SERVICES OR GOODS?—RECENT DEVELOPMENTS IN INVENTORY ACCOUNTING

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Despite a federal income tax system that is over 80 years old, there is uncertainty in the law as to whether a business is producing, purchasing or selling merchandise. In recent years, a few cases have held that a company that appeared to be selling something did not have to account for inventories either because it might not be "holding" something for sale or may be primarily a service provider. These cases call into question some earlier decisions where companies that provided both goods and services were found to have inventory.

Reg. sec. 1.471-1 provides that inventory accounting is required in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Reg. sec. 1.446-1(c)(2)(i) provides that taxpayers that must account for inventory must also use the accrual method of accounting for purchases and sales. Thus, when revenue agents find cash method businesses selling merchandise, they will propose that the taxpayers account for inventory and change to the accrual method. Some of these taxpayers challenge the Service in court and often, the Service wins. However, the Service has had two significant losses in the past year that have called into question the meaning of merchandise.

In *Osteopathic Medical Oncology and Hematology P.C. v. Commissioner*, 113 T.C. No. 26 (1999),[1] a reviewed opinion, the court held that the drugs administered by a medical clinic (OM) 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 provided the drugs to patients only 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 determination is not applicable if the drugs are not merchandise under section 471.[2]

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. No. 16 (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. Also, since liquid concrete can't be stored it cannot be considered as "held for sale."[3] 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 ser-

1. 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 (2000-23 I.R.B. 1199).

2. 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.

3. 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.

vices, such as restaurants and dot-com companies that provide the service of being able to shop at home.

The above cases call into question some prior cases where taxpayers were found to have inventory. For example, in *Surtronics, Inc.*, T.C. Memo. 1985-277, the court held that a taxpayer in the business of electroplating items for customers had merchandise that was an income-producing factor, whereas Surtronics contended it was in a service business. Since the metals lose their separate identity after the electroplating and the taxpayer primarily provides a service, the metals would likely not be viewed as merchandise by the majority judges in *RACMP*. In *Knight-Ridder Newspapers*, 743 F.2d 781 (11th Cir. 1984), the taxpayer viewed itself as primarily a provider of advertising and information services. However, the court ruled that the ink and newsprint were raw materials and that an inventory method was required even though the shelf life of a newspaper was quite short. Arguably though, a newspaper publisher is primarily a service provider and the paper is consumed in providing such services.

In light of years of precedent and the language of section 471, *RACMP* is a questionable decision. Why didn't the court view RACMP as a *producer* of concrete items? It used various raw materials to produce a product for customers. Like many businesses that produce products, labor is a key element of the activity. Also, nothing in section 471 indicates that inventory only exists if it can maintain a particular state for a certain period of time. Liquid concrete can be a raw material even if it is only in liquid form for a short time. Also, concrete is not similar to paper used by an architect. Customers of RACMP want both the services and the concrete and require both. The concrete is not consumed in providing services; instead, it is transferred to the customer. In contrast, customers of an architect primarily want the service and could obtain that service even if "title" to the blueprint is not given to them. Also, the price charged by the architect has nothing to do with the size of the blueprint delivered to the client, whereas the charge to RACMP's customer is based on the amount of materials used in delivery of the service. Similarly, Knight-Ridder's charge to its readers is not dependent on the quantity of paper provided. In contrast, customers of Surtronics want both the electroplating services and the metal and are charged for both. Businesses like RACMP and Surtronics appear to be providers of both merchandise and services.

The *RACMP* case is distinguishable from the *Osteopathic* case. A stronger argument can be made that drugs administered to patients are consumed in the process of providing services. However, they are still items transferred to patients in addition to services. Drugs are different from the syringe used to administer them in that the syringe is not transferred to the patient, but instead is consumed in providing services (and is clearly a supply).

So, pending appeal of the recent cases, there seems to have been a change in the interpretation of section 471. If a taxpayer is primarily a service provider and items transferred lose their separate identity once transferred and/or have a very short shelf life, such items may be viewed as supplies, rather than inventory. Some taxpayers, with similar fact patterns, may want to take a close look at these cases to see if they are not required to account for inventory.

As evidenced by the recent tax court cases, each with strong dissents, section 471 is complicated. One of the tax code simplification proposals offered by the ABA Tax Section is to except small businesses (gross receipts of $5 million or less) from having to deal with both section 471 and the accrual method of accounting.[4]

The Service has provided some relief through Rev. Proc. 2000-22, 2000-20 I.R.B.1008 which excepts small businesses with average annual gross receipts of $1 million or less from both the accrual method and inventory accounting provided the taxpayer also uses the cash method for its books and records. For larger businesses, some needed clarity to the inventory rules may be forthcoming in that one of the IRS/Treasury business plan items for 2000 is guidance under sections 446 and 471 on the cash method.

SUPREME COURT TO RESOLVE CIRCUIT SPLIT INVOLVING **SHAREHOLDERS OF INSOLVENT S CORPORATIONS**

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On May 1, 2000, the Supreme Court granted certiorari in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), BNA *Daily Tax Report* (No. 85) p. G-2 (5/2/00). Its decision should sort out the disarray among the courts that have addressed this complicated technical issue involving the interaction of S corporation, debt discharge, and insolvency rules. The Tenth Circuit in *Gitlitz* held that cancellation of debt (COD) income (also known as discharge of indebtedness (DOI) income) to an insolvent S corporation does not increase shareholder basis. Petitions for certiorari to the Supreme Court are pending for two other cases involving this issue, *United States v.*

4. The Tax Section presented testimony on this simplification technique before the House Committee on Small Business on April 5, 2000. See http://www.abanet.org/tax/pubpolicy/tes040600/tes_olson040600.html or 2000 TNT 68-26.