DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 18, 2001

OFFICE OF
CHIEF COUNSEL

Number: **200125001**
Release Date: 6/22/2001
CC:ITA:1
TL-N-5459-00
UILC: 471.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, SB/SE, LOS ANGELES
CC:WR:LAD:LA

FROM: ASSOCIATE CHIEF COUNSEL
INCOME TAX & ACCOUNTING
CC:ITA

SUBJECT: Change in method of accounting from the cash receipts and disbursements method to an accrual method

This Field Service Advice responds to your memorandum dated November 1, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Company =
Taxpayer 1 =
Taxpayer 2 =
Year 1 =
Year 2 =
Year 3 =
a =
b =

ISSUE

The propriety of issuing a statutory notice of deficiency imposing a change in Company's method of accounting from the cash receipts and disbursements method to an accrual method.

CONCLUSION

We do not recommend issuing the notice of deficiency under the circumstances presented.

FACTS

We rely on the facts set out in the revenue agent's report.

Company was incorporated in Year 1 by Taxpayer 1 and Taxpayer 2. Company is a subcontractor, in the business of putting up drywall on residential construction projects.

Company bids on projects by estimating the cost of all direct material, labor, subcontracting costs and indirect costs related to the contract specifications. Company's profit margin is built in to the bid. Company manages all phases of each drywall job, including ordering and purchasing the material and supplies needed for each job. Materials are drop shipped to the job site and no materials are warehoused at Company's place of business. For Year 2 and Year 3, Corporation's total amount of purchases were a and b, respectively. Thus, purchases amounted to 28% and 26% of gross receipts for Year 2 and Year 3, respectively.

For financial statement purposes, Company maintained its books and records on an accrual basis, using the percentage of completion method for long-term contracts. For tax purposes, Company has consistently used the cash receipts and disbursements method of accounting (the cash method) since its inception.

Examination has concluded that the cash method of accounting does not clearly reflect Company's income because the drywall materials constitute merchandise that is an income-producing factor in Company's business. Accordingly, the proposed notice of deficiency asserts that Company is required to use inventories and an accrual method of accounting under I.R.C. §§ 471, 446 and the regulations thereunder. The proposed notice of deficiency relies solely on the argument that sections 471 and 446 require Company to use inventories and an accrual method of accounting because the drywall materials provided by Company are merchandise that is income producing. The proposed notice does not challenge Company's use of the cash method for tax reporting purposes on any other grounds, for example, because Company has attempted unreasonably to prepay expenses or to accumulate excess supplies.

LAW AND ANALYSIS

Section 446(a) requires a taxpayer to compute taxable income under the method of accounting regularly used in keeping its books. Section 446(b), however, authorizes the Commissioner to change a taxpayer's accounting method if he determines the method of accounting regularly utilized by the taxpayer does not clearly reflect taxable income. Although section 446(c) expressly recognizes the cash method as a permissible method of accounting, Treas. Reg. § 1.446-1(a)(2) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Courts have recognized that section 446 grants the Commissioner broad authority to adjust a taxpayer's method of accounting so as to clearly reflect taxable income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-533 (1979); Asphalt Products Co. v. Commissioner, 796 F.2d 843 (6th Cir. 1986), cert. denied in part, rev'd in part on other grounds, 482 U.S. 117 (1987). Nevertheless, where a taxpayer's method of accounting does clearly reflect income, courts have held that a taxpayer cannot be required to change to a different method, even if the Commissioner's method provides a clearer reflection of income. Ford Motor Co. v. Commissioner, 71 F.3d 209, 213 (6th Cir. 1995); Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 34-35 (1988).

This issue has been the subject of a fair amount of recent litigation. In Galedrige Construction, Inc. v. Commissioner, T.C. Memo. 1997-240, the taxpayer was in the asphalt paving business. The issue was whether the emulsified asphalt used by the taxpayer was merchandise and whether the taxpayer, therefore, was required to use inventories and an accrual method of accounting. The Tax Court focused on the ephemeral qualities of emulsified asphalt and found that its physical properties prevented it from being held for sale. According to the court, the asphalt was an incidental factor in the taxpayer's business activities and constituted a "supply" within the meaning of section 162 and Treas. Reg. § 1.162-3. Because of the court's determination that the asphalt was not merchandise, it was unnecessary to reach the issue of whether it was income producing. Thus, the taxpayer was not required to use inventories or an accrual method of accounting.

The issue arose again in Jim Turin & Sons, Inc. v. Commissioner, T.C. Memo. 1998-223, a case that was factually indistinguisable from Galedrige. The opinion followed Galedrige, concluding the materials provided by the taxpayer were supplies and that the taxpayer's use of the cash method was proper. Turin was appealed to the Ninth Circuit and the Tax Court's determination was upheld. Jim Turin & Sons, Inc. v. Commissioner, 219 F.3d 1103 (9th Cir. 2000).

In Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner, 113 T.C. 376 (1999), the taxpayer furnished chemotherapy drugs to its patients in the course of providing diagnostic and other medical services. The amounts charged to patients were directly related to the amount and type of drugs used in the treatments and the cost of the drugs amounted to approximately 26% of the taxpayer's gross receipts. The Commissioner took the position that the taxpayer was required to use inventories and an accrual method of accounting because the chemotherapy drugs constituted merchandise that was indisputably a significant income-producing factor in the taxpayer's chemotherapy clinic business. Further, the Commissioner concluded the drugs were consumed by the taxpayer's patients, rather than by the taxpayer and, therefore, the drugs were not supplies.

In a split decision, the Tax Court rejected the Commissioner's determination that the chemotherapy drugs dispensed by the taxpayer constituted merchandise. Because the taxpayer was in the business of providing medical services, the court concluded it was inherently a service provider. It followed, according to the court, that where an inherent service provider furnished an item as an indispensable and inseparable part of the rendering of its services, it should not be considered in the business of selling merchandise. Id. at 385.

This conclusion represented a significant departure from the court's prior rulings on this issue by focusing on the inherent nature of the taxpayer's business and judging

the relative importance of the goods to the services. The court concluded that the drugs were subordinate to the provision of the medical services and that, therefore, the drugs were supplies rather than merchandise. The Commissioner published an acquiescence in the result reached by the Tax Court in Osteopathic Medical last year. AOD CC-2000-05 (April 28, 2000) (acquiescence in result only).

In RACMP Enterprises, Inc. v. Commissioner, 114 T.C. 211 (2000), the taxpayer was a contractor, specializing in the construction, placement and finishing of concrete foundations and flatwork for large-scale residential housing projects. The issue was whether the construction materials, including concrete, were merchandise. In addition to mixed concrete, the taxpayer in RACMP provided substantial amounts of materials that did not have ephemeral physical properties. Thus, the Service was able to demonstrate that the taxpayer could and did store materials at its place of business. The cost of concrete alone was approximately 41% of gross receipts. The cost of other "nonephemeral" materials was 21% of gross receipts.

In another split decision, the Tax Court concluded that neither the wet concrete, nor the other construction materials were merchandise. With respect to the mixed concrete, the court reasoned that, like the asphalt in Galedrige, mixed concrete could not be held for sale. Accordingly, the court concluded the mixed concrete was not merchandise and that it was consumed by the taxpayer in the performance of services. With respect to the hardware items, the court relied on the analysis in Osteopathic Medical, to conclude that the taxpayer was inherently a service provider. In reaching this determination, the court analyzed cases outside the realm of tax law, in which construction contractors have been considered consumers of materials and suppliers of services, rather than sellers of personal property. Having concluded the taxpayer was inherently a service provider, the court went on to find the materials it provided were inseparable and indispensable to its services under the Osteopathic Medical criteria. The court considered case law indicating that improvements to real property are generally not subject to inventory accounting. The court also suggested that because the materials lost their separate identity in the construction process, as the drugs did in Osteopathic Medical, they were incidental to the services and more akin to supplies.

The two cases subsequent to RACMP[1] on this issue have also resulted in opinions adverse to the Government. Vandra Bros. Construction Co., Inc. v. Commissioner, T.C. Memo. 2000-233, involved another concrete contractor and had facts virtually identical to those in RACMP. Smith v. Commissioner, T.C. Memo. 2000-353, decided on November 14, 2000, involved a taxpayer in the business of installing

[1] The Commissioner did not pursue appeals in either RACMP or Vandra Bros.

flooring materials such as carpets, hardwood flooring, and vinyl and ceramic tile. In Smith, it was undisputed that the taxpayer operated a warehouse where it stored flooring materials used in its installation business.

In Smith, the court outlined the following test for determining whether construction materials are merchandise within the meaning of Treas. Reg. § 1.471-1: "construction materials generally will not be considered merchandise within the meaning of the regulation if the inherent nature of the taxpayer's business is that of a service provider and the materials are an indispensable and inseparable part of the rendering of the services." The court went on to conclude that, "[l]ike the concrete contractor in RACMP Enters., Inc. v. Commissioner, Smith Floors is inherently a service provider." The court suggested this conclusion was based on the company's skill and craftsmanship and the fact that the company's customers were primarily interested in the firm's labor and contractual skills. The court also noted that Smith Floors was neither a manufacturer, nor a retail seller of flooring materials. The court concluded that the purchase of flooring materials was incidental and secondary to the furnishing of installation services. Accordingly, the court held that Smith Floors did not produce, purchase or sell merchandise within the meaning of Treas. Reg. § 1.471-1 and that it should not have been required to change methods of accounting.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The Tax Court has now determined that construction contractors engaged in asphalt paving, concrete construction and flooring installation are inherent service providers. We believe it highly likely that the court would find a drywall installation business, such as the one in the instant case, to be an inherent service provider as well. In fact, we believe Company has a stronger argument than the taxpayers in the decided cases that its customers are more interested in the labor and skills it provides than in the materials. If the court concludes Company is an inherent service provider, it will apply the "indispensable and inseparable" test.

We see no logical grounds for distinguishing the materials used by Company from the materials used by the taxpayers in RACMP, Vandra Bros. and Smith. The materials appear to be equally susceptible of losing their separate identity in the construction process. Further, the materials do not appear to be less indispensable and inseparable from Company's services than the materials provided in the other construction contractor cases. In addition to these considerations, Company does not appear to be a manufacturer or a retailer. [redacted]

[redacted]

HEATHER C. MALOY
Associate Chief Counsel
Income Tax & Accounting

By: THOMAS D. MOFFITT
Acting Branch Chief
CC:ITA:1