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FINDING THE OUTER LIMITS OF IRS ACCOUNTING DISCRETION: THE KOLLMAN CASE

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ABSTRACT

The statutory language of the Internal Revenue Code gives cognizance to the methods of accounting used by taxpayers for their financial reporting. The 1979 U.S. Supreme Court opinion of Thor Power acceded to the Internal Revenue Service a significant amount of discretion in its attempt to require taxpayers to change and adapt their accounting methods to its satisfaction. In particular, the Commissioner of Internal Revenue's seemingly absolute authority to prohibit lower of cost or market inventory valuation was upheld. Until the recent Tax Court decision in the case of United States v. Kollman, in fact, there were few guidelines that helped to delineate the outer limits of the IRS's discretion in demanding taxpayer adherence to its preferred tax accounting methods. This paper considers how the parameters for a taxpayers' ability to challenge this discretion have been significantly clarified, if not changed, by the Kollman case. We discuss the clear reflection of income doctrine as it has evolved over time and examine the impact of recent judicial decisions – especially Kollman – on this standard and consider whether or not there is need for revision on the law in this area. We conclude that the Commissioner's authority to arbitrarily require specific methods of accounting is in fact limited, and that the Kollman case serves as a helpful marker of the outer limits of such authority.

JEL: M4, M40, M41

KEYWORDS: Tax accounting, lower of cost or market, inventory valuation, tax administration

INTRODUCTION

Tax accounting in the United States is not a science. Indeed, it is not even an art. It is more of a dance, a negotiated process that involves a leader and a follower. The leader, at least since the U.S. Supreme Court decision in the case of *Thor Power Tool Co. vs. Commissioner* (439 U.S. 522, 1979), is the Internal Revenue Service (or, more properly, its head, the Commissioner of Internal Revenue). The followers are the U.S. taxpayers, that is, those individuals, business organizations and other entities that must rely on tax accounting principles in the derivation of the taxable income that they report for federal income tax purposes.

Generally, such entities are allowed to choose their own method of accounting for both tax and financial purposes. However, Internal Revenue Code (IRC) §446 appears to grant broad discretion to the Commissioner of Internal Revenue (Commissioner) to make determinations regarding a taxpayer's method of reporting income for tax purposes. A significant number of court cases have supported and even expanded on this provision while others have supported challenges to the apparently broad authority granted to the Commissioner. This paper will look at the determination of the Commissioner's authority by examining cases that appear to have been influential in establishing this authority. We will look at the relationship between financial and tax income and the implications of this relationship for the Commissioner's authority to require changes of accounting method under the clear reflection of income standard. We will examine the idea of the Commissioner's ability to determine what method clearly reflects a taxpayer's taxable income in general and in the context of inventory valuation. We will look at cases that have addressed this issue in prior years and compare/contrast the findings with a more recent case which appears to challenge the Commissioner's authority to change an entity's method of reporting income under the "clearly reflects income" standard. The primary question being asked here is whether the Commissioner's authority to demand adherence to its preferred accounting methods is absolute. Or, are there expectations that such accounting methods be reasonable, or even coherent? If there are such expectations, those expectations are most likely to be articulated within the judicial system, because IRS requirements for specific accounting methods are subjected to judicial review. Within the legal system in the U.S., courts can determine whether the IRS has become too arbitrary or too strict in its imposition of accounting methods. A recent clash over tax accounting methods that resulted in the case reported as *United States v. Kollman* (105 AFTR 2d 1331, 2010), serves as a case study for this inquiry.

The remainder of the paper is organized as follows: review of literature, discussion of the clear reflection of income standard, discussion of inventory write-downs, considerations for revision of the clear reflection of income standard, and conclusion.

LITERATURE REVIEW AND BACKGROUND

The clear reflection of income standard has existed almost since the beginning of the IRC and related regulations. There have been various challenges to this standard over time. Before taking a closer look at the specifics of this standard in the light of *Kollman* and *Thor Power Tool*, we will take a brief look at some of the prior literature that examines this standard.

Malman (1981) examined the application of the clear reflection of income standard as it related to revenue recognition of prepaid income for tax purposes. She evaluated a variety of cases that both supported the application of the clear reflection of income standard and denied its application. She also discussed the inter-relationship between financial accounting and tax accounting and those implications for the clear reflection of income standard. She concluded that even though the Supreme Court has ruled on the revenue recognition issue for prepaid income for tax accounting purposes, there are still situations where the facts and circumstances allow differing treatment and that the discretion of the Commissioner does not appear to be absolute.

Dubroff, *et al* (1982) examined the legislative history of the clear reflection of income standard as it relates to IRC §446 and its related regulations. They were specifically looking at the interaction of financial and tax accounting rules and how they were to be applied under the clear reflection of income standard. They looked at specific examples from actual cases where generally accepted accounting principles (GAAP) were and were not determined to meet the clear reflection of income standard. They determined that under the established principles of administrative law that the determination of the Commissioner is to be generally presumed to be correct – in other words, that the Commissioner is vested with wide discretion that is not to be interfered with unless it is clearly unlawful in its application. They concluded that the disparity in application of the clear reflection of income standard related to the acceptance of GAAP as clearly reflecting income created significant problems for taxpayers

Morse (1999) examined the clear reflection of income standard in light of the "rule of law". He stated that the rule of law has been interpreted to be in place to protect the people from arbitrary government action. Given that the clear reflection of income standard appears to give the Commissioner very broad discretionary powers, Morse investigated the implication of this and its inter-relationship with the rule of law and the federal tax laws. He concluded that "the 'rough justice" of a rule has much to offer as compared with the uncertainty of discretion, which has flowed from the Commissioner's clear reflection power." (Morse, 1999, 539)

Root (2000) also looked at the rule of law and the balance between this and the rule of man in the legal system and related this to the clear reflection of income standard in IRC §446 and the Commissioner's discretionary powers. She discussed the impossibility of legislating for all contingencies and indicated that this is part of the status quo of the current legal system. She concluded that the broad discretionary powers apparently granted to the Commissioner under this section are at odds with the rule of law and the desire by taxpayers for certainty in the application of the tax laws. She suggested that a reexamination of the discretionary powers under the clear reflection of income standard may be appropriate going forward.

DECIDING IF INCOME HAS BEEN CLEARLY REFLECTED

The Code and the Commissioner

IRC §446(a) states that "Taxable income shall be computed under the basis of which the taxpayer regularly computes his income in keeping his books" while IRC §446(b) states that "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income" (26 USC §446, 2010). Treasury regulations interpret and expand upon this by stating "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year" (26 CFR §1.446-1(a)(2), 2010). Taken together, the IRC and the regulations appear to give the Commissioner a broad brush to use to determine a taxpayer's method of accounting. However, the provisions also imply that conformity to GAAP and accepted practices in the business environment will generally be considered as "clearly reflecting income".

Interestingly, GAAP have not always been the standard for taxpayers when choosing a method of accounting for tax purposes. The Revenue Act of 1913 required a cash receipts and disbursements method of accounting for tax purposes making all taxpayers initially cash basis taxpayers (38 Stat. 166, 1913). The Revenue Act of 1916 amended existing law to include the term "clearly reflect income" for the first time. The Act provided the ability for taxpayers to report their income for tax purposes using a method other than the cash basis if such method clearly reflected their income for the year. Taxpayers were now able to prepare their return on the same basis as they keep their books "subject to Regulations made by the Commissioner of Internal Revenue" (39 Stat 763, 1916). GAAP was also recognized in regulations issued pursuant to IRC §49 (the predecessor section of IRC §446) under the 1939 Code, providing that approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. Current Treasury regulations for IRC §446 (the successor to IRC §49) as stated above reflect very similar language as that from the 1939 Code and Treasury regulations.

Historically, until the late 1950s there was not much disagreement between taxpayers and the IRS regarding the acceptability of GAAP for tax purposes from the perspective of clearly reflecting income. The first real challenge to GAAP conformity clearly reflecting income came from a series of prepaid income cases from 1957 through 1963. In all 3 cases – *Automobile Club of Michigan vs. U.S.* (353 U.S.180, 1957), *American Automobile Association vs. U.S.* (367 U. S. 687, 1961), and *M. E. Schlude vs. U.S.* (372 U.S. 128, 1963) – the entities prorated, on a monthly basis, prepaid income for services to be rendered to members in the future. The Commissioner determined that this method of proration did not clearly reflect the income of the taxpayers and disallowed the proration even though it was in accordance with GAAP. The Commissioner's rationale, which was supported by the courts, was that the proration did not result in an appropriate matching of the revenues with the related expenses of the entities because the monthly proration did not reflect the reality of when the entities would be required to perform the services for their members.

In *Artnell Company* (400 F. 2d 981, 1968) the court found for the taxpayer in another prepaid income case and determined that the Commissioner had overstepped his authority in requiring a change in the taxpayer's accounting method. The court found that the taxpayer had appropriately deferred recognition of the prepaid income and was correctly reflecting the deferred income in taxable income to result in an acceptable matching of costs and revenues, in other words, the GAAP treatment did clearly reflect the taxpayer's income. In *Cincinnati, New Orleans & Texas Pacific Railroad* (191 Ct. Cl. 572, 1970) the Court of Claims held that in determining if income is clearly reflected, GAAP "is entitled to some probative value". In an even more recent case, *Hopkins Partners vs. Commissioner* (T.C. Memo 2009-107, 2009) the court held that even though the Commissioner has broad discretion, he "cannot require a taxpayer to change from an accounting method that clearly reflects income merely because the Commissioner considers an alternate method to more clearly reflect income".

Under the law and regulations related to the Commissioner's authority to require a change of accounting method, it would seem that a method found to be in accordance with GAAP and consistently applied would ordinarily be presumed to clearly reflect a taxpayer's income. It would also seem that given much of the legislative history, consistent application of GAAP would appear to be a constraint on the Commissioner's ability to require a change in method away from a method that meets the requirements of GAAP. In the area of inventory valuation, however, there have been serious challenges to the consistent application of GAAP as a rebuttal to the Commissioner's determination that the method of reporting income used by the taxpayer does not clearly reflect income.

When making a determination regarding the clear reflection of income for matters relating to inventory valuation for an entity, the entity must look not only to IRC §446 and the related Treasury regulations but must also look to IRC §471 and the related Treasury regulations. IRC §471(a) states that "Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." While this section gives authority to require a change in the taxpayer's method of valuing inventory, it also indicates that conforming to best accounting practices is related to clearly reflecting income. This granting of authority to the IRS has also been challenged and commented on by the courts. One of the most well-known cases related to inventory valuation and the clear reflection of income standard is the *Thor Power* case.

Thor Power's Influence on the Clear Reflection of Income Standard

Thor Power Tool Co. vs. Commissioner (439 U.S. 522, 1979) seems to be viewed as the "landmark" case when it comes to discussing the Commissioner's influence on determining a taxpayer's method of calculating income, especially with regard to inventory valuation. In *Thor,* the company manufactured hand held power tools and replacements parts for these tools. Since the cost of retooling the machinery to manufacture the replacement parts for the tools was high, *Thor* manufactured and held all replacement parts management believed they would need over the lifetime of the tool the replacements related to at one time. Because these replacement parts relate to specific tools, demand for the replacement parts was not very sensitive to price and so price reductions for the replacement parts would not generally increase the sales of these replacement parts. *Thor* had always used the lower of cost or market treatment for valuing their inventory of both power tools and replacement parts for both tax and financial accounting purposes.

After a management change in the 1960s, it was decided that the inventory of the company was overvalued in general and several groups of items were either written down or written off. *Thor* wrote off/wrote-down about $3 million of obsolete parts and damaged or defective tools, replacement parts that related to unsuccessful power tools, and similar items. These items were either actually scrapped shortly after the write-downs or were sold at reduced prices. The Commissioner did not challenge these write offs/write-downs due to the scrapping of some of the items and the sale at reduced prices of others.

In addition to the previously mentioned write offs and write-downs, a decision was made that the excess parts for models of power tools that *Thor* had ceased production on were "excess inventory" i.e., the amount of parts on hand was in excess of any reasonable future demand for the parts. Management decided to write this portion of its inventory down to its net realizable value which they determined to be the scrap value for most of the excess inventory. *Thor* did not scrap these "excess" inventory items and in fact maintained them as a part of its inventory held for sale at their original price. As stated earlier, management believed that the demand for the items was not sensitive to price and therefore lowering the price would not result in additional sales. *Thor's* method of determining the value of this inventory was in accordance with its lower of cost or market method of accounting for inventory that it had been using consistently for both tax and financial accounting purposes.

The Commissioner disallowed this last write-down claiming that it was not authorized by the Treasury regulations and determined that the write-down did not clearly reflect *Thor's* income for tax purposes. The Supreme Court upheld the disallowance and determined that the Commissioner had not abused his discretion. While the Treasury regulations under IRC §471 do authorize write-downs for the lower of cost or market method for FIFO (but not LIFO) (26 CFR § 1.471-4(a), 2010) and for damaged goods (26 CFR §1.471-2(c), 2010), they do not contain any specific provisions for excess inventory. *Thor* argued that the adjustments were in conformity with GAAP and that they were in accordance with IRC §471. As stated earlier, IRC §471 indicates that methods conforming to GAAP are considered to most clearly reflect income. The Treasury regulations under IRC §471 expand upon this to provide guidance on the write-down of inventory. Treasury regulations expand upon the two tests of IRC §471 of conforming to best accounting practices and clearly reflecting income (26 CFR §1.471-2(b), 2010). The regulations state that "inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§1.471-1 through 1.471-11." *Thor* argued that this regulation would appear to give more weight to conformity with GAAP as clearly reflecting income and therefore the Commissioner should not be allowed to require a change in their method of valuing their inventory since their current method was in accordance with GAAP.

The Court determined that in *Thor Power* the taxpayer did not meet the requirements of the Treasury regulations requiring an actual offer of inventory at a reduced price to determine a lower market value for the inventory (26 CFR §1.471-2(c), 2010). Nor did the taxpayer meet the requirement that if there is no market price available due to an inactive market for the goods, then a market price can be determined by a sale price from a sale offered near the inventory date (26 CFR §1.471-4(b), 2010). Accordingly, since the taxpayer met neither of these conditions, the Court held that it did not meet the requirements of IRC §471 and therefore the Commissioner's disallowance of the write-down was upheld. Thor Power argued that since there is no specific provision in the Treasury regulations that related to "excess" inventories, their treatment of the items was acceptable because it was in accordance with GAAP. The taxpayer also argued that since their method was in accordance with GAAP – the first of the IRC §471 tests, then there should be a presumption that the method used clearly reflected their taxable income. The IRS agreed that the method was in conformity with GAAP but did not agree that this created a presumption of clearly reflecting income for tax purposes.

While the Court did agree that *Thor's* treatment was in accordance with GAAP, they did not agree that being in accordance with GAAP created a presumption that the method clearly reflected income and therefore negated the Commissioner's ability to require a different method of accounting for tax purposes. The Court stated that the Code and Treasury regulations grant broad discretion to the Commissioner to change the taxpayer's method of accounting if his opinion is that the method used does not clearly reflect income. The Court stated that the language of the Code and Treasury regulations is contrary to a presumption in favor of the taxpayer – that the language only states that in most cases GAAP will be acceptable for tax purposes. However, if the Commissioner determines that GAAP is not acceptable, he may require a different method without having to rebut any presumption in favor of the taxpayer. These statements appear to give almost unlimited authority to the Commissioner to make the determination of what methods do or do not clearly reflect income without giving weight to GAAP considerations. In fact the Court went so far as to say that the Code and Treasury regulations "leave little doubt as to which test is paramount. While § 471 of the Code requires only that an accounting practice conform "as nearly as may be" to best accounting practice, the Treasury regulations state categorically that "*no* method of accounting is acceptable *unless*, in the opinion of the Commissioner, it clearly reflects income" (emphasis added) (26 CFR §1.446-1(a)(2), 2010). Most importantly, the Court concluded that the Code and the Treasury regulations give the Commissioner broad discretion to set aside the taxpayer's method if, in the Commissioner's opinion, the taxpayer's method does not reflect income clearly.

This language in the Court's opinion appears to grant almost unlimited power to the Commissioner to apply the clear reflection of income standard. It would seem from IRC and the regulations, as interpreted in *Thor Power,* that taxpayers who are relying on conformity with GAAP to support a method that clearly reflects income need to be more concerned post *Thor Power Tool.* It would seem that this decision makes it almost impossible for taxpayers to challenge the Commissioner's determination of what does or does not clearly reflect income.

<u>Is the Commissioner's Power Unlimited?</u>

Seago and Schnee (2005) examined the deference that should be paid to the Commissioner regarding the clear reflection of income standard. While they were examining deference with respect to whether or not courts should defer to the decisions of administrative bodies related to their interpretations of regulations, their investigation provides insight into the limits – or lack thereof – on the Commissioner's power to require a change in accounting method under the clear reflection of income standard. The authors refer to the *Thor Power Tool* decision and the wide discretion granted to the Commissioner in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income. They observe that "the Commissioner's interpretation of the statute's clear reflection standard "should not be interfered with unless clearly unlawful"". (Seago and Schnee, 2005, 190) Also, "(t)he commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. (Seago and Schnee, 2005, 190) Finally, "(t)he respondent's determination pursuant to his authority under § 446(b) is presumptively correct and must be upheld unless the petitioner has proved it clearly erroneous or arbitrary". (Seago and Schnee, 2005, 190) These comments would seem to support a more unlimited role for the Commissioner in determining what does or does not clearly reflect income. However, as was discussed earlier, there have been challenges to the Commissioner's discretionary application of the standard and also there is a certain logic that must be examined regarding this provision.

While the Supreme Court acknowledged in *Thor Power* that the clear reflection of income test is paramount, and while Seago and Schnee provide evidence from other cases to support limited challenges to the Commissioner's authority, the logic of the Code and the Treasury regulations does not seem to allow for completely unlimited power to be granted to the Commissioner in applying the clear reflection of income standard. IRC §446 does not include reference to best accounting practices or to GAAP but the Treasury regulations under this section suggest that GAAP results in a clear reflection of income. If the clear reflection prong is paramount under IRC §471 as the Court determined in *Thor Power Tool*, and given that the Treasury regulations for IRC §446 support the position that GAAP results in the clear reflection of income then it would seem that the power of the Commissioner should not be considered unlimited. Conformity with GAAP should be a valid argument to defend a taxpayer's method of accounting as clearly reflecting the taxpayer's income for tax purposes. *United States v. Kollman*, discussed below, provides significant additional support for the notion that there are indeed limits to the Commissioner's discretion in applying the clear reflection of income standard related to inventory valuation.

INVENTORY WRITE-DOWNS IN THE *KOLLMAN* CASE

Background: The Rise and Fall of the Cell Tech Business

The factual narrative of the case of *United States v. Kollman* (105 AFTR 2d 1331, 2010), as related in the cited federal district court opinion as well as in one of the taxpayer's trial briefs (2009 WL 5193677, 2009), involves a perfect storm of events that highlight the potential harshness of IRS arbitrariness in unilaterally determining whether a tax return constitutes a clear reflection of income. In 1982, Daryl J. Kollman and Marta Carpenter, his wife, founded a business that harvested, processed, and sold *Aphanizomenon flos aquae* algae as a nutritional supplement. They began to harvest this blue-green algae from Upper Klamath Lake, the largest freshwater lake in Oregon and one of the largest in the United States. The business operated through two S corporations, The New Earth Co. and The New Algae Co., which were each half-owned by Kollman and Carpenter. For tax purposes, the corporations' income was attributed to Kollman and Carpenter. Together these two corporations sold the nutritional supplements under the trade name "Cell Tech". Kollman designed harvesting equipment and was the business's inspirational leader, while Carpenter ran day-to-day operations.

From 1990 through 1996, Cell Tech experienced phenomenal growth. In 1990, Cell Tech had sales of about $ 10 million, but by 1996, this small Oregon operation had reached sales exceeding $194,000,000.00. Cell Tech's products were sold across the United States and Canada through 350,000 individual distributors. Cell Tech expected sales to continue increasing the following year.

Given the rapid exponential growth of sales, Cell Tech was having serious supply issues. The algae only bloomed during the summer months, and harvesting of the raw material used in the products could only occur during a few months of the year. To meet the increasing demand for Cell Tech's products, in 1996 Kollman and Carpenter decided to build a state-of-the-art harvesting plant at one of the canal sites adjacent to Upper Lake Kamath, at a cost of about $ 20 million. The new harvesting facility required 900 gallons of fresh water per minute. Cell Tech drilled a well nearby, but it produced less than 50 gallons per minute and was abandoned. A second well produced about 200 gallons per minute. Cell Tech was forced to redesign the harvesting facility to incorporate a reserve water tank. The second well is still in use, but only to supply water for an employee break room.

At a cost of $ 450,000, Cell Tech also installed a reverse osmosis system in 1996 to extract water from harvested algae. The osmosis system was intended to reduce the cost of transporting and processing algae. On its first run, however, the osmosis system failed, ruined by water containing bentonite, a fine clay that had been used to seal the newly drilled well. The system's vendor told defendants that the clogged membranes could not be repaired and that the entire osmosis system would have to be replaced. As of late 1998, Cell Tech concluded that the system was worthless, even as scrap, and abandoned it in place.

In approximately that same period, Cell Tech learned that it had received incorrect state sales tax advice from its attorneys related to sales to its multi-level distributors. As a result, in the same time period that Cell Tech was frantically building its multimillion dollar expansion of harvesting operations, it had to come up with millions of dollars in state sales taxes.

Cell Tech used screens to harvest the blue-green algae *Aphanizomenon flos aquae* from irrigation canals fed by Upper Klamath Lake. After Cell Tech had cleaned and frozen the algae, a third-party contractor freeze-dried it, converting it to powder. Cell Tech used the powdered algae in its finished products, which were mainly food supplements for human consumption. In addition to the *Aphanizomenon flos aquae* algae harvested by Cell Tech, a second algae occurs in Klamath Lake, *Microcystis aeruginosa*, which produces microcystin, a potent liver toxin. In 1996, the Oregon Department of Agriculture considered restricting microcystin content to one part per million in finished products for human consumption. Cell Tech opposed the regulation, citing its experts' opinion that a microcystin content of five parts per million was safe for human consumption. No other jurisdiction had imposed a similar restriction on microcystin content. Despite Cell Tech's objections, however, the regulation took effect on October 20, 1997.

The microcystin regulation was an immediate public relations disaster for Cell Tech. Sales fell as customers worried that Cell Tech's food supplements were unsafe. In 1997, Cell Tech's gross receipts were about $ 113 million, down more than $ 80 million from 1996. In 1998, gross receipts were about $ 69 million; in 1999, $ 52 million; and in 2000, $ 37 million. After Oregon's ruling regarding microcystins, the companies had significant inventories of unsalable raw material, and excess capacity costs which resulted from the decrease in demand. A $20,000,000 improvement to one of the harvest sites at a canal had to be abandoned in 1998, along with a significant amount of other assets, when management determined to start harvesting solely on the lake.

After the regulation took effect, Carpenter hoped that Cell Tech would discover a novel use for the frozen contaminated algae or find a method to extract microcystins. She testified, "Given here that [the algae] was frozen, once you have it and you throw it out and then you discover, oh, my goodness, you can make biofuel out of it, it's -gone." Cell Tech never found a use for the contaminated algae, however.

Although most of its products were food supplements, Cell Tech did sell shampoo and soil amendments. Because the shampoo contained less than a gram of algae per unit, it would have used only a tiny fraction of the contaminated algae. Cell Tech also considered using frozen contaminated algae as a soil amendment, but in bulk form the algae was difficult to transport and even more difficult to spread. Freeze-drying the algae for conversion to powder would have been prohibitively expensive. Cell Tech could not even give the contaminated algae away to local farmers. One person who did accept a free sample of the algae discovered that it thawed into a stinking, viscous mess, useless as a soil amendment.

Cell Tech eventually found itself with millions of dollars of worthless inventory, plummeting sales, harvesting capabilities that far exceeded the new lower demand, and state and federal tax liabilities that greatly exceeded the companies dwindling income or cash reserves. This perfect storm of events almost consumed the company, and left its two original sole shareholders with massive federal and state tax liabilities.

In an attempt to help pull themselves from the problems facing the companies, Kollman and Carpenter hired numerous "experts". Unfortunately, these "experts" provided advice, and solutions that were anything but expert. Ultimately Kollman agreed to a plan involving the reverse merger of The New Algae Company and The New Earth Company with a shell company called Humascan. The New Algae Company and The New Earth Company became wholly owned subsidiaries of Humascan in August of 1999, which then immediately changed its name to Cell Tech International Incorporated and became a publicly traded corporation. After the reverse merger in August of 1999, Kollman was removed from any position of authority or control over the business entities and Carpenter became president and CEO of Cell Tech International. In addition, after the reverse merger, the business entities all became C corporations, and they no longer would "flow through" losses or profits.

In October 1999, Cell Tech International entered into a financing agreement with a private investor. Kollman and Carpenter then each owned more than 40% of the shares of Cell Tech International. As the company continued its downward spiral, by late 2004 the terms of the financing agreement granted the private investor ownership of more than 90% of the company. The ownership share of Kollman and Carpenter correspondingly dwindled to about 3% each. In the wake of this disaster, Kollman and Carpenter were divorced, and Carpenter was replaced in 2005 as CEO of Cell Tech International. The business now operates under the trade name Simplexity Health.

Denial of the Applicability of *Thor Power*

The primary tax accounting issue involved in the *Kollman* case was the deductibility of its write-down of contaminated inventory. The government challenged the write-down of inventory as a matter of both fact and law, but the court held otherwise. For this reason, the case allows for a careful reconsideration of the extent of the Commissioner's authority to dictate inventory accounting methods and, by extension, tax accounting methods generally.

At first glance, the *Kollman* case seems to have a lot in common with *Thor Power*, described above. Both cases involved the write-down of inventory that was no longer of any practical use or value. In both cases, the inventory write-down was consistent with generally accepted accounting principles, which require annual adjustments for the purpose of carrying of inventory assets at the lower of cost or market value. Both cases invite the application of §471 of the IRC, which calls for the taking of inventory values on such basis as the Commissioner of Internal Revenue "may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income" (26 U.S.C. §471).

As viewed in light of this section of the IRC, both cases also draw attention to the subtle conflict between the best accounting practice (which, for financial reporting purposes, requires write-downs of inventory as a proper application of the lower of cost or market protocol within the principle of accounting conservatism), and the preferred IRS method, which disallowed write-downs of obsolete or contaminated inventory and which was supported by the United States Supreme Court in the *Thor Power* decision. Indeed, Professor W. Eugene Seago, a prominent tax scholar and expert on the legal implications and applications of *Thor Power* (a scholarly authority who has already been cited in this paper in connection with that case), personally provided expert testimony in the *Kollman* trial and argued that *Thor Power* effectively precluded a tax deduction for a write-down of contaminated algae inventory.

In the *Kollman* decision, however, the U.S. District Court in Oregon brushed aside the similarities between the case at hand and the *Thor Power* case by determining that there is a significant difference between substandard inventory and excess inventory. The district court judge pointed out that in *Thor Power*, the inventory was not defective, just surplus, so it still had value. After making this distinction, the court concluded that despite the many similarities, the *Thor Power* case did not apply, and was not determinative, in the *Kollman* matter.

Application of Treasury Regulation

As noted above, §471 of the IRC, which calls for the taking of inventory values on such basis as the Commissioner of Internal Revenue may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income. As is often the case, the government "prescribes" accounting methods for inventory and other items by issuing regulations.

Regulations issued in interpretation of IRC §471 include Treasury regulation 1.471-2 (26 CFR 1.471-2, 210), which requires that for devaluation of substandard goods on a tax return, a bona fide selling price must be established by evidence of actual offering prices for the goods within 30 days of the inventory date. No further guidance, such as how the goods may be offered for sale, or what kind of evidence is required in order to prove that the substandard goods were offered for sale, is provided in the regulation.

To make matters worse for the taxpayer, the taxpayer generally has the burden of showing the subnormal nature of the goods and maintaining records verifying its disposition (*Altec. Corp. v. Commissioner*, T.C. Memo. 1977-438, 1977).

In the *Kollman* case, the IRS asserted that there was no evidence that there was an actual offering of the contaminated inventory for sale within 30 days of the inventory date, i.e. within the last 30 days of the 1997 tax year or the 1998 tax year. Even though cell Tech attempted to give the algae away to local farmers, the company did not provide evidence of when this attempt to give away the raw algae to local farmers occurred. The IRS also observed that there was no actual attempt to try to sell the raw inventory outside of Oregon

Not that it would have mattered if Kollman and Carpenter could have provided timely evidence of their attempts to sell or give away the contaminated algae inventory. That is because there is another set of hurdles: even if a taxpayer is able to show that substandard inventory has been offered for sale in accordance with the regulations, and is able to provide evidence to the satisfaction of the government in this regard, the taxpayer is not necessarily entitled to deduct the write-down of the substandard inventory. The taxpayer must first qualify for using the lower of cost or market method of accounting for inventory, and, according to Treasury Regulation 1.471-2, must obtain permission from the Commissioner of Internal Revenue. In the *Kollman* case, the government argued that the company's effort to reevaluate the algae from a cost basis to a lesser of cost or market basis required prior consent from the government for a change in accounting method. Since such consent had not been requested or consented to by the IRS, the government argued that the taxpayer was not entitled under any circumstances to such a write-down.

The *Kollman* court responded to these hurdles by offering its own technical reading of the treasury regulation. The court observed that the regulation indicated that for defective or damaged raw inventory, the determination of value is any reasonable basis, taking into consideration the usability and the condition of the goods. In other words, the court inferred that the regulations provide for the reasonable valuation of raw materials, regardless of the method of accounting utilized for valuing finished products. As a result, the court determined that no change in accounting method was occurring, and so no permission was needed. In so doing, the court disregarded the government's claim that its prior permission to write-down the inventory would have been required, and allowed the deduction by the taxpayer.

HIGHLIGHTING THE NEED FOR GREATER OBJECTIVITY

<u>The Need to Avoid Second-Guessing Taxpayer Intentions for Obsolete Inventory</u>

The IRS arguments for the denial of a write-down deduction, based on the *Thor Power* decision, reveal a somewhat less than objective approach to its application. First, the IRS assumed that Cell Tech was effectively hedging its bets by purposefully maintaining excess or worthless inventory in the hope that such inventory would increase in value at a later date. That way, the IRS claimed, the company could wait to find out whether it could eventually find a way to recover much of the value and, if not, retroactively claim a deduction in past years (that is, in those prior years during which the company had made the choice to maintain the inventory in the first place).

In the *Thor Power* case, it appears that this in fact was the Corporation's strategy, to minimize costs of production the taxpayer produced and maintained a large inventory of small tools and replacement parts. It wrote down over 44,000 items of inventory for book and tax purposes for the portion of inventory that management concluded was "excess" inventory that could not be immediately sold. The taxpayer retained the excess items and continued to sell them, although management believed that some of the inventory would eventually remain unsold. The Supreme Court ultimately concluded that the taxpayer in that case could not deduct its excess inventory because it had not suffered a loss at the time it claimed a deduction for excess inventory. The taxpayer had intentionally manufactured excess spare parts, and maintained such spare parts "on hand, just in case," and the taxpayer could not claim a deduction without scrapping the goods that it contended that it could not sell instead of simply holding onto the inventory hoping it could use the inventory in the future.

In the *Kollman* case, even though the taxpayers held out hope that they would someday find a use for the contaminated inventory, the inventory was, nevertheless, just that: contaminated. As soon as the 1997 Oregon administrative ruling outlawed green algae with more than a trace amount of microcystin, the Cell Tech inventory became virtually worthless. In effect, the preliminary announcement of the forthcoming administrative ruling rendered the inventory worthless as early as 1996. There is nothing in the facts of the *Kollman* case that hints at the possibility of a management strategy of producing excess inventory in the hope of parlaying that inventory into some level of marginal profits. That may have been the strategy in *Thor Power*, but in the *Kollman* case the taxpayers were hit with a series of events, all of them completely out of the control of the taxpayers, that resulted in virtually worthless inventory. There was never a reliable indication of any kind that the contaminated algae would produce more than mere scrap value. From the perspective of management strategy and intent, then, there is no similarity between the *Kollman* case and *Thor Power*.

<u>The Need for Greater Regulatory Coherence Regarding Inventory Accounting Methods</u>

As described above, the Supreme Court in *Thor Power* observed that sections 446 and 471 of the IRC vests the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflecting income. The Court affirmed the lower court's decision, sustaining the Commissioner, that although the taxpayer's write-down of "excess" inventory did conform to the best accounting practice in the trade or business and thus satisfied one first test of the regulations, it nevertheless failed to clearly reflect the taxpayer's income. The Court stated that where a taxpayer, under the "lower of cost or market" method of accounting, values its inventory for tax purposes at "market" (replacement cost), the taxpayer is permitted to depart from replacement cost only in those specific specified situations set forth in the Treasury regulations. When such a departure to a lower inventory valuation is made, for example, the Treasury regulations require that it be substantiated by objective evidence of actual offerings, sales, or contract cancellations and further require that records of actual dispositions be kept. The Court concluded that because the taxpayer provided no objective evidence of the reduced market value of its excess inventory, its write-down was plainly inconsistent with the Treasury regulations and was properly disallowed by the Commissioner. The taxpayer could not have properly taken advantage of any permitted write-downs since it did not scrap its "excess" inventory nor sell or offer it for sale at prices below replacement cost (IRS Revenue Ruling 80-60, 1980).

The court in *Thor Power* did not analyze, critique, or offer any judicial review of the Treasury regulations under §471 of the IRC. It simply enforced them. Of course, the court could not have anticipated cases like the *Kollman* scenario where a taxpayer may not have elected (or perceived a need for) the lower of cost or market inventory accounting method prior to a catastrophic or unexpected situation that resulted in substandard inventory. Similarly, the Treasury Department could not have anticipated these kinds of circumstances when it drafted the regulation in the first place. But as a matter of principle, the Internal Revenue Service is not opposed to the lower of cost or market method of accounting for inventory; in fact, that method is a "permissible" method to which the IRS readily consents (IRS Rev. Proc. 2008-52, 2008).

As a consequence of the Treasury regulations under §471 of the IRC, as upheld by the US Supreme Court in the *Thor Power* decision, write-downs of substandard inventory are deemed to clearly reflect the taxpayer's income so long as the taxpayer has requested permission from the Internal Revenue Service to use the lower of cost or market method (to which the IRS readily consents if asked prior to its auditing the income tax return of the taxpayer). In other words, if the taxpayer requests permission to change to the lower of cost or market method of accounting on a Tuesday, and is audited the next day (Wednesday), this inventory method "clearly reflects income." But if the taxpayer is audited on Wednesday, and, upon realizing the need to change to the lower of cost or market method of accounting, requests permission to do so the next day (Thursday), the IRS will respond in the same manner as it did in the *Kollman* case. That is, the IRS will refuse permission to do so, and will pursue and conclude the audit of the taxpayer accordingly.

Similarly, if the taxpayer wishes to write-down the inventory value of substandard inventory, irrespective of the method of accounting, the regulations provide for such write-downs so long as the inventory in question involves raw materials or partly finished goods held for use or consumption. In such case, the taking of a tax deduction for such write-downs is deemed to be a clear reflection of income. If the inventory consists of something other than raw materials (or something other than partly finished goods held for use or consumption), such as raw materials that have gone through an initial processing step (and are not held for use or consumption by the taxpayer itself), then that initial processing somehow converts the inventory to a different category. In such case, the write-downs of substandard, partially processed materials (not held for use or consumption by the taxpayer itself) do not constitute a clear reflection of income under the regulations.

CONCLUSION

This paper has revisited the clear reflection of income standard as presented in the IRC and related regulations, in an effort to ascertain whether there are outer limits as to the authority of the Commissioner of Internal Revenue to prescribe taxpayer accounting methods. As part of our consideration of this issue, we discuss the clear reflection of income doctrine as it has evolved over time and examine the impact of recent judicial decisions – especially *Thor Power* and *Kollman* – on this standard in our effort to determine whether or not there may be need for revision on the law in this area.

This analysis has shown that the *Kollman* case, and in particular, the IRS objections to the write-downs of the contaminated inventory in that case, serve to highlight the lack of coherence in the Treasury regulations. This analysis has also shown that the determination as to whether substandard inventory is, on the one hand, merely "excess" inventory produced and held as a hedge against possible future price fluctuations, or, on the other hand, has suddenly become substandard for reasons entirely unrelated to management strategies, is a determination that involves second guessing by the IRS. The IRS is a government agency that is not necessarily equipped with the skills and insights required for such a determination in regard to the management challenges and tactics of privately held or publicly held business entities. The court in the *Kollman* case effectively required that when determining whether a taxpayer's accounting methods result in a clear reflection of income, the IRS should apply an objective standard that takes into account the facts and circumstances of each case, rather than a subjective or arbitrary standard that does not. In addition, the *Kollman* case reveals a certain level of incoherence and irrationality within the Treasury regulations. The case did not overturn those regulations, but the case does serve notice to the Treasury Department that those regulations ought to be revisited, reconsidered, and possibly rewritten.

Finally, the taxpayer victory in the *Kollman* case demonstrates that when the IRS interprets its own regulations too universally, too literally, and too strictly, it will lose. In other words, there in fact are limits to the discretion afforded the IRS in its effort to assert whether or not an accounting method constitutes a clear reflection of income, despite the seeming empowerment and authorization of the IRS's discretion granted by the *Thor Power* case. We conclude here that the Commissioner's authority to arbitrarily require specific methods of accounting is limited, and that the *Kollman* case serves as a helpful marker of the outer limits of such authority.

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