Shore v. Commissioner, 69 T. C. 689 (1978)

Incorporating a sole proprietorship requires immediate recognition of the remaining section 481 adjustment as income in the year of incorporation.

Summary

In Shore v. Commissioner, the Tax Court ruled that when a sole proprietorship is incorporated, it constitutes a cessation of the individual's trade or business, necessitating the immediate recognition of the remaining section 481 adjustment as income. The Shores, who operated an acoustical and insulation business, changed their accounting method from cash to accrual in 1968, resulting in a section 481 adjustment spread over ten years. Upon incorporation in 1970, they continued to report the adjustment on their personal returns. The court held that incorporation created a new corporate entity, distinct from the individual proprietors, thus requiring the remaining adjustment to be recognized as income in the year of incorporation.

Facts

Dean and Wilma Shore operated Shore Acoustical & Insulation Co. as a sole proprietorship from 1961 to 1970. In 1968, they changed their accounting method from cash to accrual, resulting in a section 481 adjustment of $142,994. 43, which was to be spread over ten years. On July 16, 1970, they incorporated their business into Dean R. Shore, Inc. under section 351. After incorporation, the Shores continued to report one-tenth of the adjustment on their personal returns. The Commissioner challenged this, asserting the remaining adjustment should be recognized as income in the year of incorporation.

Procedural History

The Commissioner determined a deficiency of $53,903 in the Shores' 1970 federal income tax. The Shores filed a petition with the United States Tax Court challenging this determination. The Tax Court ruled in favor of the Commissioner, holding that the incorporation of the sole proprietorship required immediate recognition of the remaining section 481 adjustment.

Issue(s)

1. Whether the incorporation of a sole proprietorship causes a cessation of the trade or business of the individual proprietors within the meaning of Rev. Proc. 67-10, as amplified by Rev. Proc. 70-16, so as to require the inclusion of the balance of the section 481 adjustment as income in the year of incorporation.

Holding

1. Yes, because the act of incorporation creates a new corporate entity, distinct from

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the individual proprietors, and thus constitutes a cessation of the individual's trade or business, requiring the remaining section 481 adjustment to be recognized as income in the year of incorporation.

Court's Reasoning

The court applied Rev. Proc. 67-10 and Rev. Proc. 70-16, which provide an administrative procedure for changing accounting methods and specify that a cessation of a trade or business during the spread period requires immediate recognition of the remaining section 481 adjustment. The court reasoned that incorporation created a new corporate entity, distinct from the individual proprietors, based on cases like Hempt Bros. , Inc. v. United States and Burnet v. Clark. The court rejected the Shores' argument that incorporation was merely a technicality, noting that it resulted in splitting income between individual and corporate returns. The court also dismissed the argument that recognizing the adjustment upon incorporation contravened section 351's policy, emphasizing that the cessation of the individual's business, not the means of cessation, triggered the adjustment. The court cited the Senate Committee on Finance's statement regarding section 481(b)(4)(C)(i) to support the idea that a change in taxpayer status, like incorporation, cuts off the spread period.

Practical Implications

This decision impacts how taxpayers should handle section 481 adjustments when changing their business structure. Practitioners advising clients on incorporation must consider the immediate tax consequences of any ongoing section 481 adjustments. The ruling reinforces the principle that a corporation is a separate entity from its proprietors, affecting how income is reported and taxed. Businesses contemplating incorporation must plan for the potential acceleration of deferred income adjustments. Subsequent cases and IRS rulings, such as Rev. Rul. 77-264, have followed this precedent, requiring immediate recognition of section 481 adjustments upon incorporation, regardless of whether the individual or the corporation attempts to continue the spread.

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