Tax Accounting

BY JAMES E. SALLES

In this month's column:

- The Tax Court hands the IRS another defeat on the issue of whether a contractor sells "merchandise" in *Smith v. Commissioner*.[1]
- The Tax Court interprets Code Section 448 in *Alron Engineering & Testing Corp. v. Commissioner*.[2]
- An internal IRS memorandum suggests that reallocating basis among assets can trigger a change of accounting method.
- Taxpayers appeal several IRS victories on tax accounting issues.
- Hints begin to emerge about administrative guidance expected during 2001.

"MERCHANDISE" CONTROVERSY CONTINUES

The Tax Court Reaffirms Its Position

The Tax Court has handed taxpayers another victory on the "merchandise" issue that has been discussed in previous columns.[3] *Smith v. Commissioner*[4] involved a flooring contractor that would sometimes procure flooring materials (for example, tile) to the customer's specifications, charging its cost plus a fee. While the contractor did not "stock" flooring, the volume acquired in connection with a given job could be substantial, and several months might elapse before it was paid. Nonetheless, it maintained no inventories—aside from a constant figure of $15,000 representing "flooring installation materials" that was probably, strictly speaking, "supplies" rather than "inventory"[5]—and reported income on the cash method of accounting.

The Tax Court held that the contractor's sales of flooring were incidental to its service business, and therefore the flooring material was not "merchandise." Consequently, the rule requiring sellers of merchandise to keep inventories and accrue purchases and sales did not apply, and the taxpayer could continue to use its cash method. The court relied principally on *RACMP v. Commissioner*,[6] which reached a similar result as to a concrete contractor. The court read *RACMP* as holding not only that the "ephemeral qualities" of the liquid concrete that was principally at issue in that case precluded its status as merchandise,[7] but also more broadly that materials were not "merchandise" when they "were incorporated into the particular project to such a degree that they lost their separate identity" as something that could be "sold." Under that test, the court concluded that the flooring materials in *Smith* likewise could not be "merchandise" because they were "sold" only as part and parcel of an installation.

After *Smith*, it is clear that the Tax Court will hold that goods that are provided only "incidentally" to related services are not inventoriable "merchandise," even if the combination of substantial purchases and a substantial delay in payment means that the cash method could produce significantly different results from accrual accounting. The proper remedy in such cases—not raised or considered in *Smith*—would appear to be capitalization under Treasury Regulations Section 1.162-3. That section provides that the cost of "incidental materials or supplies" must be deducted only as they are consumed unless it is shown that income is clearly reflected by deducting them as purchased. The Internal Revenue Service (IRS), however, may be hesitating to make this fallback argument in these contractor cases for fear of encouraging the court to come out the "wrong" way on the merchandise issue.

Outlook

The "merchandise" issue is unlikely to go away in the near future. Another contractor recently filed a Tax Court petition challenging the IRS' attempt to make it inventory bricks and concrete.[8] In the meantime, Congress also included a version of the proposal to permit "small" taxpayers to use the cash method—notwithstanding sales of "merchandise"—in the pre-election tax grab-bag.[9]

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The fate of this package remains uncertain, but the proposal seems a likely candidate to hitch a ride on some legislative vehicle in the forthcoming year.

TAX COURT DECIDES SCOPE OF CODE SECTION 448

Section 448 of the Internal Revenue Code (Code) requires most C corporations with more than $5 million in annual revenues to use accrual accounting. An exception applies to "qualified personal service corporations" (QPSCs), which can continue to use cash basis accounting regardless of revenues. The statute defines a QPSC as "any corporation . . . substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting," if certain ownership requirements are met.[10] The Treasury regulations define "substantially all" for this purpose as 95 percent, including activities "incident to the actual performance of services in the qualifying field.[11]

Alron Engineering

Alron Engineering & Testing Corp. v. Commissioner[12] addresses this definition, albeit in a case under a different Code section in which the shoe was not on the usual foot. Status as a QPSC benefits a corporate taxpayer under Code Section 448, because a QPSC can use the cash method without worrying about whether it exceeds the $5 million threshold. The price of this flexibility, however, is that Code Section 11(b)(2) taxes all the income of QPSC's at the top corporate rate of 35 percent. The taxpayer in *Alron* was a "geotechnical testing and engineering firm" that argued that it was *not* a QPSC so that it could use the ordinary progressive rate schedule.

The "geotechnical testing services" provided by Alron comprised a variety of tests on concrete and soil performed both in the field and in the laboratory. The engineering staff was not involved in gathering the samples and performing the tests, and there was evidence that other geotechnical testing firms employed no engineers at all. The clients were given raw test output; if they wanted to engage the engineers to analyse the results, there would be a separate charge. For their part, the engineers frequently worked with test data compiled by others. On these facts, the Tax Court held that the geotechnical testing services provided by the Alron firm were neither engineering services nor activities "incidental to" them, but independent services provided to clients who might or might not make use of the firm's engineering services as well. With these services excluded, the 95 percent threshold was not met and the taxpayer could use the ordinary rate schedule.

IRS SIGNALS AGGRESSIVE POSITION ON METHOD CHANGES

An IRS internal legal memorandum, written in 1998 but released only earlier this year,[13] appears to take a very aggressive position as to whether there is a change in accounting method when basis is reallocated among assets. The independent significance of the memorandum is uncertain, but traces of the same reasoning appear in a technical advice memorandum issued this summer. If the views expressed in the memorandum harden into an institutional position, litigation is likely sooner or later.

The Memorandum

The memorandum itself is a somewhat unusual document. It was released as an "IRS Legal Memorandum," one of the categories of miscellaneous documents now being released in response to several rounds of litigation concerning the scope of IRS disclosure requirements. The addressee is Bonny R. Dominguez, an "issue specialist" in changes of accounting methods. ("Issue specialist" is a miscellaneous category of industry specialists. Industry specialists are overseen by the National Office in Washington but are located throughout the country.) The author is Charles Ramsey, a lawyer and a branch chief in the Chief Counsel Division of Passthroughs and Special Industries (not Income Tax and Accounting, where routine method changes are handled).

The memorandum was not written in response to a particular case. Indeed, it begins by forthrightly stating that it describes a situation that "is a hypothetical fact pattern and does not involve a specific taxpayer." Nonetheless, it outlines and dismisses several arguments described as "raised on behalf of the taxpayer," and that presumably represent a composite of arguments made in different cases. The writer notes cryptically in closing that "the substance of this memorandum will be recommended for publication as a coordinated ISP [Industry Specialization Program] paper but not as a revenue ruling or revenue procedure."

Legal Background

The Treasury regulations define a change in method of accounting as "a change in the treatment of any material item" of income or deduction. For this purpose, "a material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction."[14] In contrast, "a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction."[15] As is frequently observed, this means that method changes are changes that present *timing* issues, as distinguished from changes that affect the taxpayer's lifetime income or deductions.

Not all changes that might, in a larger sense, be timing issues are necessarily changes in method of accounting, however. Reclassifying a deductible expense as a constructive dividend,[16] or a transaction as a lease rather than a sale,[17] or changing from deducting client advances to setting them up as receivables,[18] or the computation of the foreign tax credit limitation[19] are not changes in method. From a bird's-eye (and possibly an elephant's-lifespan) perspective, all these could be timing issues, but they do not concern the timing of the *same item* of income or deduction.

One subset of accounting method changes involves the categorization of assets for cost recovery purposes. Reclassifying a category of assets—and possibly an individual asset—from depreciable to inventory,[20] or from one MACRS recovery period group to another,[21] is a change in accounting method. However, the ruling appears to break new ground in finding a change in method resulting from a reallocation of basis that is unaccompanied, so far as appears, by any reassignment of actual assets.

The Memorandum's Analysis

The memorandum's hypothetical facts involve an acquisition for $10 million, which amount was initially allocated $500,000 to land, $4.5 million to buildings, and $5 million to machinery. On audit, the allocation is changed to $750,000 to land, $5.75 million to buildings, and merely $3.5 million to machinery. There is no mention of any accompanying reclassification of specific assets, and presumably, given the memorandum's generic nature, that is unnecessary to the conclusion.[22] Allocating additional basis to land meant that $250,000 of potential depreciation could now only be recovered upon disposition, while the reallocation between building and machinery changed the timing of the depreciation deductions. Noting that both of these were "timing" adjustments, the memorandum immediately proceeds to the conclusion that the reallocation that caused them must be a change in accounting method.

The memorandum raises and dismisses several arguments described as being advanced on behalf of the hypothetical taxpayer. It notes—correctly[23]—that reclassifying an asset between ACRS/MACRS categories is different from changing an individualized estimate of useful life, which was traditionally treated similarly to a change in underlying facts.[24] Another straw man thus set up and struck down is the argument that there was no change in *method* because the change was merely a "reclassification." The writer is clearly correct in asserting that the reclassification of an asset, as distinct from the reclassification of a *transaction*, can be a change in method of accounting.

The significant point, however, is that the whole discussion overlooks the fact that there is no actual reclassification of any asset that produces a change in the treatment of depreciation deductions attributable to that asset (which would clearly be an "item" of deduction). The memorandum cites regulations under Code section 167[25] to the effect that any change in the method of computing depreciation allowances is a change in method, but that passage relates to changing the method used *as to the assets in an existing depreciation account*. Similarly, the cases cited all involved the reclassification of actual assets from one category to another.[26] It is a further—and somewhat troubling—step to assuming that any reallocation or correction of basis that results in a change in the taxpayer's total depreciation for a particular year is necessarily a change in method of accounting merely because it implicates cost recovery and is therefore in a "big picture" sense a timing issue.

TAM 200043010

There does not seem to have been any significant follow-through to date. Nonetheless, a recent technical advice memorandum (TAM) involving a reallocation of basis in another context—accounting for the right to receive "excess servicing charges" on mortgages—while distinguishable from the IRS legal memorandum,

contains broad language that may suggest similar assumptions about the standards for determining when there has been a change in accounting method.

If a taxpayer (for example, a bank) disposes of mortgage obligations, while retaining the rights to "service" the mortgage in return for an above-market fee, the IRS has ruled that the "extra" part of the fee (the "excess servicing charges") should be treated as interest income with respect to the underlying mortgage, rather than a fee for services. This means that when the taxpayer originally disposes of the mortgage, it must treat the rights to receive the excess charges as "stripped coupons" and allocate a portion of its basis to them.[27]

When the IRS published its position on retained mortgage servicing fees in 1991,[28] it provided both an elective "safe harbor" for determining the "excess" portion of the fee[29] and an automatic consent procedure for taxpayers changing methods of accounting to conform to the ruling.[30] The taxpayer in TAM 200043010[31] both changed methods and elected under the safe harbor but, evidently by oversight, applied the new methods only to its dispositions of mortgages that it originated itself. For mortgages it had acquired from third parties it continued to use its old method, which allocated some basis to its retained servicing rights, but did not follow IRS guidelines in determining the "excess" portion. As compared to the IRS method and the safe harbor, the taxpayer's method allocated too much basis to the servicing rights, and too little to the mortgages themselves, consequently overreporting income in the year of sale.

When the taxpayer later sought to correct its method by filing amended returns, the National Office ruled that this would be an impermissible change in accounting method. Beginning from the proposition that "[i]f a taxpayer's accounting practice does not permanently affect lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting," the ruling concluded that because the basis reallocation affected the taxable year of reporting it must be a method change.

TAM 200043010's facts can be distinguished from those in the Ramsey memorandum, because the taxpayer in the ruling was seeking a change in a consistently used *method* of apportioning basis, rather than correcting an individual instance of allocation.[32] However, the ruling's language appears to sweep more broadly. If the IRS seriously pursues the view that merely because something presents a timing issue it must necessarily be a method of accounting, it is only a matter of time before it finds itself in court.

CIRCUIT COURTS FACE ACCOUNTING ISSUES

Several significant tax accounting cases discussed in previous columns are now before the appellate courts.

Toyota Town, Inc. v. Commissioner, upholding the conditions imposed on deferring warranty income under Revenue Ruling 92-98, was appealed to the Ninth Circuit.[33]

Suzy's Zoo v. Commissioner, which held a stationery company subject to the uniform capitalization rules as a "producer" of goods even though the actual printing was handled by outside contractors, was appealed to the Tenth Circuit.[34]

United Dairy Farmers, Inc. v. United States, which required the taxpayer to capitalize "unexpected" environmental remediation costs, as well as certain accounting fees, has been appealed to the Sixth Circuit.[35]

USFreightways Co. v. Commissioner, holding that only cash basis taxpayers can obtain current deductions under the "one-year rule," has been appealed to the Seventh Circuit.[36]

2001 GUIDANCE EXPECTED

Some hints are beginning to emerge as to what might be on the IRS's 2001 business plan as to tax accounting issues. A letter from the Tax Executives' Institute[37] took the IRS up on its earlier hint that it might abandon its historically inflexible position as to a possible *de minimis* rule.[38] The letter also specifically requests a revenue ruling or similar guidance providing that recurring expenditures that are not part of the cost of a "separate and distinct asset" are not capitalizable, and reflecting the pro-taxpayer appellate holdings in the PNC[39] and *Wells Fargo* [40] cases.

In another development, Chief of the IRS's executive compensation branch has been quoted as saying that Revenue Procedure 71-19 [41] is likely to be either revised or superseded by a regulation at some time during 2001.[42] Revenue Procedure 71-19 states that the IRS will only rule as to the absence of constructive receipt if the deferral arrangement is made before the beginning of the taxable year in which the compensation is earned. This attempt at a "bright line" is almost universally

ignored in practice because taxpayers and practitioners generally feel that the cases and other authorities give them sufficient comfort to proceed in structuring these types of arrangements so long as the deferral is negotiated before the service provider becomes irrevocably vested in a determinable amount,[43] and possibly even after that time if the amount is not immediately payable.[44]

There appears a growing consensus within the IRS that the "before the taxable year" standard is unworkable and that the IRS should retreat to a more defensible line of demarcation.

Expected possibly more quickly is further guidance specifically under Code Section 457, which applies to deferred compensation plans sponsored by state and local governments and tax-exempt organizations.

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1. 80 TCM (CCH) 701 (2000).
2. 80 TCM (CCH) 603 (2000).
3. J. Salles, Tax Accounting, 1(9) *Corp Bus Tax'n Monthly* 34 (June 2000); *see also* J. Salles, *Tax Accounting*, 2(1) Corp Bus Tax'n Monthly 36, 38, 39 (Oct 2000); J. Salles, *Tax Accounting*, 1(12) Corp Bus Tax'n Monthly 25, 28 (Sept 2000).
4. 80 TCM (CCH) 701 (2000).
5. Treas Reg. § 1.162-3.
6. 114 TC 211 (2000).
7. *Accord, e.g.*, Jim Turin & Sons v. Commissioner, 219 F3d 1103 (9th Cir 2000), discussed in J. Salles, *Tax Accounting*, 2 (1) *Corp Bus Tax'n Monthly* 36, 38 (Oct 2000).
8. Manor Concrete Constr. Co. v Comm'r, Dkt No 9625-00 (Sept. 7, 2000).
9. HR 5542, 106th Cong., 2d Sess., Taxpayer Relief Act of 2000, § 210, incorporated by reference in HR 2614, 106th Cong. 2d Sess., reprinted at HR Rep No 106-1004, Conference Report to Accompany HR 2614, at 28–29 (Oct 25, 2000).
10. IRC § 448(d)(2).
11. Treas. Reg. § 1.448-1T(e)(4)(i).
12. TCM 2000-235 (Nov. 1, 2000).
13. IRS Legal Mem. 1998-471 (June 17, 1998).
14. Treas. Reg. § 1.446-1(e)(2)(ii)(a).
15. Treas. Reg. § 1.446-1(e)(2)(ii)(b).
16. Treas. Reg. § 1.446-1(e)(2)(ii)(b).
17. Coulter Elec., Inc v Comm'r, 59 TCM (CCH) 350, 364–65 (1990), *aff'd without published opinion*, 943 F2d 1318 (11th Cir 1991).
18. Pelton & Gunther, PC v Comm'r, 78 TCM (CCH) 578 (1999), discussed in J. Salles, Tax Accounting, 1(5) Corp Bus Tax'n Monthly 29, 29 (Feb. 2000).
19. Travelers Ins. Co v United States, 28 Fed Cl 602, 614 (1993).
20. *E.g.*, Diebold, Inc. v United States, 891 F2d 1579 (Fed Cir 1989), *cert. denied*, 498 US 823 (1990).
21. *See, e.g.*, H. E. Butt Grocery Co v United States, 86 AFTR 2d ¶ 2000-5048 (WD Tex 2000), discussed in J. Salles, *Tax Accounting*, 2(1) *Corp Bus Tax'n Monthly* 36, 40-41 (Oct 2000).
22. *See also* the discussion in IRS Legal Mem 1998-471, ¶ 47.
23. *See* Butt Grocery, supra note 21.
24. *See* Treas. Reg. § 1.446-1(e)(2)(ii)(b).
25. Treas. Reg. § 1.167-1(e).
26. Diebold, 891 F2d1579 (ATM modules reclassified from inventory to depreciable assets); Pacific Enter. v Comm'r, 101 TC 1, 17–23 (1993) (natural gas reclassified from inventory to "cushion gas" (capital asset)); Standard Oil Co. (Ind) v Comm'r, 77 TC 349, 410–11 (1981) (issue 3) (attempt to change depreciation methods on signs that were reclassified from "section 1250 property" to "section 1245 property").
27. *See* IRC § 1286.
28. Rev. Rul. 91-46, 1991-2 CB 358.
29. Rev. Proc. 91-50, 1991-2 CB 778.
30. Rev. Proc. 91-51, 1991-2 CB 779.
31. June 9, 2000.
32. *Cf.*, *e.g.*, Baltimore & Ohio Railroad Co. v United States, 603 F2d 165 (Ct Cl 1979) (change in the standard of arriving at valuation can be a change in method, but a mere substitution of one estimate of fair market value for another ordinarily is not).
33. Toyota Town, Inc. v Comm'r, 79 TCM (CCH) 1457 (2000), appeal docketed sub nom. *Bob Wondries Motors Co v Comm'r,* Nos 00-70530, -70538, -70541, -70553, -70555, -70560, and -70561 (9th Cir 2000), previously discussed in J. Salles, *Tax Accounting*, 1(8) *Corp Bus Tax'n Monthly* 29 (May 2000).
34. Suzy's Zoo v Comm'r, 114 TC 1 (2000), appeal docketed, No. 00-70461 (10th Cir 2000), previously discussed in J. Salles, *Tax Accounting*, 1(7) Corp Bus Tax'n Monthly 33 (Apr 2000).
35. United Dairy Farmers, Inc. v United States, 107 F Supp 2d 937 (SD Oh 2000), *appeal docketed*, No 00-3800 (6th Cir 2000), previously discussed in J. Salles, *Tax Accounting*, 1(12) *Corp Bus Tax'n Monthly* 25, 26 (Sept. 2000).
36. USFreightways Co. v Comm'r, 113 TC No 23 (1999), *appeal docketed*, No 00-2668 (7th Cir 2000), previously discussed in J. Salles, *Tax Accounting*, 1(7) *Corp Bus Tax'n Monthly* 33, 35 (Apr 2000).
37. Letter from Betty M. Wilson of TEI to Acting Assistant Secretary for Tax Policy Jonathan Talisman and IRS Chief Counsel Stuart Brown, Oct. 25, 2000, Tax Analysts Doc No 2000-27494, 2000 *Tax Notes Today 208–33*.
38. See the discussion of IRS Legal Memorandaum 19952010 (Sept 29, 1999), in J. Salles, *Tax Accounting*, 1(6) *Corp Bus Tax'n Monthly* 26, 26 (March. 2000).
39. 212 F3d 822 (3d Cir 2000), rev'g 110 TC 349 (1999), discussed in J. Salles, *Tax Accounting*, 1(11) Corp Bus Tax'n Monthly 26, 26 (Aug. 2000).
40. 224 F3d 874 (8th Cir 2000), aff'g and rev'g Norwest Corp v Comm'r, 112 TC 89 (1999), discussed in J. Salles, *Tax Accounting*, 2(2) *Corp Bus Tax'n Monthly* 35, 35-36 (Nov. 2000).
41. 1971-1 CB 698.
42. Jeffrey Goldfarb, *Variety of Guidance Likely By Year's End if Pension Bill Stalls*, IRS Official Says, Daily Tax Rep., Nov 3, 2000, at G-7.
43. *See*, *e.g.*, Veit v Comm'r, 8 TC 809 (1947), acq. 1947-2 CB 4.
44. *See*, *e.g.*, Veit v Comm'r, 8 TCM (CCH) 919 (1949); *See also*, *e.g.*, *Reed v Comm'r*, 723 F2d 138, 142 (1st Cir 1983).