Ansley-Sheppard-Burgess, Inc. v. Commissioner, T. C. Memo. 1995-440

The IRS abuses its discretion by requiring a small business to change its accounting method from cash to percentage of completion without clear evidence that the cash method distorts income.

Summary

In Ansley-Sheppard-Burgess, Inc. v. Commissioner, the Tax Court held that the IRS abused its discretion in requiring a small construction company to switch from the cash method to the percentage of completion method of accounting. The company, a small contractor with average annual gross receipts under $5 million, had used the cash method consistently since incorporation. The court found that the cash method did not distort the company's income and that the IRS's change requirement was unsupported by law or fact, especially given the company's small size and lack of inventory, which made it exempt under section 448 of the tax code.

Facts

Ansley-Sheppard-Burgess, Inc. , a construction company incorporated in Georgia, used the cash receipts and disbursements method for its federal tax reporting since its inception in 1980. The company did not maintain an inventory and had average annual gross receipts of approximately $2. 4 million. It was required by its bonding company and banks to prepare financial statements using the percentage of completion method. In 1993, the IRS issued a notice of deficiency asserting that the cash method did not clearly reflect the company's income and mandated a switch to the percentage of completion method for tax year 1990, resulting in an income adjustment.

Procedural History

The IRS issued a notice of deficiency in May 1993, requiring Ansley-Sheppard-Burgess to change its accounting method to the percentage of completion method for tax year 1990. The company filed a petition with the Tax Court to contest this change. The Tax Court reviewed the case and ultimately ruled in favor of the petitioner, finding the IRS's determination to be an abuse of discretion.

Issue(s)

1. Whether the IRS abused its discretion by requiring the petitioner to change its accounting method from the cash receipts and disbursements method to the percentage of completion method?

Holding

1. Yes, because the IRS's determination was an abuse of discretion, as the petitioner's use of the cash method did not distort its income and was permitted

under section 448 of the Internal Revenue Code due to its status as a small contractor with gross receipts under $5 million.

Court's Reasoning

The Tax Court's decision hinged on several key points. First, it noted that the IRS has broad discretion under section 446(b) to determine whether a method of accounting clearly reflects income, but this discretion is not unlimited. The court referenced prior cases like Knight-Ridder Newspapers and RLC Indus. Co. , which emphasize the heavy burden on taxpayers to prove an abuse of discretion by the IRS. However, the court also recognized that the IRS cannot require a change in accounting method without clear evidence that the current method distorts income. The court cited Magnon v. Commissioner and Van Raden v. Commissioner to support the use of the cash method in the construction industry, emphasizing that mismatching of income and expenses inherent in the cash method does not necessarily constitute distortion. Furthermore, the court interpreted section 448 to allow small businesses like the petitioner to use the cash method, as Congress intended to protect small contractors from the complexities and costs of other accounting methods. The court rejected the IRS's argument that a substantial-identity-of-results test was necessary, stating that such a test applies primarily to businesses required to maintain inventories, which the petitioner was not. The court concluded that the IRS's determination was arbitrary and capricious, lacking a sound basis in fact or law.

Practical Implications

This case reinforces the principle that the IRS's discretion to change a taxpayer's accounting method is not absolute, particularly for small businesses. Legal practitioners should advise clients that the cash method remains viable for small contractors, especially those with gross receipts under $5 million, and that the IRS must provide clear evidence of income distortion to mandate a change. This decision may influence future cases by emphasizing the importance of the taxpayer's size and industry norms in assessing accounting methods. Businesses should document their consistent use of accounting methods and their compliance with relevant tax code sections to challenge IRS determinations effectively. Subsequent cases, such as J. P. Sheahan Associates, Inc. v. Commissioner, have further clarified the application of accounting method rules, particularly regarding the substantial-identity-of-results test, but Ansley-Sheppard-Burgess remains a pivotal case for small contractors.

