 2002 TNT 27-41.*

[129] Letter dated Mar. 1, 2002, from Phil Thoden of the Associated General Contractors of America, *Doc 2002-5704 (4 original pages), 2002 TNT 48-27.*

[130] Comments of Felicia Cheek of the Printing Industries of America (Mar. 1, 2002), *Doc 2002-5700 (1 original page), 2002 TNT 48-23.*

[131] Rev. Proc. 2002-28, section 6, Ex. 1.

[132] *Id.,* section 4.01(2).

[133] *Id.,* section 6, Ex. 7.

[134] *See* reg. section 1.446-1(d).

[135] Letter dated February 28, 2002, from Pamela Pecarich of the American Institute of Certified Public Accountants to Ass't Secretary Weinberger, et al., (AICPA comments), *Doc 2002-5326 (4 original pages), 2002 TNT 42-85;* comments by members of the American Taxation Association submitted under cover of letter dated February 28, 2002, from Anthony P. Curatola to Commissioner Rossotti (ATA Comments), *Doc 2002-5701 (5 original pages), 2002 TNT 48-24;* comments dated February 27, 2002, by Abraham Schneier, *Doc 2002-5698 (3 original pages), 2002 TNT 48-21.*

[136] Rev. Proc. 2002-28, section 5.04.

[137] *Id.,* section 5.04(1), section 6, Ex. 8.

use the elective method of accounting for merchandise but continue to accrue receivables, or adopt both of the procedure's special methods.[138]

Although the procedure incorporated in Notice 2001-76 was only in proposed form, taxpayers were invited to rely on it pending further guidance, and after some initial confusion,[139] the IRS had provided for automatic consent to the necessary changes in accounting method in Notice 2002-14.[140] These provisions have largely carried over into Rev. Proc. 2002-28.[141] Apparently in response to a specific inquiry,[142] the final procedure specifically provides that the cumulative adjustment under section 481 resulting from adopting the procedure will be handled separately from "leftover" adjustments from prior method changes. For example, a taxpayer previously changing to an accrual method may continue to take the resulting positive adjustment into income over several years even while obtaining the benefit of an immediate negative adjustment from changing back to the modified cash method.[143]

The final procedure adds another clarification particularly helpful to contractors. The modified cash method is available for long-term contracts to the extent that they are not required to be accounted for on a percentage-of-completion basis under section 460.[144] IRS personnel had apparently taken the position that the automatic consent granted in Notice 2002-14 applied only to changes to the "overall" cash method,[145] and that taxpayers changing their method of accounting for long-term contracts from one of the specialized contract methods, such as the percentage-of-completion method, were therefore ineligible.[146] These taxpayers were left to file one application for a change to the overall cash method under the special procedure and another, which is subject to tighter deadlines and requires a user fee, to change long-term contract methods.[147] Rev. Proc. 2002-28 now makes it clear that the automatic consent extends to "any other change that is eligible to be made under this revenue procedure in conjunction with either or both [of the special methods] (such as a change from a long-term contract method that is not required to be used by section 460)."[148]

A taxpayer ceasing to meet the eligibility requirements must change to accrual accounting for the trade(s) or business(es) concerned under normal rules. A taxpayer that has had to change from using the procedure for any of its businesses thereafter cannot thereafter qualify to use the revenue procedure for all of its trades or businesses under the rules described in either of the first two bullet points in the preceding section, even if circumstances change so that the taxpayer again meets the requirements.[149] However, the taxpayer may still use the methods prescribed in the procedure for particular trades or businesses that qualify under the third bullet point.[150]

### C. Modified Cash Method

As under Rev. Proc. 2001-10, taxpayers eligible for relief under Rev. Proc. 2002-28 are allowed to report income from "open accounts receivable" (defined as receivables due in 120 days or less) on the cash method; that is, on receipt or constructive receipt. Income from other receivables remains potentially subject to section 1001, which governs sales or exchanges of noninventory property. Except in "rare and unusual circumstances,"[151] section 1001 generally requires current reporting of gain measured by the "amount received" (cash plus the fair market value of property) minus the taxpayer's basis in the property given up. The interaction of this principle with the regulations governing transactions ineligible for the installment method[152] will frequently produce a result similar to accrual accounting, because the buyer's obligation to make payment will be considered "property" that a cash basis seller has to take into account at its fair market value. Effectively, therefore, taxpayers selling property can defer income only on receivables qualifying under the 120-day rule. Of course, some sets of facts will pose the old question about whether a taxpayer is selling "property" at all, or merely services.

Sensibly, the 120 days is determined based on when payment is due, not when it is actually received. Presumably, the 120 days would be measured from billing, although this is not wholly clear. There might otherwise be issues regarding, for example, contractors' progress payments that are not directly associated with

[138] Rev. Proc. 2002-28, section 4.02.

[139] There had initially been doubt about whether taxpayers could change methods based on a merely proposed revenue procedure, and the IRS was bombarded with requests for clarification of the effective date provisions and allied issues. *See, e.g.,* comments dated January 10, 2002, by David B. Roberts Jr., *Doc 2002-3150 (1 original page), 2002 TNT 27-40;* comments dated January 15, 2002, by Joseph Kristan of Roth & Co., *Doc 2002-3152 (4 original pages), 2002 TNT 27-42;* comments dated January 19, 2002, by John Gruel, *Doc 2002-3146 (1 original page), 2002 TNT 27-36;* comments dated January 16, 2002 by G. Douglas Puckett, *Doc 2002-3148 (1 original page), 2002 TNT 27-38;* and comments dated January 16, 2002, by Judy K. Grubbs, *Doc 2002-3149 (1 original page), 2002 TNT 27-39.*

[140] 2002-8 IRB 548.

[141] Rev. Proc. 2002-28, section 7.

[142] Thoden letter, *supra* note 129.

[143] Rev. Proc. 2002-28, section 7.03(2).

[144] *See* Rev. Proc. 2002-28, section 6, Exs. 21-22.

[145] *See generally* section 460. The traditional "completed contract" and accrual methods remain in use for some "exempt contracts." *See* section 460(e)(1), reg. section 1.460-4(d). Certain other contracts are eligible for a hybrid "percentage-of-completion/capitalized cost" method. Section 460(e)(5); reg. section 1.460-4(e).

[146] *See* letter dated March 4, 2002, from Michael Pearlstein of Associated Builders and Contractors, Inc., *Doc 2002-5697 (2 original pages), 2002 TNT 48-20;* Thoden letter, *supra* note 129; comments dated February 28, 2002, from Eric Wallace of Carbis Walker & Assoc., *Doc 2002-5703 (2 original pages), 2002 TNT 48-26.*

[147] Rev. Proc. 97-27, 1997-1 C.B. 680, *Doc 97-12786 (50 pages), 97 TNT 90-8. See* discussion in Wallace comments, *supra* note 146.

[148] Rev. Proc. 2002-28, section 7.02(3).

[149] *See* Rev. Proc. 2002-28, section 4.01(1), introductory paragraph.

[150] *See generally* Rev. Proc. 2002-28, section 6, Exs. 24-26.

[151] *See* reg. section 1.1001-1.

[152] Reg. section 15A.453-1(d). Presumably, the erstwhile "merchandise" would still be "dealer property" under section 453(l)(1)(A) and therefore ineligible for the installment method.

specific sales of property. One commentator raised the issue of contractors' retainages,[153] which does not appear to have been addressed in the final procedure.

### D. Accounting for 'Quasi-Supplies'

Eligible taxpayers may also choose not to keep inventories and to treat what would otherwise be inventoriable "merchandise" as nonincidental "supplies" under reg. section 1.162-3; that is, capitalize the associated costs until the supplies are used, or in this case sold. The inventory accounting rules will not apply to these "quasi-supplies."

This of course raises the question of how to determine how much to expense. Taxpayers have some flexibility in determining the cost flow assumptions used for "traditional" supplies. The proposed revenue procedure stated that "any reasonable method" of determining cost flows could be used for merchandise treated as supplies, as long as it is used consistently, specifically citing "first in, first out" (FIFO) and average costing as reasonable methods.[154] The final procedure added the "specific identification" method, but expressly banned the use of LIFO ("last in, first out") assumptions.[155] Whether this was intended as a departure from the rules governing ordinary supplies is not clear. The LIFO inventory method will of course not apply to noninventory items, but, for example, the Tax Court has allowed a utility to use something close to a LIFO method to account for its coal supplies when on the particular facts the taxpayer's method was a reasonable surrogate for actual cost.[156]

A still more basic question is how to determine the cost of the individual items making up the stockpile. In general, all taxpayers with merchandise are subject to the inventory costing rules under section 471, which in the case of manufacturers include the potentially complex "full absorption" costing rules under reg. section 1.471-11. The UNICAP rules essentially layer on top of the inventory costing rules. There are two basic UNICAP regimes, one for "producers," including manufacturers, and the other for "resellers." The reseller rules would generally not be an issue for eligible taxpayers, as taxpayers with average annual gross revenues of $10 million or less are exempt.[157] However, the exception for "small producers" is less generous, applying only if the potentially capitalizable costs other than direct materials and labor (indirect costs) incurred during the year is less than $200,000. In these cases, indirect costs still have to be capitalized into inventory to the extent required under the "full absorption" regulations, but no additional amount has to be capitalized under section 263A.[158]

[153]Thoden letter, *supra* note 129.

[154]Notice 2001-76, Prop. Rev. Proc. 4.04, *Doc 2001-30482 (18 original pages), 2001 TNT 238-21.*

[155]Rev. Proc. 2002-28, section 4.05.

[156]*See, 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).

[157]Section 263A(b)(2)(B).

[158]Reg. section 1.263A-2(b)(3)(iv).

Rev. Proc. 2001-10 excepted goods treated as supplies from the UNICAP rules altogether,[159] and Notice 2001-76 specifically requested comments as to what relief might be appropriate for the broader category of taxpayers potentially eligible to use the new procedure.[160] Several commentators proposed simply extending the blanket exemption granted in Rev. Proc. 2001-10,[161] which is what the drafters ultimately opted to do. If the other aspects of inventory accounting, such as LIFO, do not apply to "quasi-supplies," then presumably the general inventory costing rules in reg. sections 1.471-3 and 1.471-11 do not apply either.[162] Taxpayers would therefore appear to be left with the "common law" principles requiring the capitalization of "ancillary costs" associated with acquiring property[163] and the cost of self-constructed property.[164]

## VII. And Beyond

The short period since Notice 2001-76's issue saw a plethora of public comments and requests for further guidance. The first spate of comments concentrated on the need to provide automatic consent for the necessary accounting method changes, which the IRS for the most part addressed in the follow-up Notice 2002-14.[165] Later comments, including a fairly lengthy submission by members of the ABA Tax Section committee on accounting,[166] were generally more substantive and mostly fell into one of two categories: suggestions for extensions or refinements to the procedure itself, and simplification initiatives in allied areas. Rev. Proc. 2002-28 addresses a number of the points raised, but neither it nor the accompanying Announcement 2002-45 provides much insight into the IRS's institutional thinking on the issues that were not addressed, at least for now.

### A. Additional Relief for Contractors

A number of comments raise concerns relating to contractors, which have accounted for the lion's share of recent litigation about the "merchandise rule." For example, section 460, which generally requires contrac-

[159]Rev. Proc. 2001-10, section 4.01, 2001-2 IRB 272, 273, *Doc 2000-31536 (12 original pages), 2000 TNT 236-9.*

[160]Notice 2001-76, 2001-52 IRB 613, 613.

[161]ATA Comments, *supra* note 135; comments dated February 28, 2002, by Tony Szczepaniak of RSM McGladrey, *Doc 2002-5699 (2 original pages), 2002 TNT 48-22.*

[162]Long-term contracts exempt from section 460 are generally exempt from its costing rules as well, see section 460(e)(1), unless the taxpayer voluntarily adopts the completed contract method and becomes subject to the costing rules for "exempt contracts" under reg. section 1.460-5(d). *See* reg. section 1.460-5(a).

[163]*See, e.g., Woodward v. Commissioner,* 397 U.S. 572, 576 (1970).

[164]*E.g., Commissioner v. Idaho Power Co.,* 418 U.S. 1 (1974).

[165]2002-8 IRB 548, *Doc 2002-2709 (2 original pages), 2002 TNT 23-13.*

[166]Comments submitted under cover of letter dated March 14, 2002, from Richard M. Lipton to Commissioner Charles O. Rossotti, *Doc 2002-6932 (8 original pages), 2002 TNT 56-10.* Although referred to for convenience in text and below as the Tax Section comments, in accordance with usual ABA practice the comments were submitted by the committee members in their individual capacities.

tors to use the percentage-of-completion method, excludes some short-term contracts entered into by taxpayers with average annual gross receipts of $10 million or less,[167] leaving taxpayers free to account for the contracts under the proposed revenue procedure for regular tax purposes, but the percentage-of-completion method has to be used for alternative minimum tax.[168] Several commentators had noted that this significantly limits the benefit of Notice 2001-76, and suggested that the revenue procedure should be applied for AMT purposes as well.[169] As it stands, however, Rev. Proc. 2002-28 is merely a partial waiver of the "merchandise rule" in the section 446 regulations; it is doubtful that the IRS could or would extend it to waive a statutory requirement.

**B. General *De Minimis* Rule Under Reg. Section 1.162-3**

Both the ABA Tax Section and AICPA writers requested that the IRS keep working on a general *de minimis* safe harbor applicable to any taxpayer if purchases of merchandise accounted for a sufficiently small proportion of total revenues, similar to the UNICAP exemption discussed above.[170] The Tax Section comments suggested a combined limitation on purchases of all types of supplies, including inventory treated as supplies under the proposed revenue procedure, of 15 percent of revenues, roughly the level that the courts in *Wilkinson-Beane* and *Knight-Ridder* found to indicate that sales were a "material income-producing factor" in the taxpayers' businesses. That threshold might be a little ambitious for a safe harbor. Both *Wilkinson-Beane* and *Knight-Ridder*, after all, were government victories, and the Tax Court in *Surtronics* required inventories on the basis of materials costs significantly lower than that. By comparison, the letter rulings concluding that merchandise sales were not a "material income-producing factor" involved purchases in the 3-8 percent range, and the "safe harbor" under the UNICAP rules is 5 percent.

By suggesting a combined limitation for all types of supplies, however, the Tax Section commentators make a key point. Reg. section 1.162-3 allows "incidental materials or supplies" for which the taxpayer does not keep consumption records to be expensed upon purchase "provided the taxable income is clearly reflected." Establishing a different rule for "merchandise" treated as supplies runs the risk of raising the issue the procedures are in part designed to avoid, which is whether given items were "merchandise" in the first place. The same observation may apply to the procedure's prohibition on using LIFO-type accounting, to the extent that this accounting would be acceptable for "ordinary" supplies.

[167] Section 460(e)(1)(B).

[168] Section 56(a)(3).

[169] Comments dated January 18, 2002, by Steven J. Geisenberger of Walz, Deihm, Geisenberger, Bucklen & Tennis, P.C., *Doc 2002-3147 (1 original page), 2002 TNT 27-37,* and Cornelius comments, *supra* note 128; Pearlstein letter, *supra* note 145.

[170] Tax Section comments, *supra* note 166, Part B; AICPA comments, *supra* note 135.

There is no evidence the drafters of the venerable regulatory language intended to imply the existence of a separate category of "non-incidental supplies" that could not be expensed even if the taxable income were clearly reflected. Even if "incidental" was intended to imply something about size, that base would seem to be covered by the requirement that the result must clearly reflect income. The IRS's "per se non-incidental" approach seems to have originated with Rev. Proc. 2000-22.[171] It has since cropped up in other guidance, presenting similar issues. For example, Rev. Proc. 2002-12,[172] intended to resolve capitalization issues concerning restaurant "smallwares" (glassware, flatware, pots and pans, and so forth), requires electing taxpayers to treat smallwares as "non-incidental" supplies, deducting the costs only as the items are put into use. This provides a "bright-line" rule that is both more taxpayer-favorable and much simpler than trying to compute depreciation and abandonments item by item, which is what taxpayers would otherwise have had to do if the smallwares were treated as capital. However, the smallwares, whether capital or not, are clearly supplies, so taxpayers can still argue that their particular smallwares are not capital because they do not have a useful life extending "substantially beyond the taxable year" and that a current deduction should be allowed under the "clear reflection" standard in reg. section 1.162-3. This of course puts at issue the capitalization question the procedure was designed to settle.

The IRS might resolve many of these problems by amending reg. section 1.162-3 to expressly allow current deductions if taxpayers' total outlays for materials and supplies not treated as inventory (whether because of elections under the various procedures or because they are "true" supplies) fall below a certain percentage of revenues. If that threshold were exceeded, all such items, whether properly "supplies" or only so treated by virtue of the revenue procedure, would have to be capitalized unless the taxpayer established that a current deduction would clearly reflect income. It would be easy to imagine a taxpayer — for example, the electroplater in *Surtronics* — that might appropriately be excused from the formalities of inventory accounting and the requirement to accrue its revenues while still being required to keep track of its stockpiles and capitalize the associated costs.

Likewise, if it were decided to limit the use of LIFO-type cost flow assumptions in accounting for those supplies that are capitalized, the regulations could be amended appropriately and the change made applicable to all types of supplies alike. Finally, the regulations could sidestep another set of issues by explicitly providing that sales of items properly treated as supplies — whether under the revenue procedure or not — will be treated as transactions involving services if they are made in the ordinary course of business in exchange for receivables satisfying the 120-day rule.

[171] Rev. Proc. 2002-22, section 4, 2000-20 IRB 1008, 1008, *Doc 2002-6847 (17 original pages), 2002 TNT 54-12.*

[172] 2002-3 IRB 374, *Doc 2002-550 (8 original pages), 2002 TNT 5-10.*

### C. Inventory and UNICAP Costing Rules

Another set of questions revolves around how to determine the cost of the "quasi-supplies" in the first place. As described above, the drafters of Rev. Procs. 2001-10 and 2002-28 sensibly concluded that much of the benefit of simplification would be lost if small manufacturers still had to comply with the UNICAP rules, and so provided a general exemption for "merchandise" treated as supplies. (The Tax Section comments had gone one step further and suggested that only direct materials costs should be subject to potential capitalization,[173] but the final procedure did not go that far.)

Like the automatic capitalization requirement, the exemption creates a potential for disparity in treatment between "quasi-supplies" and "ordinary" supplies, although this time the stakes are reversed: "Quasi-supplies" potentially receive more favorable treatment because they are exempt from the UNICAP rules, while ordinary supplies are at least theoretically subject to them if they are self-constructed property. Moreover, if a manufacturer produces goods that it treats as supplies under the revenue procedures, and neither the UNICAP regime nor the "full absorption" costing rules for inventory apply, it is not clear what rules do, although any computation of cost is likely to include labor and probably at least some overhead.[174]

A reasonable solution would be to amend the regulations under section 263A to prescribe a simplified set of rules for determining the cost of purchased or manufactured supplies (whether "quasi-supplies" or the genuine article), corresponding to those prescribed in reg. sections 1.471-3 and 1.471-11 for inventory property.

### D. Other Changes to the Cash Method

Finally, the Tax Section comments raise the broader issue of changes to the cash method on the part of taxpayers generally, including those exceeding the procedures' size thresholds but would be eligible to use the cash method because they do not sell merchandise at all.[175] Section 446(e) requires taxpayers to seek consent before changing accounting methods. While it likely would be an abuse of the IRS's discretion to allow a taxpayer to languish indefinitely on an improper method[176] or impose unreasonable conditions on a change from such a method,[177] the IRS's discretion in policing changes from proper methods would appear to be almost unlimited. The taxpayers in *Catto v. United States*[178] claimed that the regulation requiring accrual-method farmers to inventory breeding livestock was invalid. The taxpayers would clearly have been entitled to adopt the cash method from the outset and thus escape application of the regulation entirely. However, having reported on an accrual basis, they had not bothered to seek permission to change to the cash method because the IRS had a policy of refusing to grant permission in such circumstances. After upholding the regulation — meaning the taxpayers' current method of accounting was correct — the Supreme Court then held that even if the taxpayers had submitted proper applications, the IRS was entitled to deny them.[179] Much later, after the Ninth Circuit first decision in *Albertson's, Inc. v. Commissioner*[180] briefly permitted taxpayers to currently deduct interest accruing on deferred compensation, the IRS announced that it would not entertain applications for consent to change to the method approved by the court.[181]

The IRS often seems to frown on changes from accrual to cash accounting. The Tax Section commentators referred to instances in their practice when changes to the cash method had been denied even though the taxpayers could properly have adopted cash accounting in the first place. This is not a new development, as *Catto* itself suggests. Similarly, the court in *Cochran Hatchery, Inc. v. Commissioner*[182] referred to an established policy of refusing to permit farmers with inventories exceeding $75,000 to change to the cash method. Again, in GCM 38852,[183] the IRS National Office endorsed a practice of not permitting banks to change to the cash method, stating that "the Service should be permitted to disregard to disallow any requested change in method when [the] taxpayer is currently on a method that clearly reflects income," and referring to a general policy of refusing consent unless "the new method will result in a clearer reflection of income for federal income tax purposes than [the] present method, and there is a valid non-tax business reason for the request for change." The GCM was later revoked to permit further consideration of when such changes might be permitted, but there is no indication this was due to any revisitation of the IRS's basic approach.

The Tax Section comments urged the IRS to in effect pick up where GCM 38852 left off and publish a general policy governing discretionary changes to the cash method. The IRS has clearly concluded that at least as to some categories of taxpayers, the simplicity offered by the cash method outweighs its potential for distortion of income, and it would seem odd if taxpayers selling some merchandise are to be allowed to automatic changes under the revenue procedure while taxpayers in "pure" service businesses are to be barred from the cash method merely because they used ac-

[173] Tax Section comments, *supra* note 166, Part C.

[174] *Cf. Idaho Power, supra* note 164.

[175] Tax Section comments, *supra* note 166, Part F.

[176] *See, e.g., Diebold, Inc. v. United States,* 16 Cl. Ct. 193, 211-12, *aff'd* 891 F.2d 1579 (Fed. Cir. 1989), *cert. denied* 498 U.S. 823 (1990).

[177] *See, e.g., Security Benefit Life Insurance Co. v. United States,* 517 F. Supp. 740 (D. Kan. 1981), *aff'd on other issues 726 F.2d 1491 (10th Cir. 1984); National Bank of Fort Benning v. Untied States,* 79-2 U.S.T.C. Par. 9627 (M.D. Ga. 1979).

[178] 384 U.S. 102 (1966).

[179] *Id.* at 112-13 & n. 20.

[180] 38 F.3d 1046 (9th Cir. 1994), *94 TNT 3-2, vac'd in relevant part on reh'g* 42 F.3d 537 (9th Cir. 1994), *94 TNT 238-12, cert. denied* 516 U.S. 807 (1995).

[181] Notice 94-38, 1994-1 C.B. 350; *see also* Rev. Proc. 94-28, 1994-1 C.B. 614, excluding taxpayers seeking such a change from an automatic consent procedure.

[182] 39 T.C.M. (CCH) 210, 215 (1979).

[183] May 17, 1982, revoked, GCM 38852 (October 20, 1982).

crual accounting on their first return. A published policy could reassure taxpayers that are at least potentially eligible for relief that their trouble (and user fee) will not be wasted, while, as the commentators pointed out, discouraging applications that the IRS is unlikely to grant.

**E. Outlook**

The IRS is to be commended for a strong effort at addressing a recurring and thorny problem affecting a broad category of taxpayers. While Notice 2001-76 and Rev. Proc. 2002-28 might be criticized as continuing a trend toward "government by revenue procedure" in the tax accounting area, they provide immediate and welcome relief and should substantially diminish the recent flood of litigation. It will be interesting to see what issues arise under the new procedures, as well as how the IRS handles some of the "unfinished business."

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## ACCOUNTING NEWS

**FASB CONSIDERS CONSOLIDATION AND SPE ISSUES.** The Financial Accounting Standards Board met on June 5 to continue its discussions on consolidations and special purpose entities (SPEs).

FASB considered a draft of a proposed interpretation of FAS Statement No. 94, "Consolidation of All Majority-Owned Subsidiaries," and Accounting Research Bulletin No. 51, "Consolidated Financial Statements," which is intended to address issues related to identifying and accounting for SPEs.

The board decided that an administrator of an SPE should disclose the assets and liabilities that the entity manages. The administrator, FASB said, should also disclose the nature and purpose of an SPE that is not consolidated.

FASB determined that substantive operating enterprises are defined as enterprises with significant activities other than those of an SPE, have employees, and are not SPEs. Continuing on that theme, FASB explained that SPEs jointly owned by two or more substantive operating enterprises — and not consolidated by any of them — would not be exempt from the scope of the proposed interpretation. Further, FASB said, there would be no scope exceptions made for lessees and privately held family businesses and for any existing SPEs.

Also, the board determined that a small transfer of risk between participants in a multiparty SPE does not preclude separation of that SPE into separate SPEs for purposes of applying the proposed interpretation.

FASB decided that provisions related to market-based fees relate only to contracts for services. Financial instruments such as guarantees can be variable interests even if the providers are paid market-based fees.

Finally, the proposed interpretation would be effective for all new SPEs on issuance. The proposed interpretation would be effective for periods beginning after March 15, 2003, for SPEs existing before the issuance of the interpretation. The board said that the effect of the proposed interpretation on pre-existing SPEs should be reported as a cumulative effect of a change in accounting principle as of the beginning of the period in which the interpretation is first applied. The board then authorized the FASB staff to draft an exposure draft, which will be posted on the FASB Web site.

Turning to financial instruments, FASB considered whether to change the order of redeliberations in the liabilities and equity project. The board decided to immediately address issues related to amending the definition of liabilities in FAS Statement No. 6, "Elements of Financial Statements." FASB will later address issues related to the separation of compound financial instruments.

— David L. Lupi-Sher