City Line Candy & Tobacco Corp. v. Commissioner, 141 T. C. No. 13 (2013)

In City Line Candy & Tobacco Corp. v. Commissioner, the U. S. Tax Court ruled that the taxpayer, a cigarette wholesaler, must include the cost of New York cigarette tax stamps in its gross receipts for determining eligibility for the small reseller exception under the uniform capitalization (UNICAP) rules. The court held that the taxpayer's method of subtracting stamp costs from gross receipts was inconsistent with its accrual accounting method and New York law, leading to the taxpayer's ineligibility for the exception. This decision clarifies the calculation of gross receipts for UNICAP purposes and impacts how resellers account for state-imposed taxes.

Parties

City Line Candy & Tobacco Corp. (Petitioner) was the plaintiff throughout the litigation. The Commissioner of Internal Revenue (Respondent) was the defendant. The case was heard in the United States Tax Court.

Facts

City Line Candy & Tobacco Corp. (City Line) is a New York corporation engaged in the wholesale trading of tobacco products. City Line is also a licensed cigarette stamping agent for New York, responsible for purchasing unstamped cigarettes from manufacturers, affixing New York State and New York City cigarette tax stamps to the cigarette packages, and selling the stamped packages to subjobbers and retailers. New York law mandates that all cigarettes possessed for sale must bear a tax stamp, and the stamping agent must include the cost of these stamps in the sale price of the cigarettes. For the relevant tax years, the combined stamp tax was $3. 00 per pack. City Line used the accrual method of accounting and a fiscal year ending October 31. For financial statement purposes, City Line calculated its gross receipts from cigarette sales by including the full sale price, without subtracting the cost of the cigarette tax stamps. However, for income tax reporting purposes, City Line subtracted the approximate cost of the cigarette tax stamps purchased during the fiscal year from its gross receipts, resulting in a lower reported gross receipts figure. This method was used to argue that City Line qualified for the small reseller exception under I. R. C. § 263A(b)(2)(B), which exempts certain resellers from the UNICAP rules if their average annual gross receipts for the preceding three years do not exceed $10 million.

Procedural History

Following an examination of City Line's income tax returns for the taxable years ending October 31, 2004, 2005, and 2006, the Commissioner issued a notice of deficiency determining that City Line had underreported its gross receipts by the amount of the cigarette tax stamps purchased during each year. The Commissioner determined that City Line was subject to the UNICAP rules because its average annual gross receipts exceeded the $10 million threshold. City Line filed a petition

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with the U. S. Tax Court challenging the Commissioner's determinations. The case was tried and decided by the Tax Court, which applied a de novo standard of review.

Issue(s)

Whether the cost of New York cigarette tax stamps must be included in the calculation of City Line's gross receipts for determining eligibility for the small reseller exception under I. R. C. § 263A(b)(2)(B)?

Whether City Line qualifies for the small reseller exception under I. R. C. § 263A(b)(2)(B)?

Whether the costs of cigarette tax stamps are indirect costs that must be capitalized under the UNICAP rules of I. R. C. § 263A?

Whether the Commissioner properly allocated a portion of the cigarette tax stamp costs to City Line's ending inventory using the simplified resale method?

Rule(s) of Law

I. R. C. § 263A requires taxpayers to capitalize certain direct and indirect costs allocable to real or personal property acquired for resale. The small reseller exception under I. R. C. § 263A(b)(2)(B) exempts certain taxpayers from these rules if their average annual gross receipts for the preceding three years do not exceed $10 million. Treas. Reg. § 1. 263A-3(b)(2)(i) defines gross receipts as the total amount derived from all trades or businesses under the taxpayer's method of accounting. Treas. Reg. § 1. 263A-1(e)(3)(i) defines indirect costs as costs allocable to property acquired for resale when they directly benefit or are incurred by reason of resale activities. Treas. Reg. § 1. 263A-3(d) allows taxpayers to use the simplified resale method to allocate costs to ending inventory.

Holding

The Tax Court held that the cost of New York cigarette tax stamps must be included in the calculation of City Line's gross receipts for determining eligibility for the small reseller exception under I. R. C. § 263A(b)(2)(B). The court found that City Line's method of subtracting the cost of cigarette tax stamps from its gross receipts was inconsistent with its accrual method of accounting and New York law. Consequently, City Line did not qualify for the small reseller exception because its average annual gross receipts exceeded $10 million. The court further held that the cigarette tax stamp costs are indirect costs that must be capitalized under the UNICAP rules and properly characterized as handling costs. Finally, the court upheld the Commissioner's use of the simplified resale method to allocate a portion of these costs to City Line's ending inventory.

Reasoning

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The Tax Court's reasoning focused on several key points. First, the court emphasized that under City Line's accrual method of accounting, its gross receipts for financial statement purposes included the full sale price of cigarettes, without subtracting the cost of cigarette tax stamps. This approach was consistent with New York law, which requires the cost of cigarette tax stamps to be included in the sale price. The court rejected City Line's argument that the cigarette stamp tax is imposed on consumers, not resellers, finding that the tax is at least partially imposed on the reseller under New York law. The court also rejected City Line's contention that the cost of cigarette tax stamps should be excluded from gross receipts under Treas. Reg. § 1. 263A-3(b)(2)(ii), as taxes are not specifically listed as an exclusion. Regarding the small reseller exception, the court found that City Line failed to prove its average annual gross receipts for the relevant testing periods did not exceed $10 million. On the issue of capitalization, the court determined that the cigarette tax stamp costs are indirect costs under Treas. Reg. § 1. 263A-1(e)(3)(i) because they are incurred by reason of City Line's resale activities and are attributable to materials and supplies used in those activities. The court rejected City Line's argument that the cigarette tax stamp costs are selling expenses, noting that such costs are specifically included as capitalizable indirect costs under Treas. Reg. § 1. 263A-1(e)(3)(ii)(L). Finally, the court upheld the Commissioner's use of the simplified resale method to allocate a portion of the cigarette tax stamp costs to City Line's ending inventory, finding that the method was a reasonable way to reconstruct City Line's income under I. R. C. § 446(b).

Disposition

The Tax Court upheld the Commissioner's determinations and ordered that a decision be entered under Rule 155, which allows for the computation of the deficiencies based on the court's findings.

Significance/Impact

The decision in City Line Candy & Tobacco Corp. v. Commissioner has significant implications for resellers subject to state-imposed taxes on inventory. It clarifies that such taxes must be included in the calculation of gross receipts for determining eligibility for the small reseller exception under the UNICAP rules. This ruling may impact how resellers account for state taxes in their financial and tax reporting, potentially affecting their eligibility for certain tax exemptions. The decision also reinforces the broad discretion of the Commissioner to reconstruct a taxpayer's income using any reasonable method that clearly reflects income, such as the simplified resale method. Subsequent courts have cited this case when addressing similar issues of gross receipts calculation and the application of the UNICAP rules. Practically, this case may lead resellers to more closely scrutinize their accounting methods and ensure compliance with both federal and state tax laws.

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