Department of the Treasury

Internal Revenue Service

Office of Chief Counsel

Notice

CC-2001-010

February 9, 2001

Upon Incorporation

Subject: Change in Litigating Position Cancel Date: into the CCDM

The purpose of this Notice is to announce a change in the Service's litigating position regarding the requirement that certain taxpayers must use inventory accounts and an accrual method of accounting.

Several court decisions have recently upheld the use of the cash method of accounting by certain contractors. In these cases, the courts have rejected the Service's argument that the taxpayers were in the business of providing merchandise and therefore required to use inventory accounts and an accrual method of accounting. In Smith v. Commissioner, T.C. Memo. 2000-353, the Tax Court held that a taxpayer who installed flooring materials for customers was inherently a service provider eligible to use the cash method of accounting. The court rejected the Service's argument that the taxpayer's purchase and warehousing of flooring materials prior to installation constituted the production, purchase, or sale of merchandise within the meaning of section 1.471-1 of the regulations.

Similarly, in Jim Turin & Sons, Inc. v. Commissioner, 219 F.3d 1103 (9th Cir. 2000), the Ninth Circuit held that a taxpayer that purchased asphalt and used the emulsified asphalt to provide paving services was not required to use inventory accounts and an accrual method of accounting. The court concluded that because the asphalt could not be stored, it was not susceptible of being inventoried and was not merchandise within the scope of section 1.471-1 of the regulations. In RACMP Enterprises, Inc. v. Commissioner, 114 T.C. No. 16 (March 30, 2000), in a court reviewed opinion, the Tax Court held that a construction contractor that constructed, placed, and finished concrete foundation, driveways, and walkways was permitted to use the cash method of accounting. See also, Galedrige Construction v. Commissioner, T.C. Memo. 1997-240, involving a contractor using emulsified asphalt where the court permitted the taxpayer to use the cash method of accounting.

The Office of Chief Counsel is studying the issue addressed by the courts in the cases discussed above. Until further guidance is issued, the Office of Chief Counsel will not assert that taxpayers in businesses similar to those considered by the courts in these cases are required to use inventory accounts and an accrual method of accounting. In particular, this notice covers

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construction contractors involved in paving, painting, roofing, drywall, and landscaping. This interim policy does not apply to taxpayers that are resellers, manufacturers, or otherwise required by section 448 to use an accrual method of accounting – e.g., a C corporation with gross receipts of $5 million or more. In addition, this interim policy does not apply to situations subject to the provisions of section 1.162-3 of the regulations (involving materials and supplies).

In determining whether a taxpayer is permitted to use the cash method of accounting, you should also be aware of Rev. Proc. 2001-10, 2001-2 I.R.B. 272, which permits taxpayers with average annual gross income of $1 million or less to use the cash method of accounting. In addition, the IRS has recently acquiesced in the result reached in Osteopathic Med. Oncology & Hematology, P.C. v. Commissioner, 113 T.C. 376 (1999), where the taxpayer furnished chemotherapy drugs in the course of providing medical services. As explained in AOD 2000-05 (April 8, 2000), under circumstances comparable to those presented in Osteopathic, the IRS agrees that prescription drugs or similar items administered by health care providers are not merchandise within the meaning of §1.471-1. However, a health care provider may be required to treat the cost of prescription drugs or similar items as deferred expenses that are deductible only in the year used or consumed under §1.162-3.

Any questions regarding this notice should be directed to the Office of Associate Chief Counsel (Income Tax & Accounting) at 202-622-7900.

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