Unit I: Methods of Accounting

Part A: Introduction; Annual accounting with exceptions

Readings:

(1) McDaniel, McMahon, Simmons & Polsky, Federal Income Taxation (6th ed.): 169-72; 965-69 (up to part C); p. 1040 (Section 5-- up to Illustrative Material); 1043-1059 (up to part D); 1065-67 (Up to Illustrative Material). [For anybody using the prior 5th edition by McDaniel, McMahon, Simmons, & Abreu, the corresponding pages are: pp. 159-63; 787-91 (up to part C); 862 (Section 5)-863 (Up to Illustrative Material); 866-881 (up to part D); 887-88.]

(2) Rev. Rul. 93-75 available on Blackboard.

(3) Post-Taping Email Sent to Live Class: If I recall correctly, we discussed the Nacchio case during the first week of our class in connection with Section 1341. In this regard, note that the Court of Appeals rendered its opinion shortly after the end of our class. The appellate court disallowed the deduction, thereby negating the 1341 issue. The link to the case follows: http://www.ca7.uscourts.gov/sites/default/files/opinions-orders/15-5114.Opinion.6-8-2016.1.PDF.

Questions:

1. What was the problem faced by the taxpayer in Sandford & Brooks? Since the time of the case, a provision has been added to the Code to address such problem. What is such provision?

2. For which method or methods of accounting are each of the following taxpayers eligible?

   (A) Matt, an airline pilot, who balances his checkbook. (See §446; Reg. § 1.446-1(a)(1)-(2), (b)(2), (c)(1).)

   (B) The Reserve, a C corporation that runs an upscale spa and resort that currently has, and for at least three years has had, gross receipts of over $5 million per year. (See §§446, 448.)

   (C) The Chosen Few, a rock band that incorporated a few years ago and later hit it big; now it has, and for at least three years has had, gross receipts of over $5 million per year. (See id.)

3. The Chosen Few, a rock band, has decided to switch from the cash method to the accrual method. Under §446(e), (f), the band must secure the government’s consent to such change. Why do you think the
4. In May of year 2, Gail received a $500 refund from NYS on account of state income taxes that had been withheld during year 1 in excess of her state tax liability for year 1. In each of the following situations, will Gail be required to report income on account of the refunded state taxes? If so, when and in what amount? (See §111; Reg. §1.111-1(a), (b); Rev. Rul. 93-75 on Blackboard.)

(A) Gail didn't itemize her deductions in year 1; instead she took the standard deduction.

(B) Gail did itemize her deductions in year 1 (including the state income taxes withheld by her employer). In the aggregate, Gail's itemized deductions exceeded the standard deduction by many thousands of dollars.

(C) Gail did itemize her deductions in year 1. Her only itemized deduction was $5,000 of state income taxes withheld by her employer in year 1. The standard deduction for which she was eligible was $4,700.

5. In 2003, right after law school, David travels to Hong Kong and while there is measured for and pays for ten new suits. He claims a deduction on his 2003 taxes for the $1,000 he paid for the suits, which were supposed to be mailed to David by January 2004, at the very latest. The tailor didn't live up to his end of the bargain, and after many months of phoning the tailor, eventually in 1/2005 David recouped the $1,000 he had paid for the suits. The Service audits David in 6/2007, after the statute of limitations has run on David's 2003 return (when the payment was deducted), but before the statute of limitations has run on David's 2005 return (when the deducted payment was recovered). The revenue agent (correctly) determines that the 2003 deduction was improper. How should the Service proceed? How should David respond? (See MMSP 1052-53 [corresponding pages in 5th ed: 875-76].)

6. JB, a pro fisherman, won the $10,000 grand prize in the December 2006 fishing derby in Long Lake, Georgia for catching the largest small mouth bass in the derby. The prize money was wired to JB's account on 12/30/2006. In early 2007, while weighing and measuring the fish for the Guinness Book of World Records, the ichthyologist hired by Guinness
concluded the fish was not a small mouth bass, but was instead a close relative of the small mouth. Assume JB was contractually obligated to refund the prize money on discovery that his fish was not a small mouth and JB did in fact refund the money, but only after he had already filed his 2006 income tax return. When and how should JB account for the $10,000 repayment? (Assume JB’s marginal tax rate is the same --35% -- for both 2006 and 2007.) (See §1341; Reg. §1.1341-1(a), (b)(1); MMSP 1055-59 [corresponding pages in 5th ed: 877-81].)

7. Assume instead that JB ran out of luck on the pro fishing circuit in 2007 and was in the 25% tax bracket that year.
   (A) What problem would JB face absent §1341 and how does §1341 address such problem? (See id.)
   (B) If a deduction in this amount puts JB in a loss position, is he entitled to a refund? If so, how much? (See id.)

8. Same facts as the previous question except assume JB was not contractually obligated to refund the money. The derby rules are that the judge’s determination that the fish is a small mouth bass, made at the derby weigh in, is conclusive. To preserve his reputation on the pro fishing circuit, to ensure he would be invited back to the Long Lake derby in future years, and to protect his many lucrative sponsorships with fishing tackle companies, JB refunded the prize money. How, if at all, does your answer change? (See id.)

9. Same facts as question 6 but assume JB still believed that the fish was a small mouth bass. After conferring with his lawyer, JB’s best estimate was that he had a 40% chance of defending the derby’s claim seeking recovery of the prize money (stated otherwise, the derby had a 60% chance of success in enforcing its claim for refund). How, if at all, does your answer change? (See id.)

10. Which taxable years are permissible for the following taxpayers?
   (A) Matt, the airline pilot who balances his checkbook. (See §441(a), (b), (g).)
   (B) Christine’s Cookies, a C corporation that manufactures edible treats for pets and uses a fiscal year of September 1 through August 31 for its internal books. Because many pet owners feel guilty keeping their pets cooped up when it’s cold out, winter is Christine’s peak season. (See 441(b), (c), (e).)