

Chapter 1

Introduction to Accounting Methods

Primary Authority (read where referenced in this chapter)

- IRC §§ 446, 448, 471
- Regs. §§ 1.446-1, 1.448-1T, 1.471-1, 1.1502-17

Learning Objectives – This lesson will enable you to be able to answer these questions:

- What is the significance of accounting methods to taxpayers and tax practitioners? Why are these rules needed for the income tax? Are they also needed for other types of taxes?
- What is an accounting method for tax purposes?
- What choices of methods do taxpayers have?
- What is inventory?
- How is an accounting method adopted by a taxpayer?
- What is the significance of §448 that prohibits specified taxpayers from using the cash or hybrid method and what are the basics of how this rule operates?

Typical taxpayer questions that arise regarding the material covered in this chapter:

- What overall method of accounting may (or must) a new taxpayer adopt on its first tax return? Must it use the same methods for tax as are used for financial reporting or book purposes?
- Who is allowed to use the cash method?
- How do you know if a taxpayer is using a proper method of accounting?
- Can a taxpayer have more than one method of accounting?
- What should be done if a taxpayer is using an improper method of accounting or not the most optimal method available to it?
- If companies merge or there is an acquisition, what accounting method does the combined entity use?
- Can a taxpayer change a method of accounting?

Introduction to Tax Accounting Methods

Importance of Method of Accounting Questions Arise in Tax Practice

- Accounting methods provide a set of rules necessary to enable taxpayers to calculate gross income, cost of goods sold, deductions and thus, taxable income. That is, it enables taxpayers to file a correct return. (§1.446-1(a)(1) & (4))
- Accounting method questions often arise in IRS Examinations - overall methods of accounting and methods of accounting for specific items, such as inventory, are common audit areas. In addition, the IRS has identified various accounting method and period issues in specific industries through its Industry Specialization Program (ISP) within the Coordinated Examination Program, and its Market Segment Specialization Program (MSSP). [Some of these issues will be covered in appropriate chapters of this Reader. The full text of many of these papers are available at the IRS Internet site; there is a link at the 223F Reading website too.]
- The subject of accounting methods is also important in deciding what methods of accounting are available to a new taxpayer or new business and how to make the selections. This is an important decision because the taxpayer will need IRS consent to change any method later. Factors relevant in selecting a method:
 - What methods are required? What choices does the taxpayer have?
 - Cost considerations - calculation of book/tax differences, cost to change if method initially adopted not desired later, possibility that IRS will not consent to later change, costs to correct erroneous method voluntarily or by IRS upon audit (interest + possibly penalties).
- Is a "method" involved in a particular practice of the taxpayer?
 - §381 and §1.1502-17 refer to "methods"
 - A change in "method" requires IRS consent and involves §481.
 - If it isn't a "method" and IRS determines that items were treated incorrectly, the IRS may generally only correct years that are still open under the statute of limitations. If it is an incorrect method and it is changed by the IRS, tax effect back to 1954 may be corrected, while if change initiated by taxpayer, all years effecting change are considered (§1.481-3). See *Graff Chevrolet* case discussed later in this chapter.
 - Rev. Rul. 90-38 (1990-1 C.B. 57) - if treatment of items is done correctly, such treatment on just one tax return establishes a method that can only be changed with IRS consent. If the treatment is erroneous, its use in two or more tax returns establishes a method which can only be changed with IRS consent. [Rev. Rul. 90-38 is included at the end of this chapter; read it when you get to it as doing so will be a good review of the material in this chapter.]
 - It is important to be able to distinguish between:
 1. A *change in underlying facts* which would allow the taxpayer to adopt a new method. Here is an example from Reg. §1.446-1(e)(2)(iii) Example 3:

“A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now

arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.”

2. A *change in method* which can only be accomplished by following the procedures for a change in method of accounting (covered in Chapter 4). Here is an example of a change in method from Reg. §1.446-1(e)(2)(iii) Example 1:

“Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.”

3. *Correction of an error* which can be done via an amended return. An example of an error is accidentally reporting depreciation expense on a particular machine as \$1,200 rather than as \$2,100 (a posting error).

What is a method of accounting?

There is no specific definition of "method of accounting" in the Code or regulations. In Rev. Proc. 97-27, as modified, the IRS provided the following definition:

- (1) Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. In determining whether a practice involves the proper time for the inclusion of an item in income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer's lifetime. If the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, it involves timing and is therefore considered a method of accounting. See Rev. Proc 91-31, 1991-1 C.B. 566.
- (2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment.

Method of accounting rules address the **WHEN** questions about computing taxable income, rather than the **WHETHER** questions. For example, if a landlord receives two years of prepaid rent today, **WHEN** must it report it in income? This is an accounting method question. On the other hand, a question as to whether or not a particular expenditure is deductible is a **WHETHER** question and does not involve a method of accounting (it involves other tax rules).

Question 1: You have discovered that your new client Raptor Corporation has been deducting 100% of its meals and entertainment expenses, rather than only 50%. How do you fix this - request permission from the IRS to change its erroneous method of accounting, or file amended returns because this is an error? Explain.

Question for self study:

Suppose an individual normally pays his 4th quarter estimated state income tax payment in December, but this year, decided to pay it the following January instead. Is that a change in method? After all, in the past, the 4th quarter payment was deducted in the tax year it pertained to and this year it will be deducted in the subsequent year (sounds like timing doesn't it?). What do you think?

Answer: A change in the "normal" payment date for an item is *not* a method change. This was addressed in *Avon Products, Inc. and U.S. Subsidiaries, v. U.S.*, 97 F.3d 1435; 96-2 USTC ¶50,525; 78 AFTR2d 6682; (Fed. Cir. 1996). Avon, an accrual method, calendar year taxpayer had a profit sharing plan in its Mexican subsidiary that required payment within five months of year end. To maximize a foreign tax credit, taxpayer wanted to deduct profit payments for 1980 and 1981 in 1981. To do so, it delayed payment of 1980 payment until 3/26/81 (more than 2 1/2 months of year end). It made the 1981 payment prior to 3/15/82. The IRS challenged the 1980 payment saying that it should have been deducted in 1980 - the year the obligation accrued and the year the obligation legally accrued under Mexican law. The IRS argued that the payment did not fall under §404. Alternatively, it argued that even if §404 applied, the payment was made within a reasonable time after year end. Its final argument was that Avon's treatment of the 1980 payment was an impermissible change in accounting method.

The Court concluded that §404 was broad enough to include the profit plan payment. "According to the House committee report, section 404(b) was intended to "make it clear that if there is any arrangement deferring payment of compensation for services rendered by one or more employees," section 404 would govern the deductibility of the employer's payments. H.R. Rep. No. 83-1337, at A152 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4290." Also, "the government has long regarded a bonus or salary payment that is not made shortly after the end of the year in which it was earned to be a form of deferred compensation that is subject to the deduction-timing rules of section 404, i.e., a form of compensation that is deductible in the year of payment and not in the year of accrual." With respect to the reasonable time argument, the Court remanded the case in order to gather more facts. With respect to the IRS' final argument, the Court held that there had been no change in method. Avon continued to use the accrual method and a change in payment date just caused the accrual method to lead to a different result. "Taxpayers make such choices all the time without those choices being subject to nullification on the theory that they reflect a change in accounting method. For example, a cash-basis taxpayer may postpone a payment normally made on December 31 until January 1 of the next year in

order to shift the deduction for that payment into the next taxable year. That decision would not be subject to challenge as a change in taxpayer's method of accounting."

Question 2: Accounting method rules deal with timing. Are they only relevant for an income tax or might such rules also be relevant for other types of taxes, such as a sales tax or property taxes? Explain.

General Rules on Methods of Accounting

Read §446.

Skim the regulation sections noted in the reading that follows.

Per §446(a), taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Comment: What if the taxpayer's book method is to report income when they remember to do so - would the IRS also allow this for tax purposes? What if the taxpayer is not publicly-traded and has no need for GAAP financial statements or for following SEC reporting rules? Would a non-GAAP method be okay with the IRS? Section 446(a) contains somewhat of a misleading statement, because you will soon find out in your study of tax accounting that even GAAP rules are not necessarily always allowed in computing taxable income. This is discussed in the frequently cited case, *Thor Power Tool* (USSC 1979) (Chapter 5).

- IRS is generally allowed to exercise broad discretion in the accounting method area:

IRC §446(b) provides that if no method of accounting has been used regularly by the taxpayer, or if the method used does not clearly reflect income, taxable income is to be computed under a method which in the opinion of the IRS does clearly reflect income. The regulations at §1.446-1(a)(2) state this in broader terms - "no method of accounting is acceptable *unless*, in the opinion of the Commissioner, it clearly reflects income" (emphasis added).

Comment: It is this subsection that gives the IRS such broad authority in the tax accounting methods area. However, the IRS does not unlimited discretion to say that a taxpayer's method does not clearly reflect income, particularly when the method is correct under the statute and case law (more on this later).

How much authority does the IRS have? In *Mulholland v. U.S.* (93-1 USTC ¶50,286, 71 AFTR2d 1916 (Fed. Cls.), aff'd. 72 AFTR2d 1693 (Fed. Cir. 1994)), the lower court explained that the IRS does

not have sole discretion to determine if a taxpayer's method of accounting clearly reflects income. Instead, the court can review the IRS' determination. Here is an excerpt from this case:

"the court recognizes that the Commissioner has "broad discretion to modify a taxpayer's accounting method to insure a clear reflection of income" in his opinion, ... and that said discretion should be upheld unless "clearly unlawful or plainly arbitrary," *Thor Power Tool*, 439 U.S. at 532-33. This discretion, however, may not be exercised according to §446(b) unless the taxpayer's reported method of accounting does not clearly reflect income, which is subject to this court's *de novo* review. Obviously then, the threshold issue before this court becomes - whether the taxpayer's income is clearly reflected by his selected method of accounting. for if it is not, then according to §446(b) there is no abuse of discretion where taxable income is recomputed under a method of accounting as *in the opinion of the Secretary*, does clearly reflect income." ...

"In reviewing this explicit grant of authority, it is patently clear from the statute, therefore, that Congress has, in his instance, only given the Commissioner wide latitude in determining *which corrective method* of accounting he deems appropriate *to clearly reflect the taxpayer's income*, after a finding that the taxpayer's selected method does not do so. In this circumstance, it is not within the court's discretion to second guess the Commissioner and substitute its own determination as to what method is the most appropriate to clearly reflect, *i.e., correct*, the taxpayer's income."

Additional examples of the discretion the IRS has in the accounting method change area:

- Rev. Proc. 97-27, §8.01 - IRS reserves the right to decline to process a Form 3115 if "it would not be in the best interest of sound tax administration to permit the requested change. In this regard the Service will consider whether the change in method of accounting would clearly and directly frustrate compliance efforts of the Service in administering the income tax laws." (Form 3115 is used when a taxpayer wants to change its method of accounting.)
- TAM 9253004 (10/7/92) - "As stated in *Capital Federal Savings & Loan v. Commissioner*, 92 T.C. 204, 224 (1991) even if an application is otherwise eligible for consideration, Rev. Proc. 80-51 makes clear that a taxpayer is not automatically entitled to receive consent to change a method of accounting, or even to have a request for change considered. Further, the Commissioner has a legitimate interest in ensuring that, where a taxpayer is under examination, the District Director's efforts are not compromised or defeated by the action of another department within the Internal Revenue Service."

Note: Despite the fact that IRC §446 seems to say that a taxpayer may use whatever method of accounting clearly reflects its income, IRC §448, added by the Tax Reform Act of 1986, requires certain taxpayers to use the accrual method of accounting regardless of what method clearly reflects their income.

Features of Methods of Accounting

- 1) Involves the **timing** of an item of income or deduction.
 - This is an important point when trying to distinguish changes in method of accounting (requiring IRS consent in order to change) versus correction of errors (no IRS consent required and statute of limitations is relevant).
 - §1.446-1(e)(2)(ii)(b)

2) Involves **consistent application** of how an item is treated (a "method").

§1.446-1(a)(2) §1.446-1(c)(2)(ii)
§1.446-1(e)(2)(ii)(a) Rev. Rul. 90-38

Rev. Proc. 97-27, §2.01(2) - "a method of accounting is not adopted in most instances without consistent treatment."

Drazen (34 T.C. 1070 (1960)) - "Minor deviations and errors in the treatment of certain items which do not play a large role in the computation of taxable income are not sufficient to refute the Commissioner's determination that the cash method does clearly reflect income.... Consistency is the key and is required, regardless of the method or system of accounting used or thought by the parties to be more helpful taxwise."

3) Involves accounting for **material items**.

§1.446-1(e)(2)(ii)(a) - item is material if involves proper time for inclusion of the item in income or taking of a deduction

4) **Book conformity** - use method with which taxpayer regularly computes his income in keeping his books.

§446(a)
§1.446-1(a)(1) & (2)

- There is no requirement to use book method identically for tax, in fact, often a taxpayer may not use the book method even if it is based on GAAP. For example, for tax purposes, bad debts may not be expensed until the debt is uncollectible while the matching and conservatism principle of GAAP requires an estimate be reported on the income statement for bad debt expense.
- As a condition for obtaining permission to change its accounting method, the IRS may require a taxpayer to do certain things such as to use same method for books.
 §1.446-1(e)(3)(ii)
 - However, in recent years, the IRS has not been as strict with this position.
- What are the "books"?¹
 - §1.446-1(a)(4)

 - Generally, "books" are the regular books of account and other records and data such as reconciliation schedules.
- Per §6001, a taxpayer is required to maintain accounting records in order to file correct return.
 (§1.446-1(a)(4))
- If the taxpayer's only source of income is wages, the taxpayer need not keep formal books in order to have an accounting method. (§1.446-1(b)(2))

¹ See *St. Luke's Hospital, Inc.*, 35 T.C. 236 (1960), acq. 1991-1 C.B. 1; and *Geometric Stamping Co.*, 26 T.C. 301 (1956), acq. in result, 1958-2 C.B. 5.

Question 3 – An engineering consulting firm formed in 1992 operates as a partnership and uses the cash method of accounting for both book and tax purposes. In 2008, the firm’s accountant installed a better accounting system that put the firm on the accrual method of accounting. For 2008, what method should the firm use for its tax return – cash or accrual?² Explain. If your answer is cash, does that treatment violate the book-tax conformity requirement that is implied at §1.446-1(a)? Explain.

More background on book conformity:

- In *St. Lukes Hospital, Inc. v. Comm’r.*, 35 TC 236 (1960), the taxpayer had obtained IRS consent to change from the accrual method to the cash method. However, it continued to keep its books on the accrual method and use adjustments to convert that book income to cash method for tax purposes. The IRS challenged such treatment as not meeting the conformity requirement of §446. The Tax Court allowed the hospital to use the cash basis on its tax returns as it had proven that its books sufficiently reflected cash basis income, despite the fact that adjusting entries were needed to convert accrual basis books to the cash basis tax return. The IRS issued a nonacq at 1963-2 CB 6, but later reversed that nonacq in AOD 1991-07; acq. 1991-1 CB 1.

In AOD 1991-007 where the IRS reversed its earlier non-acquiescence to the case, the IRS stated:

“No deviation from strict book-tax conformity is specifically sanctioned by the Code or regulations. However, case law permits taxpayers to use reconciling entries, which include accountant's work papers, to convert a taxpayer's books to the method of accounting used for tax purposes under I.R.C. section 446(a). *Patchen v. Commissioner*, 27 T.C. 592 (1956), aff'd in part and rev'd in part, 258 F.2d 544 (5th Cir. 1958); *Hi-Plains Enterprises, Inc. v. Commissioner*, 60 T.C. 158 (1973). Administrative pronouncements by the Service also support this position. Rev. Rul. 68-35, 1968-1 C.B. 190; Rev. Rul. 68-83, 1968-1 C.B. 190. In addition, the legislative history to section 448 reflects an interpretation of the conformity requirement as permitting the use of reconciling entries.

In the instant case, the accuracy and reliability of the adjusting entries was sufficient to satisfy the book-tax conformity requirements of section 446(a). Additionally, the cash method clearly reflected income so that section 446(b) was not violated.”

² *Patchen et al v. Comm’r.*, 58-2 USTC ¶9733, 2 AFTR2d 5433 (5th Cir.).

- In PLR 9103001 (similar to PLR 9113003), the IRS noted that courts have generally not required a strict book-tax conformity for accounting methods. The IRS also referred to the legislative history of §448:
 - "The legislative history of section 448 recognizes the use of reconciling entries to satisfy the section 446(a) conformity requirement. H.R. Rep. No. 496, 99th Cong., 1st Sess., at 604 (1985) states: Under present law, a taxpayer generally may elect (on its first income tax return) to use any method of accounting that clearly reflects income and that is regularly used in keeping the taxpayer's books and records (sec. 446). The latter requirement is considered satisfied even if the tax accounting method differs from that used by the taxpayer in keeping its books and records so long as sufficient records are maintained to allow reconciliation of the results obtained under the two methods.

"Based on the above, if we were to conclude that section 446(a) of the Code requires a strict book-tax conformity, the only taxpayers section 448 would require to use the accrual method, who weren't already required to use the accrual method under section 446(a), would be those taxpayers who are not required to comply with GAAP. We do not believe that the intent of Congress in enacting section 448 was that it would apply only to this limited universe of taxpayers.

"Although the use of reconciling entries may be used to satisfy the conformity requirement under section 446(a), whether the entries used by a particular taxpayer do so is a question of fact. Accordingly, the accuracy and reliability of the adjusting entries is an important factor in determining whether the book-tax conformity requirement of section 446(a) has been satisfied."

5) Taxpayer should adopt method which best suits his needs. No uniform system can be prescribed for all taxpayers. BUT – the method is only acceptable if it clearly reflects income in the opinion of the IRS. (§1.446-1(a)(2))

- *Huntington Securities*, 40-2 USTC ¶9508 (6th Cir.):
Issue - valuation of inventory of securities. "The selection of a system of accounting is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income and whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change."
- **NOTE:** The accrual method is required for certain taxpayers either under §448 or because inventories are a material income-producing factor.

6) Method must "**clearly reflect income**" per Commissioner's opinion in order to be an acceptable method. (§446(b), §1.446-1(a)(2), §1.446-1(c)(2)(ii))

- Generally, consistent application of GAAP for that type of business is expected, but compliance with GAAP does not necessarily mean a method clearly reflects income for tax purposes. (*Thor Power Tool*)
- What about the concept of materiality? "[W]e accept the fact that the petitioner's method of accounting fairly reflected the results of its operations for commercial accounting purposes, we do not think its departure from applicable generally accepted accounting principles and tax regulations can be justified for tax purposes on the argument that the errors were not material. [The accounting doctrine of materiality] finds broad application in commercial accounting, but we do not think it may appropriately be extended to the law of taxation in cases in which the taxpayer's method of accounting is clearly erroneous." *All-Steel Equipment Inc.*, 54 T.C. 1749, 1755 (1970)

- Income and expense need not match:

Drazen - "While it is theoretically desirable to match expenses with income earned in incurring those expense, it must be remembered that exact and precise matching is seldom, if ever, achieved with either method of accounting."

Example: Per §1.61-8, prepaid rent must be reported when received, even though the related expenses will not be deducted until later when incurred.

- Clear reflection of income is primarily a question of fact
 - *Applied Communications, Inc.* TC Memo 1989-469
 - to be determined on a case-by-case basis (*Ford Motor Co.*, 102 TC 87 (1994), aff'd, 95-2 USTC ¶50,643, 76 AFTR2d 7789 (6th Cir.), pet. reh. denied 1996 U.S. App. LEXIS 2332 (2/13/96))
- Per *Fort Howard Paper Co. v. Comm'r.*, 49 T.C. 275 (1967), "several broad theses" are pertinent to determine whether a taxpayer's method of accounting "clearly reflects income" per §446:
 - "Income must be reflected with as much accuracy as recognized methods of accounting permit."
 - "[IRS] is given broad discretion in determining whether a particular method of accounting clearly reflects income and a heavy burden is imposed upon the taxpayer to overcome a determination by respondent in this area."
 - "Even though a particular method may be in accordance with generally accepted accounting principles, it may not so clearly reflect income as to be binding upon the Commissioner."
 - [M]ere failure of the Commissioner previously to object to the taxpayer's accounting method will not stop him from later challenging it."
 - [C]onsistency of application is an important consideration and may be entitled to considerable weight. ... But consistency standing alone is not sufficient to satisfy the taxpayer's burden. ...Indeed, it will be disregarded where an erroneous method of accounting has been used."
 - The above theses must be applied "in light of the particular facts and circumstances of each case with reference to the particular business involved, the particular method employed, and the specific item at issue."
- IRS is likely to look for "substantial identity of results" where IRS says taxpayer's method does not clearly reflect income and taxpayer argues that the same result is reached under both methods. See *Wilkinson-Beane* case later under inventory on the strictness of the identity of results argument.
 - In *Ansley-Sheppard-Burgess Co. v. Comm'r.*, 104 T.C. 367 (1995), the Tax Court stated that the "substantial identity of results test was not applicable where the taxpayer was not required to maintain an inventory.
- Industry practice may be considered
 - §1.446-1(a)(2)
 - *American Fletcher* (summarized below)
- Regulatory agency required method may be considered in determining if a method clearly reflects the taxpayer's income.
 - *Comm'r. v. Idaho Power Co.* (USSC 1974) - "where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency and that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences."
- The method should be correctly applied

- Estimates are not appropriate
 - *American Fletcher* (summarized below)
- "Clearly" means "'accurately,' not just 'fairly and honestly.'" *Asphalt Prod. Co. v. Comm'r.*, 86-2 USTC ¶9556, 58 AFTR2d 5453 (6th Cir.), quoting *Caldwell v. Comm'r.*, 202 F.2d 112, 114-15 (2d Cir. 1953). Also, per *Huntington Securities Corp. v. Busey, Collector of Internal Revenue*, 40-2 USTC ¶9508 (6th Cir.), "clearly" does not necessarily mean "accurately."

American Fletcher Corp. v. U.S. (87-2 USTC ¶9603, 60 AFTR2d 5897 (7th Cir.))

Rule: Many factors may be applied by the IRS to determine if a taxpayer's method of accounting clearly reflects its income and is thus permissible. The weighting of the factors will vary from case to case. Relevant factors include, 1) which method would be permissible under GAAP and industry standards; 2) whether estimates were used; and 3) whether the results derived by the taxpayer's and IRS desired methods were substantially the same.

Facts: American Fletcher's subsidiary, SCS, was a credit card charge account service. In 1973 and 1974, SCS used the accrual method for books, but the cash method for tax purposes. Some use of estimates was involved in converting the books to cash basis. In 1973, the accrual basis loss was \$300,000, but a \$1,700,000 loss for tax purposes. In 1974, the tax loss was over \$200,000 greater than the book loss. During its audit, the IRS held that the cash method did not clearly reflect SCS' income and converted it to the accrual basis. The District Court held that the IRS had not abused its discretion in making the change.

The IRS set forth the following reasons as to why it converted the taxpayer from the cash to the accrual method:

- 1) the accrual method was consistent with GAAP, as used in its financial statements;
- 2) both the Federal Reserve Board and SEC required the use of the accrual method in financial statements;
- 3) prior to the acquisition of SCS by American Fletcher, SCS used the accrual method for both book and tax purposes;
- 4) an affiliate of American Fletcher operated a Master Charge credit card service and used the accrual method for tax;
- 5) after American Fletcher acquired SCS, SCS used the accrual method for every purpose other than its tax return;
- 6) the estimates used by SCS resulted in only "estimates" of its cash basis income; and
- 7) the IRS found that the cash method of accounting was particularly inappropriate because of the impact Christmas shopping had on the credit card business.

The District Court relied mainly on three grounds to conclude that SCS should use the accrual method. They were:

- 1) the cash method did not conform with GAAP;
- 2) the taxpayer impermissibly relied on estimates; and
- 3) the cash method produced results that were not "substantially identical" under its method and the method required by the IRS.

Issue: Did the IRS abuse its discretion in converting the taxpayer from the cash basis to the accrual basis?

Law: IRC §446(b) states that if the method of accounting used by the taxpayer "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." However, as the Supreme Court noted in *Thor Power Tool Co. v. Comm'r.* (1979), the IRS' interpretation of this rule is not to "be interfered with unless clearly unlawful."

Analysis: The Seventh Circuit agreed with the District Court that the three factors it relied on to determine that the IRS was correct were relevant. However, they noted that none of the three grounds would be enough if each were relied upon alone. The weight to be given the factors will vary in each taxpayer situation. The Court held that other factors were also relevant and that the three along with the IRS' list, were sufficient to find that the IRS had not abused its discretion under §446(b).

The following comments were made by the Circuit Court:

- GAAP - Reg. §1.446-1(a)(2) provides that the "method of accounting which reflects the consistent application of generally accepted accounting principles ... will ordinarily be regarded as clearly reflecting income." Thus, GAAP is a criterion used to determine if a method clearly reflects income. Standing alone, this criterion would dismiss use of the cash method. However, the District Court found that use of the cash method in the credit card industry was almost unheard of.
- Use of estimates - there is not statutory authority to determine taxable income using estimates. Again, standing alone, this fact would not prohibit use of the cash method, but it is allowable for the IRS to take this into consideration in applying §446(b).
- Substantial Identity of Results - in *Wilkinson-Beane, Inc. v. Comm'r.* (1st Cir., 1970), the Court held that "the taxpayer must demonstrate the substantial identity of results between his method and the method selected by the Commissioner."

Conclusion: The IRS did not abuse its discretion in finding that the cash method did not clearly reflect the taxpayer's taxable income.

- The IRS "cannot resort to [its] §446 authority to require a change in accounting method just because [it] disagrees with a taxpayer's choice of method." *Asphalt Prods. Co. v. Comm'r.*, 86-2 USTC ¶9556, 58 AFTR2d 5453 (6th Cir.).
- "Though the temporary increase in inventory in the present case was not significant, the large increase in accounts receivable created a situation where only the use of the accrual method of accounting would avoid a serious distortion. Under these circumstances, the Commissioner's finding that the cash method no longer clearly reflected the taxpayer's income was fully supported by the record and the requirement that the taxpayer adopt the accrual method for 1974 and subsequent years was not an abuse of discretion." *Asphalt Products Co. v. Comm'r., supra.*
- *Hallmark Cards v. Comm'r.*, 90 T.C. 26 (1988) - "[IRS'] broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis."
- *Ford Motor Co.*, 102 TC 87 (1994), aff'd. 95-2 USTC ¶50,643, 76 AFTR2d 7789 (6th Cir.) - Tax Court disagreed with taxpayer position that expenses that met the all events test of §461 could not be disallowed under §446(b). Court looked at language of §446, noting that §446(c) on "permissible methods" states, "*Subject to the provisions of subsections (a) and (b)*, a taxpayer may compute taxable income under any of the following methods..." [emphasis added by Court]. Thus, a deduction, even though allowable under the cash or accrual method, may be postponed if the IRS does not view that treatment as clearly reflecting income. (In the *Ford* case, which years predate the economic performance rules of §461(h), Ford deducted \$24,477,699 of tort liability even though its outlay for the year at issue was \$4,424,587 to purchase annuity contracts to fund the structured settlements for the tort claims. The Tax Court helped to illustrate the "distortion" such a deduction creates by providing examples showing that a taxpayer in Ford's situation was better off taxwise than a taxpayer with the same income, but no tort payments - an "incongruous result" (102 T.C. 94).)

6th Circuit: "Our holding in the instant case is not intended to draw a bright line that can be applied mechanically in other circumstances. We decide only the ultimate question of fact in the instant case; namely, whether, for tax purposes, petitioner's method of accounting for its obligations under the structured settlements clearly reflects income. We hold that it does not and that the Government did not abuse its discretion in making that determination. ... We find the tax court's language sufficient to limit its holding to extreme cases such as this one in which the economic results are grossly different from the tax results and therefore conclude that the tax court's decision does not allow the Commissioner arbitrary or unprincipled discretion."

- Does change in book method require change in tax method?
 - Not necessarily per *Patchen* (see Question #3 earlier) and Rev. Rul. 74-383
 - Rev. Rul. 74-383, 1974-2 C.B. 146: "A cash method State savings and loan association that is required to convert to an accrual method for book and financial statement purposes for the State may continue to file its Federal income tax returns on the cash receipts and disbursements method; however, its permanent books and records must clearly reflect a proper reconciliation between the two methods used."

Question 4 – ABC Management Company is an S corporation that manages rental homes. It uses the cash method of accounting. Sometimes, to “manage” its taxable income, it postpones sending out bills for December until January. Is ABC at risk of having the IRS change its method to the accrual method if ABC were audited? Explain.

7) Gross income and expenses need not be in the form of cash - just need to be capable of being valued in terms of money (§1.446-1(a)(3))

8) “Method” involves both overall method of accounting and accounting treatment of any item (§1.446-1(a)(1))

9) Permissible Overall Methods (§446(c) & 1.446-1(c))

a) The cash receipts and disbursements method (§1.446-1(c)(i))
§448 - certain taxpayers may not use cash method

b) An accrual method (§1.446-1(c)(ii))

§1.446-1(c)(2)(i) - if necessary to use an inventory, the accrual method must be used with regard to purchases and sales. However the IRS has provided some exceptions which are discussed later in the course.

- *Ford Motor Co.*, 102 T.C. 87, 99, fn. 11 - the Court stressed the "an" at §446(c)(2) "an accrual method." The Court stated (fn. 11):

The use of the word "an" in sec. 446(c)(2) suggests that more than one accrual method of accounting is permissible under sec. 446(c). Accordingly, although "an" accrual method of accounting is authorized generally by sec. 446(c), no particular method of accrual accounting is specifically authorized with respect to structured settlements. In this manner, it can be said that respondent [IRS] has not denied petitioner the use of a specifically authorized accounting method.

c) Any other method permitted by Chapter 1 of the IRC, such as (§1.446-1(c)(iii)):

Cash method - §61 & 162

Installment method - §453

Corporations engaged in farming - §447

d) Any combination of the above methods per IRS regulations (hybrid) (§1.446-1(c)(iv))

- is permitted if the combination clearly reflects income and is consistently used
- taxpayer using accrual method with respect to purchases and sales may use cash method in computing all other items of income and expense (unless §448 prohibits that type of entity from using the cash or hybrid method)
- if use cash method for income, must use cash method for expenses
- if use accrual method for expenses, must also use it for income reporting
- *Wilkinson-Beane, Inc.*, TC Memo 1969-79 – the lower court noted that its conclusion that the caskets were inventories did not consider the hybrid method. "It must be remembered that our analysis of the above regulations and cases is in the context of the cash or accrual bases of accounting. We are not faced with a hybrid method." Query - was the court implying that the taxpayer might have been able to use a hybrid method (where accrual was used for the purchase and sale of the caskets and the cash method was used for the reporting of the funeral services income and expenses)? (this inventory is discussed in more detail later)

e) Caveats:

- the method selected under §446(c) must still meet the clear reflection of income requirements of §446(a) and (b).
- "we hold that satisfaction of the all events tests for accrual does not necessarily preclude respondent's [IRS] use of section 446(b) to determine that the accrual does not clearly reflect income" *Ford Motor Co. v. Comm'r.*, 102 T.C. 87 (1994); similarly, *Mooney Aircraft*, 420 F.2d 400 (5th Cir. 1969).

10) Examples of Methods for Items (§1.446-1(a)(1)):

Research and experimentation expenditures - §174

Soil and water conservation expenses - §175

Depreciation - §167, 168

NOLs - §172

Receivables of accrual basis service providers - §448(d)(5) & 1.448-2T & Notice 88-51

Long-term contracts - §460

11) Inventory

Read §471.

- In every case in which the production, purchase, or sale of merchandise is an income-producing factor, it is necessary to account for inventories. (§1.471-1, §471, §1.446-1(a)(4)(i), §1.446-1(c)(2)(i))

- If necessary to use an inventory, generally must use accrual method to account for purchases and sales. (§1.446-1(c)(2)(i))
- Rev. Proc. 2001-10, 2001-2 I.R.B. 272, excepts small businesses with average annual gross receipts of \$1 million or less from both the accrual method and inventory accounting. The exception does not apply to a §448(a)(3) tax shelter. Eligible taxpayers using this exception must account for their inventoriable items as non-incidentals supplies under §1.162-3.
- Rev. Proc. 2002-28, allows *qualifying small business taxpayers* with gross receipts of \$10 million or less to use the cash method. This exception does not apply to taxpayers subject to the accrual method under §448 or to taxpayers in specified NAICS codes, such as for manufacturers, retailers and wholesalers. The details of this Rev. Proc. And Rev. Proc. 2001-10 are covered in Chapter 5.

The above guidance on the ability of certain small businesses to use the cash method even though they may have inventory is covered in Chapter 5.

- LIFO guidance - §472 and regulations
- Capitalization of direct and indirect costs - §263A and regulations and notices (covered in Chapter 6)
- Taxpayers need to distinguish inventory from supplies. Often, two possible issues arise in this context:
 - 1) Supplies versus inventory - if the items are "inventory," generally, the taxpayer must use the accrual method of accounting (regardless of its level of gross receipts)
 - 2) Incidental versus non-incidentals supplies (§1.162-3) - if the items are supplies, rather than inventory, the taxpayer must determine whether it is allowed to treat the supplies as deductible when purchased, or only deductible as used.

More background on “what is inventory”?

(This is an introduction, this topic is further discussion in Chapter 5.)

- *Wilkinson-Beane Inc. v. Comm'r.*, 420 F.2d 352, 70-1 USTC ¶9173, 25 AFTR2d 418 (1st Cir.)—Taxpayer operated an undertaking establishment and used the cash method, which the IRS disallowed on the basis that the taxpayer's caskets were inventory, which required use of the accrual method in order to clearly reflect income. The taxpayer's argument that the caskets were not merchandise, but merely incidental supplies necessary in performing its personal services, failed. The court interpreted the term, "merchandise" to mean something held for sale. Because the price of funeral services varied with the cost of the casket, the court held that they were merchandise. The court also held that the caskets were income-producing factors because their cost constituted approximately 15% of the taxpayer's receipts. The court also held that use of the cash method did not clearly reflect the taxpayer's income. The taxpayer produced records that showed that over a 5-year span, the difference in gross income between the cash and accrual methods was \$708.
- *Knight-Ridder Newspapers, Inc. v. U.S.*, 84-2 USTC ¶9827, 54 AFTR2d 84-6120 (11th Cir.) - Court viewed ink and paper as raw materials. "[I]n our case, where the cost of raw materials for the newspapers was 17.6% of total revenues and the actual sales price accounted for 20% of revenues, we hold that the sale of newspapers was a material income-producing factor. We do not believe the newspaper is any less merchandise because it provides information. Books are classic examples of merchandise requiring the use of inventories, yet their primary value likewise inheres in the message they communicate.¹⁷"

¹⁷ We recognize that books may serve other purposes, e.g., filling empty spaces on one's bookshelf and lending a scholarly atmosphere to the den. Newspapers, however, can also serve residuary purposes, e.g., doubling as kindling for a holiday fire."

- *Surtronics, Inc. v. Comm'r.*, TC Memo 1985-277 - purchase and sale of metals by taxpayer in business of electroplating metals was held to be an income-producing factor, whereas taxpayer contended it was in a service business. While the difference in total gross receipts for a 5-year period was only 1.32% less under the cash method than under the accrual method, based on \$18,000,000 of gross receipts over 5 years, the difference was over \$240,000, "a significant distortion."

Question 5 – Jamie operates a shoe shine stand as a sole proprietor. Is the shoe polish inventory or a supply? Explain.

- TAM 9218008 (1/9/92) - The IRS held that a veterinarian's supplies, medication, drugs, and pet foods were income-producing factors and thus inventory. Per §1.446-1(c)(2)(i), the taxpayer would have to use the accrual method to account for the inventory. "TP has represented that during the years under examination, the sale of supplies, medication or drugs, pet foods, and livestock antibiotic food additives averaged over 50 percent of TP's gross receipts. The cost of the items sold by TP as a percentage of gross receipts was in excess of 30 percent for each year in question. The Service's position is that these percentages are more than sufficient to make the sale of these items an income-producing factor within the meaning of sections 1.471-1 and 1.446-1(a)(4)(i) of the regulations. In many other cases, the courts and the Service have required taxpayers that furnish some tangible product in the course of rendering professional services to use inventories pursuant to section 1.471-1 of the regulations. See, e.g., *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984); *Fred H. McGrath & Son, Inc. v. United States*, 549 F. Supp. 491 (S.D.N.Y. 1982) (funeral service and casket provider); Rev. Rul. 74-279, 1974-1 C.B. 110 (optometrist who purchases and maintains a supply of eyeglass frames that are sold in the ordinary course of the taxpayer's business); Rev. Rul. 73-485, 1973-2 C.B. 150 (corporation that fabricates and fits patients with artificial limbs and orthopedic braces in addition to providing various services.)"
- *J.P. Sheahan Associates v. Comm'r.* (63 TCM 2842 (1992)) - The Tax Court held that a corporation in the business of repairing roofs had to use the accrual method of account as its roofing materials were income producing factors, or inventory. The taxpayer listed the materials separately on customer bills and added a 25% markup. The taxpayer had argued that it had no inventory because it only bought supplies as needed for each job, which the Court viewed as irrelevant and it had not inventory on hand at year end. The Court relied on the *Wilkinson-Beane* case.
- *Ansley-Sheppard-Burgess Co. v. Comm'r.*, 104 TC 367 (1995) - taxpayer in the construction business was allowed to continue to use the cash method despite IRS' argument that the accrual method should be used. The Court stated that the "fact that P did not maintain an inventory, consistently used the cash method since its incorporation, and made no attempt to unreasonably prepay expenses or defer the recognition of income" were factors which

"weigh heavily" in support of use of the cash method. Also, P was not subject to the provisions of §448 or §460 due to the nature of its work and the size of its gross receipts. The Court also stated that the "substantial identity of results" test was not applicable to a taxpayer who is not required to maintain an inventory.

- *Thompson Electric Inc. v. Comm'r.*, T.C. Memo 1995-292 - electrical contractor's cost of materials "varied from 37 to 44 percent of its cash basis receipts during the years in issue. These amounts are more than enough to establish that material is a substantial income-producing factor for petitioner. *Knight-Ridder Newspapers v. United States*, 743 F.2d 781, 790 (11th Cir. 1984) (17.6 percent of total cash receipts suggests that supplies are an income-producing factor; *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d at 355; *Fred H. McGrath & Son, Inc. v. United States*, 549 F. Supp. 491, 493 (S.D.N.Y. 1982) (16.7 percent, 15.4 percent, and 14.7 percent suggests that caskets are income-producing factors to a funeral home); cf. *Honeywell, Inc. v. Commissioner, supra* (no inventory where parts represented 11 and 12 percent of revenue)." Court also noted that it does not matter that taxpayer does not mark-up what it sells to customers.
- In *Osteopathic Medical Oncology and Hematology P.C. v. Commissioner*, 113 T.C. 376 (1999),³ a reviewed opinion, the court held that the drugs administered by a medical clinic specializing in chemotherapy and hematology treatments were supplies rather than merchandise. Chemotherapy drugs are pharmaceuticals that may only be prescribed by a doctor and sold by a licensed pharmacist. OM was not a licensed pharmacist and thus, did not (and could not) sell the drugs, but used them only in providing services to patients. OM typically had only a two-week supply of the chemotherapy drugs on hand. OM used the cash method for financial and tax purposes and expensed the drugs as purchased.

Key to the majority's conclusion was that OM did not look like or behave like a typical "merchandiser." That is, OM was prohibited from selling the drugs, it did not display the items as a grocery store would, and the drugs did not play a role in whether or not a customer decided to purchase OM's services. The court did not view OM as "peddling products." Instead, OM was a service business that only provided the drugs to patients as an integral and inseparable part of its services. While OM did separately state the drugs on patient bills, the court noted that this was mostly due to insurance rules. Finally, the majority noted that it was not relevant that the cost of the drugs represented 26% of OM's gross receipts because the "income-producing" factor determination⁴ is not applicable if the drugs are not merchandise under §471.

Dissenting judges noted that health care providers do sell goods. While a physician may recommend the drug, patients decide whether or not to receive the drugs. "Moreover, if those patients decide to receive chemotherapy drugs, they want the drugs and nothing in the record (or in common sense) leads me to believe that the drugs are necessarily subordinate to the physician's services."

- In *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000), another reviewed opinion, the court held that a provider of concrete foundations and walkways did not have to account for inventory or use the accrual method. The majority viewed RACMP as primarily a service provider and under various laws, including the UCC, was treated as operating under contracts for labor, not for the sale of personal property. The liquid concrete used by RACMP was viewed as a supply because it was used up in providing services to customers.

³ Similarly, see *Mid-Del Therapeutic Center Inc.*, T.C. Memo. 2000-130. In April 2000, the Service issued Action on Decision 2000-05 acquiescing, in result only, to the *Osteopathic* case (acq. 2000-23 I.R.B. 1149).

⁴ In *Wilkinson-Beane Inc.*, 420 F.2d 352 (1st Cir.), the court established a rule that "income-producing factor" is measured by a fraction where cost of the merchandise is the numerator and gross receipts is the denominator. In *Wilkinson-Beane*, the fraction was 15%, which the court concluded made the merchandise an income-producing factor. In TAM 9808003, fractions of 3%, 3% and 6% in three consecutive years led the Service to conclude that the merchandise was *not* an income-producing factor.

Also, since liquid concrete can't be stored it cannot be considered as "held for sale."⁵ The majority also viewed the sand and rock used by RACMP as a supply, rather than inventory, noting that such items lost their "separate identity to become an integral and inseparable part of the real property in the construction activity" just as chemotherapy drugs lost their identity separate from that of the patient. Also, customers did not want to buy materials from RACMP, thus RACMP was not a merchant.

Dissenting judges noted that while RACMP was in a service-oriented business, it did produce a product, such as a walkway. They also noted that there is no requirement that materials be held for a certain period of time in order to be considered inventory. They also distinguished the *Osteopathic* case where calling the items a supply was clearer because "no product resulted from the administration of drugs into patient's bodies." Finally, dissenting judges noted that the majority's conclusion would lead to wrong results for other businesses that primarily provided services, such as restaurants and dot.com companies that provide the service of being able to shop at home.

- In *Edward G. Smith v. Comm'r.*, T.C. Memo. 2000-353, the court found that a business that installed flooring materials (carpet, tile, etc.) was not selling merchandise. The taxpayer did purchase and store the materials needed for each job and customers were charged a markup on the cost of the materials. The court noted that this practice was due to the need to manage the project and that the markup was to cover taxpayer's services of storing and inspecting the materials.

Important factors leading to the court's conclusion that Smith was a service provider and not subject to §471 included:

- "The high cost of materials relative to labor costs is insufficient, standing alone, to transform the sale of a service to the sale of merchandise and a service."
- "Smith Floors is inherently a service provider. Smith Floors' stock in trade is its expertise in installing flooring materials in a variety of unique applications and petitioner's skill and craftsmanship in hand-cutting and incorporating specialized designs into flooring materials. The companies contracting with Smith Floors are primarily interested in the firm's labor and contractual skills."
- The taxpayer does not manufacture or sell flooring materials; it only purchases materials as needed for a particular job. "Smith Floors' practice of purchasing the flooring materials for a particular job is incidental and secondary to Smith Floors' provision of flooring installation services."⁶

Question 6 - In light of the *Osteopathic* and *Smith Flooring* cases, do you think that the same conclusion would be reached today in the *Wilkinson-Beane* case? Explain

⁵ The majority also relied on *Galedrige Constr., Inc.*, T.C. Memo. 1997-240, which held that a contractor of asphalt pavements did not have inventory due to the ephemeral nature of emulsified asphalt.

⁶ This is one of the rare cases involving the issue of whether a taxpayer had merchandise that did not mention the *Wilkinson-Beane* case. Thus, there was no discussion as to whether Smith charged more to clients who had more expensive flooring materials.

12) Rules on year of inclusion and deduction (§1.446-1(a)(3)) (Timing rules for income are covered in Chapter 2 and those for deductions in Chapter 3.)

Inclusion – examples of rules:

- §451 & 1.451-1
- cash method - generally, when cash received
- accrual method - all events test
- constructive receipt §1.451-2
- claim of right doctrine - *North American Oil Consolidated v. Burnet* (USSC 1932)
- deposits - *Indianapolis Power & Light* (USSC 1990)
- redemption of trading stamps and coupons §1.451-4
- advance payments for goods and long-term contracts 1.451-5
- advance payments of accrual method service providers - Rev. Proc. 71-21
- crop insurance proceeds election §451(d), 1.451-6
- livestock sold on account of drought §451(e), 1.451-7
- installment method §453
- prepaid subscription income §455
- prepaid dues income of certain membership organizations §456
- deferred compensation plans of state and local governments and tax-exempt organizations §457
- magazines, paperbacks, and records returned after close of tax year §458

Deduction – examples of rules

- §461 and 1.461-1
- cash method - when paid
- accrual method - when all events test and economic performance requirement met
- contested liabilities §1.461-2
- limitations: at-risk (§465) & passive activity (§469)
- certain payments for use of property or services - §467
- mining and solid waste reclamation and closing costs - §468
- nuclear decommissioning costs - §468A
- designated settlement funds - §468B
- payments to related parties - §267(a)(2): related parties must match the timing of when interest and expenses are reported.
 - EX - 100% shareholder loans money to corporation and interest due at maturity in 5 years. Shareholder only reports income when receives it in 5 years, but corporation using accrual method would deduct each year even though not paid. §267 would require corporation to take no deduction until year 5 when related party reports the income.
 - A special rule applies when foreign parties involved.
- deferred compensation arrangements - §404 and regulations and Rev. Rul. 88-68
- depreciation and amortization rules (§1.446-1(a)(4)(iii))
- expensing versus capitalization rules (§263 and regulations)
 - "The object of sections 162 and 263 of the Code, read together, is to match up expenditures with the income they generate." *Encyclopaedia Britannica, Inc. v. Comm'r.*, 82-2 USTC ¶9530, 50 AFTR2d 5547 (7th Cir.)
 - "We are satisfied that, under the circumstances involved herein, section 263 and 446 are inextricably intertwined. A contrary view would encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of Congress nor required for the effective discharge of respondent's revenue-collecting responsibilities." *Fort Howard Paper Co. v. Comm'r.*, 49 TC 275 (1967).

14) If a taxpayer has more than one separate and distinct business, each may use a different method of accounting, provided it clearly reflects income. (§1.446-1(d))

- Businesses are not considered separate and distinct unless there are complete and *separable* sets of books and records kept for each business.
- TAM 9408003 (11/10/93) - the IRS ruled that the sale of food supplements and the provision of services under weight reduction contracts were not separate trades or businesses for purposes of §446(d). Only customers who bought weight reduction contracts were allowed to purchase food supplements. The same personnel were involved in selling food supplements and contracts. Also, the taxpayer's books were such that the net income from each activity could not be computed separately.
- What about an individual wage earner who also has a sole proprietor business (Schedule C) that must use the accrual method? *Hanover v. Comm'r.*, 12 T.C. 342 (1949) - cash basis individual may use different method for business operations.
- If instead of a single taxpayer with more than one line of business, there is a consolidated group of corporations, then Reg. §1.1502-17 is relevant for each of the legal entities. To determine the methods of accounting for members of a consolidated group - determine the method of accounting for each member as if each filed a separate return.

More on §1.446-1(d) – Are businesses separate and distinct? The classic case under §1.446-1(d) is *Peterson Produce Company v. US*, 63-1 USTC ¶9301, 11 AFTR2d 892 (8th Cir.).

Rule: A taxpayer may not use a method of accounting different from its overall method for a division unless it proves that the division is independent and separate and distinct from the other divisions of the taxpayer's business. There must also be a sufficient separation of the books and records and the method must clearly reflect income of that division.

Facts: Taxpayer was engaged in the feed and hatchery business. It sold chicks, feed and other poultry supplies to growers and was involved in the raising and selling of chickens through financing arrangements with the growers who bought feed from the taxpayer. Taxpayer also had a separately incorporated breeding farm operation, which used the cash method of accounting for tax purposes. Taxpayer later established a broiler division by hiring growers to raise broilers for the taxpayer. The taxpayer was considered the owner of the chickens, not the growers, unlike their earlier financing arrangements with the growers. Taxpayer's overall method of accounting was the accrual method, but the income from the broiler division was reported on the cash method. This allowed the broiler division to deduct the costs spend in processing unsold chickens at year end. A single general ledger was used, but it was possible to separate the broiler division accounts. Taxpayer had a single bank account for all three divisions. In addition, administrative costs were distributed pro rata among the three divisions. Taxpayer reported an NOL in 1956 and carried it back. The IRS disallowed the loss arguing that the taxpayer was not entitled to use the cash method of accounting without obtaining IRS permission because the broiler division did not constitute a new, distinct and separate business which could use a different method of accounting from the taxpayer's other divisions.

The District Court held that addition of the broiler division did not cause a significant change in the taxpayer's overall operations and that all three departments were too interdependent and integrated to be considered separate and distinct. Also, they found that there was no sufficient separation of the books and records and that the taxpayer's method did not clearly reflect its income.

Law: None was specifically cited in this case as the 8th Circuit relied on the fact finding and holding of the District Court.

Analysis: The 8th Circuit found that the District Court's findings were

"well supported and manifestly correct." In addition, the Circuit Court stated that the broiler division was more closely related to the feed and hatchery departments rather than the cash-basis breeding farm.

Conclusion: The 8th Circuit affirmed the District Court that the taxpayer could not use the cash method for its broiler division and the accrual method for its other two divisions because the divisions were not separate and distinct businesses and separate records were not kept.

Question 7 – Century Corporation is a calendar year C corporation. It manufactures widgets and it also operates a freight loading operation. Occasionally, widgets are shipped using Century's freight loading services, but typically not. Are Century's manufacturing and freight operations separate trades or businesses per §446(d)? Explain.

- Potential concerns with respect to the use of different entities to ensure the use of different methods of accounting for different lines of businesses:
 1. Could §269, *Acquisitions made to evade or avoid income tax*, apply to disallow a new subsidiary's method of accounting? Maybe; see the *Rocco* case summarized below.
 2. Could new lines of businesses be set up in new or existing subsidiaries to allow for a method of accounting different from that of the parent corporation? Possibly. For example, Peterson Produce may have been able to form new subsidiaries for its new businesses and used the cash method per §1.1502-17. However, the IRS is aware of the potential for abuse in this area and in 1995, issued final regulations⁷ that may limit the use of new subsidiaries as a technique for using a method of accounting different from that used by the parent corporation.

§1.1502-17 (b) and (c) and new examples at §1.1502-17(d) provide:

(b) ADJUSTMENTS REQUIRED IF METHOD OF ACCOUNTING CHANGES -- (1) GENERAL RULE. If a member of a group changes its method of accounting for a consolidated return year, the terms and conditions prescribed by the Commissioner under section 446(e), including section 481(a) where applicable, shall apply to the member. If the requirements of section 481(b) are met because applicable adjustments under section 481(a) are substantial, the increase in tax for any prior year shall be computed upon the basis of a consolidated return or a separate return, whichever was filed for such prior year.

(2) CHANGES IN METHOD OF ACCOUNTING FOR INTERCOMPANY TRANSACTIONS. If a member changes its method of accounting for intercompany transactions for a consolidated return year, the change in method generally will be effected on a cut-off basis.

⁷ T.D. 8597, 60 FR 36671-36710, 7/18/95) replacing proposed regulations at CO-11-91, 4/15/94, 59 FR 18011, dealing with "the intercompany transaction system of the consolidated return regulations to more clearly reflect consolidated taxable income."

(c) ANTI-AVOIDANCE RULES -- (1) GENERAL RULE. If one member (B) directly or indirectly acquires an activity of another member (S), or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without securing consent from the Commissioner) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired or undertaken activity determined under paragraph (c)(2) of this section or must secure consent from the Commissioner under applicable administrative procedures to use a different method.

(2) TREATMENT AS DIVISIONS OF A SINGLE CORPORATION. B must use the method of accounting that would be required if B acquired the activity from S in a transaction to which section 381 applied. Thus, the principles of section 381(c)(4) and (c)(5) apply to resolve any conflicts between the accounting methods of S and B, and the acquired or undertaken activity is treated as having the accounting method used by S. Appropriate adjustments are made to treat all acquisitions or undertakings that are part of the same plan or arrangement as a single acquisition or undertaking.

(d) EXAMPLES. The provisions of this section are illustrated by the following examples:

EXAMPLE 2. ADOPTING METHODS. Corporation P is a member of a consolidated group. P provides consulting services to customers under various agreements. For one type of customer, P's agreements require payment only when the contract is completed (payment-on-completion contracts). P uses an overall accrual method of accounting. Accordingly, P takes its income from consulting contracts into account when earned, received, or due, whichever is earlier. With the principal purpose to avoid seeking the consent of the Commissioner to change its method of accounting for the payment-on-completion contracts to the cash method, P forms corporation S, and S begins to render services to those customers subject to the payment-on-completion contracts. P continues to render services to those customers not subject to these contracts.

(b) Under paragraph (c) of this section, S must account for the consulting income under the payment-on-completion contracts on an accrual method rather than adopting the cash method contemplated by P.

EXAMPLE 3. CHANGING INVENTORY SUB-METHOD. (a) Corporation P is a member of a consolidated group. P operates a manufacturing business that uses dollar-value LIFO, and has built up a substantial LIFO reserve. P has historically manufactured all its inventory and has used one natural business unit pool. P begins purchasing goods identical to its own finished goods from a foreign supplier, and is concerned that it must establish a separate resale pool under section 1.472-8(c). P anticipates that it will begin to purchase, rather than manufacture, a substantial portion of its inventory, resulting in a recapture of most of its LIFO reserve because of decrements in its manufacturing pool. With the principal purpose to avoid the decrements, P forms corporation S in Year 1. S operates as a distributor to nonmembers, and P sells all of its existing inventories to S. S adopts LIFO, and elects dollar-value LIFO with one resale pool. Thereafter, P continues to manufacture and purchase inventory, and to sell it to S for resale to nonmembers. P's intercompany gain from sales to S is taken into account under section 1.1502-13. S maintains its Year 1 base dollar value of inventory so that P will not be required to take its intercompany items (which include the effects of the LIFO reserve recapture) into account.

(b) Under paragraph (c) of this section, S must maintain two pools (manufacturing and resale) to the same extent that P would be required to maintain those pools under section 1.472-8 if it had not formed S.

NOTE: With the addition of §448 and the applicability of the single employer rules of §52/§414 in measuring gross receipts, a consolidated group will not be able to use a subsidiary to avoid application of §448 where its gross receipts exceed \$5,000,000.

Rocco, Inc., et al v. Comm'r., 72 T.C. 140 (1979)

Facts: In efforts to expand and vertically integrate its business, Rocco, Inc. and Marval Poultry Co, acquired a poultry processing operation, known as Farm Foods, with Rocco owning 80%. Farm Foods acquired a processing plant and its principal business is processing and marketing of broiler chickens. Rocco Broiler Farms was formed as a wholly-owned subsidiary of Farm Foods, to provide broiler chickens to Farm Foods. Farm Foods uses the accrual method and Broiler Farms uses the cash method. Rocco Turkeys, Inc. was a wholly-owned subsidiary of Rocco, Inc. Turkeys was engaged in range production of turkeys. It expanded into confinement growing of turkeys and formed a separate wholly-owned subsidiary for that business, Turkey Farms. Turkeys used the accrual method and Turkey Farms used the cash method. Rocco filed a consolidated return with its subsidiaries which allowed losses from Turkey Farms and Broiler Farms to offset income of other members. The IRS adjusted the losses of the two subsidiaries to consider cost of goods sold and argued that the principal purpose was to obtain deductions for the inventories of the subs and an adjustment was necessary under §269. The IRS did not raise §446 as an issue because under §1.471-6, farmers may initially elect to use the inventory method or the cash method. The IRS argued that Rocco and Turkeys had previously been in the broiler and turkey business and used the accrual method. If the subs had not been set up as separate corporations, ending inventories would have had to been taken into account in calculating taxable income.

Analysis: The court stated, "On its face the scope of section 269(a) may be broad enough to preclude adoption of an accounting method by newly created subsidiaries if the requisite tax avoidance purpose is present." The IRS raised the holding of *Peterson Produce* to support its argument. However, the court noted that that case dealt with §446, not §269.

Conclusion: The Court held for the taxpayer. "In order for section 269 to be applied in this case, the tax avoidance motive must be the principal purpose for the acquisition of control (i.e., the organization of Broiler Farms and Turkey Farms as wholly owned but separate subsidiary corporations)." Rocco's formation of the subs was supported by Rocco's past practices in that it had historically operated its various divisions through separate corporations, for non-tax reasons.

15) Corporate acquisitions and reorganizations (Type A, C, D, F or G)

- §381 - carryover of accounting method and inventory methods.
- If Corporation A using LIFO merges with Corporation B using FIFO, which method should the merged entity use and what procedures must be followed to get both entities on that method? This question is addressed in Reg. §1.381(c)(4)-1 and 1.381(c)(5)-1.

16) Adoption/Election/Change of Accounting Method (§446(e) & (f), §1.446-1(e) & §481)

This topic is discussed in more detail in Chapter 4.

- Generally, may adopt any permissible method by using it on the first filed return.
- *Pacific National Co. v. Welch*, 304 U.S. 191 (USSC 1937) - where taxpayer has choice of methods and uses one on first return, may not change by later filing an amended return [*Doctrine of Election*]
- When, if ever, can change be made using amended return?
 - Generally, may only use amended return to correct "method" if isn't really a method, such as use of an erroneous method for just one tax return (Rev. Rul. 90-38)
 - Rev. Rul. 90-38 is at the end of this chapter; read it when you reach that point as it will be a good review of concepts covered in this chapter.

- *Ronnie L. Barber*, 64 T.C. 314 (1975) - validity of retroactive change in method - taxpayer filed amended return which used percentage of completion method where original return used completed contract method. IRS accepted the amended return. Taxpayer later decided would rather use completed contract and argued that IRS was wrong to accept amended return. Court held for IRS. "A finding here of the power in respondent [IRS] to grant retroactive changes in accounting method, we think, is in line with the acknowledged "broad discretion" of respondent in determining whether to permit or forbid a change in accounting method. ... We think the logical inference to be drawn from a reading of section 446(e) permits the respondent to allow both retroactive and prospective changes in accounting method.
- *American Liberty Pipe Line Co.* (2 T.C. 309 (1943)) and *Lenox Clothes Shops, Inc.* (43-2 USTC ¶9665 (6th Cir.)) - designation of an inventory valuation method (cost or lower of cost or market) on the tax return designates use of a method of accounting which cannot be changed without IRS consent. In *American Liberty*, taxpayer designated "cost" as valuation method in 1936 and 1937 at a time when cost was equal to market. In 1938, it changed the designation to lower of cost or market (LCM). Taxpayer argued that earlier designation of "cost" was not really an election because at the time, the inventory valuation was the same under both the cost and LCM methods. Court agreed with IRS that taxpayer had adopted the cost method and could not change without IRS consent.⁸
- A taxpayer must obtain the consent of the IRS to change an accounting method.
 - WHY? "If taxpayers were permitted to change their method of accounting whenever so inclined, confusion would result and respondent [IRS] would be placed under an almost impossible administrative burden. Our system of taxation contemplates that the taxpayer shall fairly and honestly keep his books under an accepted method and report his income for taxation as shown on those books. To permit changes such as here proposed would destroy the balancing effect of 'consistency' which results over a period of time in justice to both sides. The courts have, therefore, uniformly approved respondent's refusal to permit a change in method without prior consent." *Drazen* (TC 1960)
 - The IRS has issued various Revenue Procedures allowing for automatic changes for certain method changes. However, a Form 3115 is usually still required and the IRS is still granting permission, by allowing for the automatic change procedure.
- Most changes in method require the computation of a *§481(a) adjustment* in order that income or deductions not be omitted or duplicated when a taxpayer changes its method of accounting. This adjustment, if positive, will increase the taxpayer's income in the year of change and if negative, will decrease the taxpayer's income in the year of change. Generally, positive net §481(a) adjustments are spread out (picked up into income) over four years while negative adjustments are reported entirely in the year of the accounting method change.
 - When a taxpayer changes its method, it will act as if it had always used the new method. For example, if a calendar year, cash method taxpayer changed to the accrual method effective January 1, it would have accounts receivable and accounts payable on its books at that date. When it collects a receivable that existed at January 1, it would debit cash and credit accounts receivable, no income would be recorded because the taxpayer was on the accrual method when the payment was collected. Because this income was also not reported when the taxpayer was on the cash method (because no payment was yet collected from the customer), without some type of adjustment, this income would be omitted from the taxpayer's income

⁸ Also see *Ed Smithback Plumbing*, 37 AFTR2d 76-486, 76-1 USTC ¶9139 (Ct. Cl. 1975), aff'd 37 AFTR2d 76-1368 (Ct Cl Trial Judges Op, 12/19/1975).

forever. The §481(a) adjustment is designed to prevent this omission of income. Similarly, when the taxpayer pays an accounts payable item that existed on January 1, it will debit accounts payable and credit cash, there will be no entry to expense. Again, because this expense was also not recorded when the taxpayer was on the cash method (because it was not yet paid), without a §481(a) adjustment, this expense would forever be omitted from the taxpayer's income.

- A §481(a) adjustment can be a powerful item because it is calculated without regard to the statute of limitations. For example, if the taxpayer in the earlier example paid cash for supplies five years ago and has not yet received the supplies, when it computes its §481(a) adjustment, the amount of these supplies which really represent prepaid supplies, will increase the §481(a) adjustment amount, even though the taxpayer expensed the supplies (when paid) on a return for which the statute of limitations has expired.
- The rationale for the §481(a) adjustment is explained in the *Graff Chevrolet* case (below).

Graff Chevrolet Co. v. Campbell, Jr., 65-1 USTC ¶9316 ((5th Cir.) - Excerpt:

The only question before us is whether section 481 gives the Commissioner power to tax amounts that should have been reported in closed years. Nothing in the language of the section prevents its application to amounts omitted in the closed years, but nothing in the language expressly authorizes adjustments of such amounts. ...

Since section 481 taxes in the year of the change all income omitted in prior years under the old accounting system, 481 may present the taxpayer with a staggering tax bill in the year of the change. To lighten this burden, in 1954 the Senate added the present section 481(b)(2) to the Code. ...

There is no necessary conflict between section 481 and the statute of limitations. Until the year of the accounting change, the Commissioner has no claim against the taxpayer for amounts which the taxpayer should have reported in prior years. The statute of limitations is directed toward stale claims. Section 481 deals with claims which do not even arise until the year of the accounting change. ...

Section 481 is designed to prevent a distortion of taxable income and a windfall to the taxpayer stemming from a change in accounting at a time when the statute of limitations bars reopening the taxpayer's returns for earlier years. It authorizes "necessary" adjustments, "to prevent amounts from being duplicated or omitted," in the "year of change" whether "initiated" by the taxpayer or the Commissioner.

The Commissioner has ample power to change accounting methods and reassess income for open years; section 481 would be virtually useless if it did not affect closed years. ...

- For some types of accounting method changes, a taxpayer might be allowed to use the *cut-off method* instead of computing a §481(a) adjustment. Under the cut-off method, the new method of accounting only applies to items that arise after the beginning of the tax year of change. For example, if the taxpayer in the earlier example were allowed to use the cut-off method, when it collected a receivable that existed at January 1, it would report income. It would only apply its new accrual method to sale transactions that arose after the beginning of the year of change.
- Improper adoptions: When can an erroneous method of accounting be fixed using amended returns? Is "adoption" of an erroneous method a valid adoption?

- Rev. Rul. 90-38 - if taxpayer has used a proper method for just one tax return, it has established a method of accounting which cannot be changed by filing an amended return; it may only be changed by obtaining IRS consent. If an erroneous method has been used for two or more tax returns, taxpayer must get IRS consent to change; if an erroneous method has been used for just one tax return, it may be corrected using an amended return.
- TAM 9140001 - after filing of 1985 return, taxpayer hired a new accountant who discovered that taxpayer used straight-line depreciation rather than ACRS and filed an amended 1985 return, claiming more depreciation expense. IRS held that by filing over two years of returns, taxpayer had established a consistent method of accounting for depreciation and could only change with the consent of the IRS.
- Rev. Rul. 90-38 and Substitute Returns:

How does Rev. Rul. 90-38 apply when instead of an amended return, the taxpayer files a *substitute return* and makes the change on such substitute return? A substitute return is a return filed after the original return, but prior to the due date of the tax return. For example, if a corporate return of a calendar year taxpayer were filed on February 1, it could be replaced with a return filed by March 15. This concept stems from a 1940 Supreme Court case, *Haggar Co. v. Helvering* (308 US 389 (1940)). In that case, the Court held that a "first return" meant an amended return, if filed prior to the due date for the return. With respect to extended tax returns, in PLR 7739044 (6/29/77), the IRS stated that the return for a particular year is "considered to be the last return filed on or before the due date (including extensions) for the filing of such return."

Example: X Corporation, a calendar year taxpayer, filed its first return on February 1, 1995, for its 1994 tax year (no extension was filed). On that return, X treated its research and experimentation expenditures as current deductions per §174(a). If X files an amended return by March 15, 1995, it should be able to change the treatment for its R & E expenditures by electing to use the capitalization and amortization method of §174(b). However, after March 15, 1995, the only way that X could change to the §174(b) method would be to obtain permission from the IRS (such a change would not be retroactive to earlier years). See TAM 6603315940A (3/31/66) and Rev. Rul. 58-76 (1958-1 C.B. 148).

Example: In early 1993, X Corporation adopted a 12-month liquidation plan and sold the majority of its assets to A in exchange for an installment note. X filed its Form 1120S before March 15 and reported the entire gain from the sale of the assets. Shareholders later noted that the gain should have been reported per §453, the installment method. X filed another return, again, before March 15, and attached Form 6252 and used the installment sale method. Under the Haggar/substitute for return rule, X was held not to have elected out of the installment method as indicated because its last return filed before 3/15 was considered the first return. (PLR 9446007 (8/12/94))

Note: The *Haggar* rule will not apply very often because most business taxpayers do not file their tax returns sufficiently in advance of the due date.

Question 8 – Your new client, G Corporation has been in business since 1994. In reviewing the prior year return, you discover that it has treated a building as 7-year property for depreciation purposes and it deducted a penalty it should not have (per §162(f)). How will you advise G in fixing these problems?

17) Possibility of assessment of penalties for use of an erroneous method:

a) See §446(f).

b) Case law: In *J.P. Sheahan Associates, Inc. v. Comm'r.*, T.C. Memo 1992-239, 63 T.C.M. 2842, (discussed earlier under "inventory") the court ruled that the taxpayer was properly assessed a substantial understatement of tax penalty (§6661), but not the negligence penalty (§6653). This case involved the taxpayer's year ended 5/31/87. The court noted that it was aware of only one case in which a negligence penalty was discussed in relation to the use of an erroneous method of accounting - *Gilbert v. Comm'r.* (TCM 1952). In that case, the negligence penalty was found to be inapplicable because the taxpayer had used for a few years and the deficiency resulted from the Service's change in the taxpayer's method. The court noted that the taxpayer had "kept sufficient books and records from which his accrued income could be ascertained." In the *Sheahan* case, the court made the same conclusion with respect to the negligence penalty.

However, the court noted that a different analysis applies for the substantial understatement of tax penalty, a more objective penalty based on the size of the understatement. This penalty can only be avoided by adequate disclosure or having substantial authority for the position taken on the tax return. In *Sheahan*, the taxpayer did not argue that it had adequate disclosure, but that it had substantial authority in that use of the cash method was allowed per the IRC and regulations. Because the court found that the *Asphalt Products* case was against the taxpayer's position to use the cash method of accounting, the court agreed with the Service's assessment of the §6661 penalty. "We are not prepared to adopt such an automatic test, at least where the case law rejects the use of the cash method under circumstances such as exist herein and particularly where one of the cases is *Asphalt Products Co. v. Commissioner, supra*, decided by the Court of Appeals to which an appeal herein would lie prior to the time petitioner's 1987 return was filed. To do so would do violence to the substantial authority standard set forth in section 1.6661-3(a)(2), Income Tax Regs." The pertinent part of these regulations stated: "a position with respect to the tax treatment of an item that is arguable but fairly unlikely to prevail in court would satisfy a reasonable basis standard, but not the substantial authority standard."

Rev. Rul. 90-38 **1990-1 CB 57**

ISSUE AND FACTS

The Internal Revenue Service has reconsidered the position set forth in Rev. Rul. 70-539, 1970-2 C.B. 70. In Rev. Rul. 70-539, a corporation organized in 1966 and engaged in developing real estate capitalized interest, taxes, and other carrying charges by including them in the tax basis of real estate sold. Rev. Rul. 70-539 holds that the corporation did not make a valid election under section 266 of the Internal Revenue Code because it failed to file a statement with its returns for 1966, 1967, and 1968 identifying the items it was capitalizing as required by section 1.266-1(c)(3) of the Income Tax Regulations. Because the corporation capitalized these items without making a valid election, Rev. Rul. 70-539 holds that the corporation may treat these items as current operating expenses on amended returns for 1966, 1967, and 1968. Rev. Rul. 75-56, 1975-1 C.B. 98, distinguishes Rev. Rul. 70-539 by holding that a taxpayer may not amend its returns to deduct erroneously capitalized expenses if the period for amending the first return reflecting the capitalized expenses has expired.

LAW AND ANALYSIS

Section 446(e) of the Code and section 1.446-1(e) of the regulations provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes.

Section 1.446-1(e) of the regulations provides rules for determining what a method of accounting is, how an adoption of a method of accounting occurs, and how a change in method of accounting may be made.

Section 1.446-1(e)(2)(ii)(a) of the regulations provides:

A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment.

The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(ii)(a) of the regulations. See *Diebold, Inc. v. United States*, 891 F.2d 1579 (Fed. Cir. 1989). In addition, section 1.446-1(e)(2)(i) indicates that the consistent, but erroneous, treatment of material items constitutes a method of accounting. See section 1.446-1(e)(2)(iii), Examples (6)-(8); see also *Fruehauf Corp. v. Commissioner*, 356 F.2d 975 (6th Cir.), cert. denied, 385 U.S. 822 (1966); *Commissioner v. O. Liquidating Corp.*, 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961); and Rev. Rul. 80-190, 1980-2 C.B. 161. Compare Rev. Rul. 72-491, 1972-2 C.B. 104, which holds that a taxpayer erroneously using an accelerated method of depreciation for “used” property may file an amended return using a proper method, provided the taxpayer has not filed the tax return for the succeeding tax year.

If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns before it has adopted a method of accounting. Section 1.446-1(e)(1) of the regulations provides, for example, that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the tax year covered by such return. Similarly, the Supreme Court has held that once a permissible election as to a method of accounting for an item has been made on a return, it may not be changed after the time for filing the return has expired. See *Pacific National Co. v. Welch*, 304 U.S. 191 (1938), 1938-1 C.B. 274; see also *Lord v. United States*, 296 F.2d 333 (9th Cir. 1961); *National Western Life Insurance Co. v. Commissioner*, 54 T.C. 33 (1970); Rev. Rul. 74-154, 1974-1 C.B. 59.

Section 1.446-1(e)(3)(i) of the regulations provides that (except as otherwise provided by administrative procedures prescribed by the Commissioner) in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115, Application

for Change in Accounting Method, within 180 days after the beginning of the tax year in which the taxpayer desires to make the change.

If a taxpayer's treatment of an item is a method of accounting under these principles, section 446(e) of the Code and section 1.446-1(e)(3) of the regulations preclude a taxpayer from making a retroactive change in method of accounting by amending prior tax returns without the consent of the Commissioner. Section 446(e) authorizes the Commissioner to consent to a retroactive change in method of accounting, whether the change is from a permissible method or an impermissible method. *E.g., Barber v. Commissioner*, 64 T.C. 314 (1975); Notice 89-15, 1989-1 C.B. 816; Notice 88-78, 1988-2 C.B. 394, *modified by* Notice 89-67, 1989-1 C.B. 723; Rev. Proc. 78-6, 1978-1 C.B. 558. Section 446(e) does not give the taxpayer a right to demand that a change in method be made retroactively, however. *See Diebold, Inc.*, 891 F.2d at 1583. Except in certain limited circumstances, and as specifically provided by revenue procedure or other administrative pronouncement, a taxpayer that seeks to change its method of accounting in accordance with section 1.446-1(e) may only request to change the method of accounting prospectively. *See* section 1.446-1(e)(3)(i); section 4.04, Rev. Proc. 84-74, 1984-2 C.B. 736, 741.

Under section 1.446-1(e)(2)(i) of the regulations, consent to change any method of accounting used by a taxpayer is a matter within the discretion of the Commissioner. The Commissioner, however, may prescribe other administrative procedures, subject to such limitations, terms and conditions as are deemed necessary to obtain the Commissioner's consent, to permit taxpayers to change their accounting method to a permissible method. *See* section 1.446-1(e)(3)(ii). Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. *See* section 1.446-1(e)(3)(i).

The corporation under consideration in Rev. Rul. 70-539 adopted a method of accounting when it filed the second consecutive tax return in which it erroneously capitalized charges for interest, taxes, and other carrying charges associated with real estate. In that ruling, the corporation, which was required to obtain the Commissioner's consent to change the erroneous method, was permitted by the Service to change the method which capitalized charges to a method that treated the charges as current expenses by timely amending all prior returns reflecting the erroneous capitalization. However, upon reconsideration, the Service has determined that the special procedure under section 266 of the Code contained in Rev. Rul. 70-539 is not an appropriate departure from the general requirements of section 446(e) and the regulations. The Service has further determined that, in the circumstances described in Rev. Rul. 70-539, consent should be granted only for a prospective change of accounting method and only pursuant to an application for consent made under the generally applicable rules of section 1.446-1(e)(3)(i).

HOLDING

A taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired. Thus, a taxpayer that, for two or more consecutive tax years, has capitalized interest and other carrying charges under section 266 of the Code without making a valid election as required by applicable regulations has nonetheless adopted a method of accounting with respect to the interest and carrying charges. The taxpayer may not change that method of accounting by filing amended returns for those prior tax years. Instead, the taxpayer may only change the method of accounting with the consent of the Commissioner pursuant to section 1.446-1(e) of the regulations.

Consistent with the above, the Service will not follow *Gimbel Bros., Inc. v. United States*, 535 F.2d 14 (Ct. Cl. 1976), in which the court permitted the taxpayer to file amended returns for prior open years to effect a change in method of accounting for a material item.

IRC §448 - Limitation on use of cash method of accounting

- IRC §448 was added by the Tax Reform Act of 1986. Congress was concerned that some large corporations without inventory were using the cash method for tax purposes, but the accrual method for financial reporting purposes in order to defer taxes.
- Legislative History to IRC §448 on the required use of the accrual method - explanation for certain exceptions to the general rule (House Rpt. No. 99-426, 99th Cong., 1986-3 C.B. Vol 2 605):

"the committee recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continued use by certain types of taxpayers and for certain types of activities. The committee believes that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher costs of compliance which will result if they are forced to switch from the cash method. Similarly, the committee believes that farming businesses (other than certain corporate farming businesses required to use the accrual method under present law) should be able to continue to use the cash method in order to avoid the complexities required to account for growing crops and livestock under any other acceptable method of accounting."

"Finally, the committee believes that individuals, whatever the size of their activities, should be able to continue to use the cash method. Individuals, especially individuals engaged in professional activities, traditionally have used the cash method of accounting in the operation of their trades or businesses. Similarly, the committee believes that personal service corporations and entities where the income is taxed at the individual level (such as partnerships and S corporations) traditionally have used the cash method of accounting in the operation of their trades or businesses and, accordingly, should be eligible for the continued use of the cash method of accounting."

- IRC §448 also includes a rule on the "non-accrual experience method" (§448(d)(5)). The non-accrual experience (NAE) method was created by the TRA '86. It was designed to provide some relief from repeal of the bad debt experience method. Basically, the NAE allows eligible taxpayers to avoid accruing a certain percentage of uncollected receivables for the year. However, the relief was only available to accrual basis service providers who did not charge interest on their receivables. The NAE was changed by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147, 3/9/02, §403) which limited the number of taxpayers who could use the NAE. We will not go over the details of the NAE in class other than to focus on who is eligible to use the NAE. Be sure to read IRC §448(d)(5).

Read IRC §448.

Questions for class discussion (be sure to review them before class)

1. What is the basic rule of §448?

In addition to the Code and regulation definition of QPSC, consider this ruling.

Rev. Rul. 91-30, 1991-1 C.B. 61 - "A corporation whose employees perform veterinary services is a qualified personal service corporation under sections 448(d)(2) and 11(b)(2) of the code, and a personal service corporation under section 441(i)(2)." "Veterinarians are 'similar health care professionals' within the meaning of section 1.448-1T(e)(4)(ii) ... the term 'field of health' includes the provision of medical services by veterinarians."

7. In applying the function test, how should the wages paid to the bookkeeper and payroll clerk at a law firm be treated? What is the logic of this answer (that is, why might the IRS have written the regs that way)?

8. What % ownership does "substantially all" require? (§1.448-1T(e)(5)(i))

9. Should you recommend to a C corporation client to become a QPSC (assuming it is feasible) so that it may continue to use the cash method? Why?

10. Assuming 95% of employee time is spent in the following activities of a corporation, does it meet the function test of §1.448-1T(e)(4)?
 - a. health club⁹
 - b. processor of computerized billings (such as filing of insurance claims and billing of patients) for individual doctors and hospitals¹⁰
 - c. radio station¹¹
 - d. computer repair service

⁹ Reg. §1.448-1T(e)(4)(ii).

¹⁰ TAM 8927006.

¹¹ Reg. §1.448-1T(e)(4)(iii).

- e. investment advisor paid by the hour¹²
- f. investment advisor paid by the trade (commission)
- g. dance studio (lessons)
- h. legislative lobbying company that influences outcome of legislation per wishes of clients¹³
- i. emergency medical ambulance service-provider¹⁴
- j. corporation that employs the services of a director of motion pictures¹⁵
- k. corporation that is a full-service business valuation firm providing valuations or appraisals for its clients who are primarily accountants, attorneys and financial institutions; a flat fee is charged for the analysis and report ¹⁶
- l. corporation operates a bookkeeping and tax return preparation business with employee-owners doing the work; none of the employees are CPAs; state law limited the practice of accounting to CPAs¹⁷

11. F Corporation is owned 100% by Sarah who also works full-time for F. F provides accounting and tax services to its clients and all employees perform such services. Sarah's compensation represents 18% of the total compensation cost of F.

a. Is F a qualified PSC under §448? Explain.

b. Is F a PSC under §441(i) and §1.441-4T? Explain.

¹² Reg. §1.448-1T(e)(4)(iv)(B) Ex 5.

¹³ PLR 8901021.

¹⁴ TAM 9309004.

¹⁵ TAM 9416006.

¹⁶ PLR 200606020. Also see Example 10 at §1.448-1T(e)(4)(iv)(B). Per the IRS in the PLR, the corporation “at the direction of its clients, composes and delivers a written product that represents the culmination of the services provided (that is, the ascertainment of value).” The corporation provides a valuation based on client and other data, it does not provide accounting or legal services or render advice and counsel. “While Taxpayer does provide a service (that is, ascertaining value), Taxpayer is not considered to be engaged in the performance of services in the field of consulting.”

¹⁷ Meets the function test. “Public accounting, which generally consists of the preparation and/or audit of financial statements, and generally requires a C.P.A. license, represents a branch of accounting, not the entire realm of accounting.” IRC §448 specified “accounting.” It does not have to be “public accounting.” Bookkeeping and tax preparation services fall within the broad definition of accounting services. *Rainbow Tax Services, Inc. v. Comm’r.*, 128 TC No. 5 (2007).

