Current Federal Tax Developments

Week of August 26, 2019

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SECTION: 446
TAXPAYER BOTH REQUIRED TO USE ACCRUAL METHOD AND HAD BEEN USING THE METHOD FOR TAX PURPOSES

Citation: King Solarman, Inc. v. Commissioner, TC Memo 2019-103, 8/19/19

In the case of *King Solarman, Inc. v. Commissioner*, TC Memo 2019-103[1] the key issue was whether the taxpayer was reporting on the cash or accrual overall method of accounting and, even if the business was on the cash method of accounting, it was nevertheless required to use the overall accrual method of accounting for tax purposes.

Taxpayers are generally eligible to use the overall cash or accrual method of accounting or another method permitted under the Code or regulations.[2] However, once a taxpayer has chosen an overall method of accounting, the taxpayer must obtain the IRS's permission to change that method.[3]

The taxpayer selects its overall method of accounting generally on the taxpayer's initial tax return.[4] A method of accounting is established based on the consistent use of the method by the taxpayer on the taxpayer's tax returns.[5] Thus, if a taxpayer makes an error in single year in how an item is treated, that is generally not considered a selection of a method[6] But if the taxpayer continues to make that same error (such as using the wrong depreciable life for a class of assets), the consistency makes the treatment the taxpayer's method of accounting.

However, taxpayers do not have unfettered discretion in how items are treated—the method chosen must be one that clearly reflects income or in other cases mandated by the IRC.[7] For instance, if a taxpayer is required to use an inventory under IRC §471, the taxpayer is required to use the overall accrual method of accounting unless the IRS

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[1] https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12019, August 19, 2019, retrieved August 24, 2019

[2] IRC §446(c)

[3] IRC §446(e)

[4] Reg. §1.446-1(a)

[5] Reg. §1.446-1(e)(2)(ii)

[6] Reg. §1.446-1(b)

[7] IRC §446(b)

has otherwise authorized.[8] IRC §471 mandates the use of inventories by a taxpayer whenever the production, purchase or sale of merchandise is a material income producing factor.[9]

The case before the Tax Court involved a business that manufactured solar equipment. The company had accepted an order for 162 towers. While the towers could accept various accessories, the buyer did not have any of those optional items installed on these towers.[10]

The transaction is described by the Court as follows:

> The total purchase price was $7,938,000, payable in two cash installments totaling $2,143,260 and a promissory note for the $5,794,740 balance. The note was secured by the solar towers and called for 240 monthly payments of $31,388.50. During FYE 2015 the Fund paid the two cash installments and made four monthly payments on the note, yielding total cash payments of $2,268,814 ($2,143,260 + (4 × $31,388.50)). At the close of FYE 2015, KSI's general ledger showed "net sales" to the Fund of $2,268,814, "deferred sales" of $5,669,186, and "accounts receivable/note" of $5,669,186.[11]

The Court continues to describe how this transaction was reported by the taxpayer on the tax return for the year in question:

> KSI included in its reported COGS — as "purchases" or "purchases/agent" — 100% of the material costs attributable to the 162 solar towers it sold to the Fund. And it included among its deductions — either as "salaries and wages" or as "other deductions" — 100% of the labor costs attributable to the 162 solar towers. But it excluded from its gross receipts $5,669,186, the portion of the purchase price that it did not receive in cash during FYE 2015.[12]

The IRS objected that the taxpayer was either on the accrual method of accounting for tax purposes or was required to be on that method, thus requiring all of the revenue

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[8] Reg. §1.446-1(c)(2)(ii)

[9] Reg. §1.471-1

[10] https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12019, August 19, 2019, retrieved August 24, 2019, p. 8

[11] *Ibid*, p. 9

[12] *Ibid*, p. 11

from the contract to be included in income for the year of the sale. The taxpayer objected that it was properly reporting on the cash basis.[13]

The Court first looked at whether the taxpayer had ever actually been on the cash basis of accounting, or rather had adopted to use the accrual basis of accounting on its prior returns. The taxpayer had checked the box to indicate it was using the accrual method of accounting on all of its tax returns.[14]

The taxpayer suggested that this box had been checked in error, but the Court found nothing to support that assertion. The Court noted that each of its returns had been prepared by a CPA and that CPA had not advised the taxpayer to seek permission to change its method of accounting. The CPA was not asked to give testimony at trial by the taxpayer to support the view that this had been a mistake despite having the box checked on multiple returns and no request to change methods had been filed—thus, the Court found it did not seem a "mistake" had been made.[15]

Nor did the returns and books of the taxpayer suggest that the taxpayer was reporting on any method of accounting other than accrual. In response to the taxpayer's claim that its books really were kept on the[16] accrual basis, the Court noted:

> In a related vein petitioner contends that, despite its election of the accrual method, it actually used the cash method in keeping its books. We find little if any factual support for this counterintuitive proposition. Petitioner did not introduce into evidence its general ledger (or any other bookkeeping records) for FYE 2012, 2013, or 2014. There is thus no record evidence regarding petitioner's internal bookkeeping practices for the first three years of its existence. For FYE 2015, petitioner's general ledger includes various entries that are consistent with its use of the accrual method, e.g., accounts captioned "accrued salaries," "accounts payable," "payroll taxes payable (Federal)," "payroll taxes payable (State)," "payroll taxes payable (FUTA)," and "income tax payable." Many of these same items, as well as "credit card payables," appeared on the Schedules L and attached statements included in petitioner's tax returns for FYE 2015 and prior years.4
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> General ledger account 154, captioned "Equipment-Solar Light Tower," appears to capture inventory because it has no matching

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[13] *Ibid*, pp. 12-13

[14] *Ibid*, pp. 18-19

[15] *Ibid*, p. 19

[16]

> subaccount for accumulated depreciation. Its entries include "solar light tower," "solar trailer," and "solar panel." That general ledger account balance, $1,062,241, was zeroed out in December 2014 (shortly after the sale of the 162 solar towers) and "reclassif[ied] to cost." This treatment in substance reflects the inclusion of inventory in COGS.[17]

The Court notes that it's clear that the taxpayer's return had errors in applying the accrual method, for instance showing no opening or closing inventory or cost of labor on Form 1125-A. But the existence of errors in applying the method does not constitute evidence that it was truly using the cash method of accounting.[18]

The Court also found that, regardless of what method the taxpayer had been using, it was required to use the accrual method of accounting because the production, purchase and sale of merchandise was an income producing factor.[19]

The taxpayer objected that it did not keep inventories on its books or its tax returns—but the Court noted that neither issue is relevant, noting:

> The dispositive question is not whether petitioner actually maintained inventories but whether "it [wa]s necessary to use an inventory." Sec. 1.446-1(c)(2)(i), Income Tax Regs. As explained above, it was necessary for petitioner to use an inventory because "the production, purchase, or sale of merchandise [wa]s an income-producing factor." See sec. 1.471-1, Income Tax Regs. Indeed, the production, purchase, and sale of merchandise were the sole income-producing factors for petitioner's business.[20]

Similarly, the fact that the taxpayer had no inventory on hand at the end of the year also is not a relevant issue—and, again, that fact itself is not relevant. As the Court noted:

> …[I]n determining whether petitioner was required to use the accrual method, the question is not whether it actually had inventory on hand at year end. See *J.P. Sheahan Assocs., Inc. v. Commissioner*, T.C. Memo. 1992-239, 63 T.C.M (CCH) 2842, 2844 ("[T]he fact that * * * use [of inventory] may produce a zero or minimal year-end inventory is irrelevant."). The dispositive question is whether the material that produced petitioner's income was susceptible to being inventoried. See

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[17] *Ibid*, pp. 20-21

[18] *Ibid*, p. 21

[19] *Ibid*, p. 23

[20] *Ibid*, p. 24

> *Jim Turin & Sons, Inc.*, 219 F.3d at 1109 (distinguishing *J.P. Sheahan* where taxpayer's asphalt supplies could not be stored and were thus "not susceptible to being inventoried"). It is obvious that petitioner's solar towers, as well as their component parts, were readily susceptible to being inventoried.[21]

Some issues are important to note in this case. First, under revisions to §448(c), §471 and §263A enacted as part of the Tax Cuts and Jobs Act it is possible that this business might now qualify to use the cash basis of accounting and treat inventory as supplies—the Court noted that it did not qualify or pre-TCJA relief under Revenue Procedure 2002-28 since it wasn't a type of business that qualified for relief, a rule not included in the codified version of this relief enacted by Congress.

But even in that case, the taxpayer would have to file a Form 3115 to obtain permission to change its accounting method since the taxpayer was already using the accrual method. The fact that the IRS has to allow the change under the law does not relieve the taxpayer from the requirement to request permission to change under IRC §446(e).

Another significant fact to note is that the Court's discussion of the checked box for accrual method may be a bit misleading. As is suggested later in this case, that likely would not matter if, in fact, the taxpayer had actually been reporting on the cash basis. The consistent use of the cash method in all prior returns would, per the regulations, have been the taxpayer's method regardless of what the taxpayer called it.

But when the evidence was, at best, ambiguous regarding the actual use of the cash receipts and disbursements method by the taxpayer on the taxpayer's books and returns, the fact that the returns consistently stated the accrual basis was being used served to bar the taxpayer from now claiming that the cash method had been the one actually used.

SECTION: 451
OIRA COMPLETES REVIEW OF PROPOSED REGULATIONS FOR TCJA CHANGES TO §451

Citation: Nathan J. Richman, "Tax Accounting Proposed Regs Could Be on the Horizon," Tax Notes Today Federal, 8/22/19

We are getting close to our first look at the IRS's proposed regulations to implement the revenue recognition conformity and advance payment provisions added to IRC §451 by the Tax Cuts and Jobs Act. *Tax Notes Today Federal* reported on August 22, 2019, that the IRS's proposed regulations related to both issues have now completed

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[21] *Ibid*, pp. 24-25

their review at the Office of Information and Regulatory Affairs of the Office of Management and Budget.[22]

The revenue conformity rules of IRC §451(b) apply to any taxpayer who reports on the accrual method of accounting for tax purposes[23] that has an *applicable financial statement* (AFR) as defined in IRC §451(b)(3). Under these rules, the taxpayer must generally recognize revenue for tax purposes no later than the date on which the revenue is recognized in the AFR.

IRC §451(b)(3) provides the following definition of an AFR:

> (3) Applicable financial statement
>
> For purposes of this subsection, the term "applicable financial statement" means—
>
> > (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is—
> >
> > > (i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission,
> >
> > > (ii) an audited financial statement of the taxpayer which is used for—
> >
> > > > (I) credit purposes,
> >
> > > > (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or
> >
> > > > (III) any other substantial nontax purpose,
> >
> > but only if there is no statement of the taxpayer described in clause (i), or

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[22] Nathan J. Richman, "Tax Accounting Proposed Regs Could Be on the Horizon," *Tax Notes Today Federal*, August 22, 2019, 2019 TNTF 163-4, https://www.taxnotes.com/tax-notes-today-federal/accounting-periods-and-methods/tax-accounting-proposed-regs-could-be-horizon/2019/08/22/29vvm (subscription required), retrieved August 24, 2019.

[23] IRC §451(b)(1)(A)

> (iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii),
>
> (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the United StatesSecurities and Exchange Commission and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A), or
>
> (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B).

IRC §451(c) governs the treatment of advance payments received by the taxpayer, codifying Revenue Procedure 2004-34, changing it form an elective to mandatory treatment for such advance payments.[24]

The article notes some specific concerns practitioners have regarding §451 that they hope will be positively addressed by these regulations:

> Practitioners have raised concerns about the broad scope of section 451(b) — when it was only supposed to address a couple of issues — and its potential for unintended consequences. Some have asked the IRS and Treasury to allow cost of goods sold offsets to follow the income accelerations of section 451(b) and (c). The Joint Committee on Taxation's blue book doesn't agree with that suggestion.[25]

OIRA now reviews proposed regulations under the IRC coming from the Treasury Department prior to their release, either as proposed or final regulations. The completion of this review clears the way for Treasury to release these proposed

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[24] Nathan J. Richman, "Tax Accounting Proposed Regs Could Be on the Horizon," *Tax Notes Today Federal*, August 22, 2019, 2019 TNTF 163-4, https://www.taxnotes.com/tax-notes-today-federal/accounting-periods-and-methods/tax-accounting-proposed-regs-could-be-horizon/2019/08/22/29vvm (subscription required), retrieved August 24, 2019.

[25] *Ibid*

regulations, but there's no guarantee how quickly Treasury will move to release this guidance.

SECTION: 469
COURT FIND TAXPAYER'S LOG OF PARTICIPATION TIME FOR RENTALS INFLATED BY 150 HOURS, DID NOT MEET TESTS FOR REAL ESTATE PROFESSIONAL

Citation: Hairston v. Commissioner, TC Memo 2019-104, 8/20/19

In what has happened quite often over the past few years, the Tax Court found in the case of *Hairston v. Commissioner*, TC Memo 2019-104[26] that the taxpayers had failed to show that either was a real estate professional. Thus, losses of just under $55,000 over three years were treated as passive activity losses.

IRC §469(c)(2) provides a blanket rule that a rental activity is automatically treated as a passive activity. However, IRC §469(c)(7) was added to the law to grant relief from this automatic treatment to individuals who are real estate professionals.

To be a real estate professional, a taxpayer must meet the following two tests under IRC §469(c)(7)(B):

- More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[27]

Married couples are not allowed to meet these tests by combining their hours, even if they file a joint return. Rather, at least one of the spouses must meet these tests individually.[28]

Most often, the problems arise when the taxpayers are asked to show documentation that these requirements are met—and this case is no different.

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[26] https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12024, August 20, 2019, retrieved August 24, 2019

[27] IRC §469(c)(7)(B)

[28] IRC §469(c)(7)(B)

The Court summarized the requirements the taxpayers must meet to adequately document their hours to qualify as a real estate professional:

> A taxpayer may substantiate the required 750 hours of participation by any reasonable means, but a "ballpark guesstimate" will not suffice. *Moss*, 135 T.C. at 369. In the absence of "[c]ontemporaneous daily time reports, logs, or similar documents," the extent of participation may be established by "the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." Sec. 1.469-5T(f)(4), Temporary Income Tax Regs., 53 Fed. Reg. 5727 (Feb. 25, 1988).[29]

The taxpayers had a calendar for each of their two rental properties that claimed to show the number of hours worked each day on the rental properties, with a total of 360 entries on the two calendars. The calendars indicate what was done and time claimed to be spent but did not indicate which spouse undertook each activity. The court noted that the handwriting appeared identical on each of the calendars and that while some entries were recorded on the date the work was performed, most were recorded at the end of the week in question or even later.[30]

The calendars showed a total of 932 hours of work that was claimed to have been performed, but it was not clear which spouse performed which services. Ultimately the parties disagreed on how the hours should be divided—the IRS found that 170 hours were performed by the wife, 669 hours by the husband and that 93 hours were unclear. If all of the uncertain hours were assigned to Mr. Hairston (who was retired and thus would likely meet the second test), that put him barely over the required hours of 762.[31]

The taxpayers took a different view of the hours, but in the end, they were asserting that 782 hours were performed by Mr. Hairston.[32] So in either event, if Mr. Hairston's hours were even slightly inflated on the calendars, the test would not be passed.

Unfortunately for the taxpayers, the Tax Court found a number of reasons to doubt that the hours in the calendar accurately reflected the hours of activity performed by

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[29] https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12024, August 20, 2019, retrieved August 24, 2019, p. 8

[30] *Ibid,* p. 8

[31] *Ibid*, p. 9

[32] *Ibid*

Mr. Hairston even if the taxpayer's 781 hours of activities were accepted as tasks performed by Mr. Hairston. Some of the problems included:

- Every task, no matter how trivial, was shown as taking at least one hour to perform. 36 of these one-hour activities consisted of receiving a rent payment, issuing a receipt for a rent payment or depositing the check at the bank. Similarly, there 13 entries for one hour for paying the mortgage and 11 one hour tasks for reminding tenants to pay the rent.[33]

- Between 93 and 105 hours was related to snow removal for 2014. Nothing in the terms of the leases indicated that the landlord was responsible for such snow removal. As well, one-third of hours were listed as preparing for a single snowstorm and "deciding" related to this snowstorm. At trial, it was discovered this snow removal related to a garage the tenants had no right to use—the taxpayers stored vehicles and tools in that garage.[34]

- Additional hours consisted of time that Mr. Hairston reportedly was simply "watching" contractors. He spent 33 hours watching carpet being installed and cleaned, and other 40 supervising contractors painting the inside of one rental. The Court found that even though Mr. Hairston, being retired, had "time on his hands," it wasn't credible to believe he spent "an entire week watching paint dry." Even if he had been there, the Court found that the hours did not count as participation—at best he was "on-call" to answer questions, and on-call time does not count towards participation. [35]

The Court determined that Mr. Hairston's hours were inflated by a minimum of 150 hours—and regardless of which total hours number the Court decided to accept (the IRS's or the taxpayers'), once 150 hours were deducted Mr. Hairston no longer met the 750-hour minimum to be a real estate professional.

Taxpayers need to understand the detailed requirements for such records, and the need to pass a "smell" test for the hours they claim to taken to accomplish certain tasks. While the adviser does not have to check into the taxpayers' records in detail before preparing a return claiming real estate professional status, the preparer must clearly communicate the type of records that will need to be available to sustain the position on examination.

A failure to properly document that the client was informed of these requirements can come back to haunt the preparer should the taxpayer be upset at the end of the exam

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[33] *Ibid,* pp. 9-10

[34] *Ibdi*, pp. 10-11

[35] *Ibid*, p. 11

and look to file a civil complaint for damages (likely any penalties and return/exam professional fees) and/or a complaint with the state board of accountancy.

SECTION: 901
MEMORANDUM ISSUED CONFIRMING TWO FRENCH TAXES ELIGIBLE FOR FOREIGN TAX CREDIT

Citation: LB&I-04-0819-007, 8/6/19

Formalizing a change of view by the agency noted on its website in July,[36] the IRS has issued an LB&I, SB/SE directive on the ability of taxpayers who pay two French taxes to claim a foreign tax credit.[37]

The taxes imposed by France that the IRS now agrees are eligible for foreign tax credit treatment are:

- Contribution sociale généralisée (CSG) and
- Contribution pour le remboursement de la dette sociale (CRDS)

The memorandum explains the IRS prior position as follows:

> For U.S. income tax purposes, taxes paid to a foreign country, even if they are otherwise eligible for a credit under I.R.C. § 901, are not creditable to the extent they are "paid… with respect to any period of employment… which is covered under the social security system of such foreign country in accordance with the terms of a [totalization agreement]." § 317(b)(4), P.L. No. 92-516 (the "1977 Social Security Act"). The Agreement on Social Security between the United States of America and the French Republic, signed March 2, 1987, (the "Totalization Agreement") applies to the French laws listed in Article 2(1)(b) and, under Article 2(3), any legislation which "amends or supplements" those French laws.

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[36] See Ed Zollars, "Refunds Going Back to 2009 May Be Available to Certain Taxpayers Who Paid French Taxes," *Current Federal Tax Developments* website, July 21, 2019, https://www.currentfederaltaxdevelopments.com/blog/2019/7/21/refunds-going-back-to-2009-may-be-available-to-certain-taxpayers-who-paid-french-taxes, retrieved August 24, 2019

[37] LB&I-04-0819-007, August 2, 2019, https://www.irs.gov/businesses/corporations/lbi-and-sbse-joint-directive-on-creditability-of-french-social-taxes, retrieved August 24, 2019

> The CSG and CRDS are French taxes imposed on income and, to the extent imposed on income from employment, they are withheld by the employer in a similar manner to other social levies and appear on the employee's pay stub as a social contribution.
>
> Historically, the IRS has denied foreign tax credits for CSG and CRDS imposed on employment income pursuant to § 317(b)(4) of the 1977 Social Security Act. While the CSG and CRDS are not listed in Article 2(1)(b) of the Totalization Agreement, the IRS's position was that, under Article 2(3), the CSG and CRDS "amend[] or supplement[]" the laws in Article 2(1)(b) of the Totalization Agreement.[38]

While the Tax Court agreed with that position when the IRS was challenged on it in the case of *Eschel v. Commissioner*, 142 TC 197 (2014), that ruling was reversed on appeal by the Circuit Court of Appeals for the DC Circuit (831 F.3d 512 (D.C. Cir. 2016)).[39]

In May of this year, the State Department informed the IRS that the USA and France have a "shared understanding" that the CSG and CRDS do not amend or supplement the laws referenced under The Agreement on Social Security between the United States of America and the French Republic. The IRS no longer takes the position that these taxes are not eligible for the foreign tax credit under IRC §901.

The "Recommendation" section of the memo provides:

> Effective upon issuance of this Joint Directive, examiners will no longer challenge foreign tax credit claims, including claims for refund, for CSG and CRDS payments on the basis that the Totalization Agreement applies to these taxes nor will examiners assert that the CSG and CRDS are not creditable income taxes.[40]

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[38] *Ibid*

[39] *Ibid*

[40] *Ibid*