

26 What's New Business

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What's New—2024 and Beyond

Related Topics

- What's New, Tab 1
- Inflation Adjusted Amounts chart, page 1-2
- Per Diem Rates, page 8-2
- Vehicle Depreciation Limitations (Section 280F), page 10-1

Beneficial Ownership Information

In 2021, Congress enacted the bipartisan Corporate Transparency Act to curb illicit finance. This law requires many companies doing business in the United States to report information about who ultimately owns or controls them.

Effective January 1, 2024, many companies in the United States must report information about their beneficial owners—the individuals who ultimately own or control the company—to the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury.

Filing is simple, secure, and free of charge. Beneficial ownership information reporting is not an annual requirement. Unless a company needs to update or correct information, a report only needs to be submitted once.

Who has to report? Companies required to report are called reporting companies. Reporting companies may have to obtain information from their beneficial owners and report that information to FinCEN.

A company may need to report information about its beneficial owners if it is:

- 1) A corporation, a limited liability company (LLC) (including single member LLCs disregarded for federal tax purposes), or was otherwise created in the United States by filing a document

with a secretary of state or any similar office under the law of a state or Indian tribe; or

- 2) A foreign company and was registered to do business in any U.S. state or Indian tribe by such a filing.

Who does not have to report? Twenty-three types of entities are exempt from beneficial ownership information reporting requirements, including publicly traded companies, nonprofits, and certain large operating companies.

How do I report? Reporting companies report beneficial ownership information electronically through FinCEN's website: www.fincen.gov/boi. The system provides a confirmation of receipt once a completed report is filed with FinCEN.

When do I report? FinCEN began accepting reports on January 1, 2024.

- If a company was created or registered prior to January 1, 2024, it will have until January 1, 2025 to report BOI.
- If a company is created or registered in 2024, it must report BOI within 90 calendar days after receiving actual or public notice that the company's creation or registration is effective, whichever is earlier.
- If a company is created or registered on or after January 1, 2025, it must file BOI within 30 calendar days after receiving actual or public notice that its creation or registration is effective.
- Any updates or corrections to beneficial ownership information that was previously filed with FinCEN must be submitted within 30 days.

For details on who must report and who does not need to report, go to the FinCEN website at www.fincen.gov/boi.

Author's Comment: Recent tax seminar speakers have stated it is risky for tax professionals to do this reporting for their clients. There could be potential preparer liability risks. Malpractice insurance carriers might exclude it from their coverage. Some also consider it to be a form of practicing law, which most tax preparers are not licensed to do. We suggest informing all affected clients about their responsibility to report, but make clear it is not a service we can provide. The fine for failure to report is \$500 per day up to \$10,000, and/or up to two years imprisonment. We also suggest including in your engagement letter a statement that you do not provide any beneficial ownership information reporting services.

Cost of Goods Sold is Mandatory

Cross References

- *Villa*, T.C. Memo. 2023-155

Deductions from gross income, such as for ordinary and necessary business expenses under IRC section 162(a) are a matter of legislative grace and are allowed only to the extent provided by statute. By contrast, the reduction of gross receipts by cost of goods sold is mandatory and not a matter of legislative grace. Only income is taxable under the Sixteenth Amendment to the Constitution. (*Doyle v. Mitchell Bros.*, U.S. Supreme Court, May 20, 1918) (Reg. §1.61-3(a), providing that gross receipts are reduced by cost of goods sold to arrive at gross income.)

Author's Comment: A good example of this is IRC section 280E which disallows deductions and credits for a taxpayer engaged in the illegal sale of drugs. While gross income from the illegal sale of drugs is taxable and related expenses are non-deductible, Congress does not have the right to disallow the reduction of gross receipts by the cost of goods sold.

The taxpayer in this case builds fences as a contractor. The IRS determined that the taxpayer had unreported income on the basis of a bank deposits analysis. The taxpayer only reported the income received that was reported to him on a Form 1099-MISC. He did not report any of the income received from customers who did not issue him a Form 1099-MISC.

The issue before the Tax Court was whether such unreported income could be offset by the costs of goods sold.

The court noted that if a taxpayer clearly shows that he incurred a deductible expense but is unable to substantiate the exact amount, the “*Cohan rule*” permits the court to estimate the amount of the expense, provided there is a reasonable basis for making such an estimate (*Cohan*, 2nd Circuit Court of Appeals, 1930). In making an estimate under the *Cohan* rule, the court “bears heavily if it chooses upon the taxpayer whose inexactitude is of his own making.” Further, while the *Cohan* rule by its terms applies to deductible expenses, the Tax Court has adapted it to estimate cost of goods sold as well. However, the court may not use the *Cohan* rule to estimate expenses covered by the strict substantiation requirements of IRC section 274(d), such as expenses for transportation, lodging, and meals.

The taxpayer testified that he used cash withdrawals to pay for both business needs and personal expenses. He did not specify what proportion of the withdrawals went towards business needs versus personal expenses. He provided a small amount of evidence indicating that he made modest cash payments to a fencing supply distribution company and large cash payments towards business-related accounts he held at building supply stores.

He also testified about the details of recent work he performed on one of his contracting jobs. He built an 81-foot fence using \$1,584 of materials and \$166 of contract labor, and the customer paid \$2,400. The taxpayer asked the court to use this sample job as a basis for estimating total cost of goods sold. He suggested that the job's 73% ratio between cost of goods sold and gross receipts can be used to fairly estimate total cost of goods sold.

While the court found the taxpayer's testimony credible and likely representative of the contracting work completed during the years in issue, it does not apply to the indeterminate portion of cash withdrawals used for personal expenses. In addition, it is unclear whether some portion of the estimated cost of goods sold might already have been included in labor or other expenses that were allowed by the IRS during the audit. The court stated such inexactitude will be held against the taxpayer under the *Cohan*

rule. As a result, the court allowed 50% of the cash withdrawals as cost of goods sold.

Safe Harbor Exception for Failure to File Correct Information Returns

Cross References

- TD 9984, December 19, 2023

The penalty for failure to file a correct information return under IRC section 6721 is \$250 for each return with respect to which such a failure occurs. The penalty is reduced to \$50 in lieu of \$250 if the failure is corrected on or before the 30th day after the required filing date. The penalty is reduced to \$100 in lieu of \$250 if the failure is corrected after the 30-day period but on or before August 1 of the year in which the required filing date occurs. The maximum penalty for all such failures during any calendar year cannot exceed \$3 million.

The IRS recently issued final regulations on the de minimis error safe harbor exceptions to penalties for failure to file correct information returns or furnish correct payee statements. The number of returns that the de minimis exception can apply to for any calendar year is limited to the greater of 10 or one-half of one percent of the total number of all information returns the filer is required to file during the year.

An error is considered to be de minimis if the difference between any single amount in error and the correct amount is not more than \$100. With respect to an amount of tax withheld, the difference between the error and the correct amount cannot be more than \$25.

This safe harbor exception does not apply if the person to whom the statement is required to be furnished (the payee) makes an election that the safe harbor not apply with respect to the statement. The payee must elect no later than the later of 30 days after the date on which the payee statement is required to be furnished, or October 15 of the calendar year. The payee must make the election by delivering the election in writing to the filer.

E-Filing Now Required for 10 or More Information Returns

Cross References

- <https://www.irs.gov/filing/e-file-forms-1099-with-iris>

The IRS is reminding businesses that file 10 or more information returns that they must be e-filed with the IRS starting with the 2023 tax year. In previous years, the e-file requirement threshold was 250 or more information returns. The 250-return threshold applied separately to each type of return. The new 10-return threshold applies to the combined total of all information returns that a business must file.

Information returns that fall under this requirement include Form W-2 that is e-filed with the Social Security Administration, as well as all Forms 1099 (Form 1099-MISC, *Miscellaneous Income*, Form 1099-NEC, *Nonemployee Compensation*, etc.).

Businesses can e-file any Form 1099 with the Information Returns Intake System (IRIS). This is a free, web-based filing system. To use this system, go to:

<https://www.irs.gov/filing/e-file-forms-1099-with-iris>

Businesses can also e-file information returns by using a third-party software or service.

Beneficial Ownership Reporting Ruled Unconstitutional

Cross References

- *National Small Business Association v. Yellen*, U.S. District Court, N.D. Ala., March 1, 2024

District Judge Liles C. Burke has ruled that the Corporate Transparency Act is unconstitutional because it cannot be justified as an exercise of Congress' enumerated powers. As a result, the plaintiffs in the case, all of the members of the National Small Business Association, are not subject to the new Beneficial Ownership Reporting Rules administered by the Financial Crimes Enforcement Network (FinCEN). The ruling only affects the plaintiffs in this case and does not apply to non-members who are otherwise subject to the Beneficial Ownership Reporting Rules.

The case will likely be appealed to 11th Circuit Court of Appeals. For beneficial ownership reporting rules, see *Beneficial Ownership Information*, page 26-1.

Poor Mathematical Skills is No Excuse for Failure to Pay Employment Taxes

Cross References

- *Taylor*, T.C. Memo. 2024-33

IRC section 6672(a) provides that any person required to collect, truthfully account for, and pay over any federal tax who willfully fails to do so shall be liable for a penalty equal to the total amount of that tax. A "responsible person" subject to this rule includes an officer or employee of a corporation who is under a duty to collect, account for, and pay over the tax. Whether someone is a responsible person is a matter of status, duty, and authority, not knowledge. The essential question is whether the person had sufficient control over a taxpayer's affairs to ensure the payment of the taxpayer's employment taxes. The indicia of that control held by a responsible person includes the holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees. In considering an individual's status, duty, and authority, the test is one of substance, and the focus of the inquiry does not involve a mechanical application of any particular list of factors. The inquiry must focus on the actual authority to control, not on trivial duties.

The taxpayer in this case was the company's chief executive officer (CEO) and sole shareholder. He had the authority to hire and fire employees and exercise control over the company's bank accounts.

The taxpayer testified that his successes in management consulting and other professional endeavors are attributable to his interpersonal skills. He claims to suffer from a learning disability with respect to mathematics, but he is otherwise competent to conduct his personal and business affairs. As a result of his poor mathematical skills, he hired and delegated many business and personal financial responsibilities to his employees and accountants, including a CPA named Robert Gard.

Over an unspecified period of years, Mr. Gard embezzled between one and two million dollars from the company. After the embezzlement scheme was discovered, the taxpayer hired attorneys and accountants to reconstruct the amount of losses sustained because of the embezzlement. The taxpayer eventually sued Mr. Gard and a bank to recover those losses.

The lawsuit was settled upon a \$175,000 payment to the company from an insurance company. A bank also settled the lawsuit by a payment of \$900,000 to the taxpayer. The taxpayer used portions of the settlement proceeds from both lawsuits to pay personal expenses. Apparently, none of the settlement proceeds from either lawsuit were used to pay any of the company's outstanding employment tax liabilities. The taxpayer also paid himself a bonus of over \$77,000 from company funds while the lawsuits were pending.

The IRS eventually named the taxpayer as a responsible person subject to the penalty under IRC section 6672 for failure to pay the company's employment tax liability.

In court, the taxpayer argued that because of his limited ability to comprehend mathematical concepts, he should not be a responsible person described in IRC sections 6671 and 6672. The IRS argued that because of his position, authority, and control over the company's affairs, he is a responsible person.

The court agreed with the IRS.

During the relevant periods, the taxpayer was the company's CEO and sole shareholder. He controlled the financial affairs of the company, disbursing corporate funds both to himself and to another newly formed business entity. He also exercised authority to hire and fire employees and delegated various tasks involved in operating the company to those employees. He apparently made the decision to sue Mr. Gard on the company's behalf. The taxpayer clearly had and exercised control over the company's corporate affairs.

The taxpayer pointed to his difficulties comprehending mathematical concepts and notes that he hired others, including Mr. Gard, to take responsibility for the company's bookkeeping and tax matters. As the taxpayer views the matter, the failure to pay the company's employment taxes results from Mr. Gard's embezzlement, not from anything the taxpayer did or failed to do. Relying heavily on these reasons, he argued that he should not be held liable as a responsible person for the company's employment taxes.

The court stated the focus, however, is on the taxpayer's authority to control the company's obligations to pay its employment taxes, not on whether he personally took responsibility for that duty.

Considering his position with the company and taking into account his decisions to disburse company funds to pay for items other than the employment tax liabilities, the court ruled that the taxpayer was a responsible person under IRC section 6672 for purposes of the company's outstanding employment tax liabilities.

Transfer of Certain Credits

Cross References

- IRC §6418, *Transfer of certain credits*
- TD 9993, April 30, 2024

Effective for tax years beginning after December 31, 2022, eligible taxpayers may elect to transfer their eligible credits to a transferee taxpayer which is not related to the eligible taxpayer. Under this election, the transferee taxpayer claims the credit rather than the eligible taxpayer that originally qualified for the credit.

For any amount paid by a transferee taxpayer to an eligible taxpayer as consideration for a transferred credit, such consideration must be paid in cash, is not includible in gross income of the eligible taxpayer, and not deductible by the transferee taxpayer.

If a partnership or S corporation makes this election with respect to the credit:

- Any amount received as consideration for a transfer is treated as tax exempt income for purposes of IRC section 705 and 1366, and
- A partner's distributive share of such tax exempt income is based on the partner's distributive share of the otherwise eligible credit for each tax year.

The election is made at the partnership or S corporation level.

An eligible taxpayer is any taxpayer other than a taxpayer described under IRC section 6417(d)(1)(A) (tax exempt organizations, state or political subdivisions, the Tennessee Valley Authority, Indian tribal governments, Alaska Native Corporations, and cooperatives engaged in furnishing electric energy to persons in rural areas).

Final regulations. In April of 2024, the IRS issued final regulations on the application of the transfer of certain credits rules under IRC section 6418. The final regulations define the term "eligible credits" to mean the following 11 credits:

- The alternative fuel vehicle refueling property credit under IRC section 30C,
- The renewable electricity production credit under IRC section 45,
- The carbon oxide sequestration credit under IRC section 45Q,
- The zero-emission nuclear power production credit under IRC section 45U,
- The clean hydrogen production credit under IRC section 45V,
- The advanced manufacturing production credit under IRC section 45X,
- The clean electricity production credit under IRC section 45Y,
- The clean fuel production credit under IRC section 45Z,
- The energy credit under IRC section 48,
- The qualifying advanced energy project credit under IRC section 48C, and
- The clean electricity investment credit under IRC section 48E.

The purpose of the transfer of certain credits provision is similar to the clean vehicle credit provision that allows a taxpayer purchasing an electric car to transfer the credit to the dealership in exchange for a reduced purchase price. Under the transfer of certain credits provision, a partnership could purchase property eligible for one of the energy credits and elect to transfer the credit to the seller in exchange for a reduced purchase price rather than having to pass through the credit to the partners.

The final regulations provide guidance on:

- The mandatory information and registration requirements for transfer elections,
- The definition of an applicable entity,
- The definition of an eligible taxpayer,
- The definition of eligible credit property,
- The definition of the term "paid in cash," and
- The definition of the term "specified credit portion."

The final regulations also provide general rules on the specifics of how to make a transfer election and the transfer election statement that must be attached to the taxpayer's tax return.

The final regulations also include special rules related to excessive credit transfers and recapture events. They also provide rules for a mandatory IRS pre-filing registration process through an electronic portal and describe specific rules for partnerships and S corporations as eligible taxpayers and transferee taxpayers.

See the final regulations for details.

Obligation to Redeem Shares is Not a Liability

Cross References

- *Connelly*, U.S. Supreme Court, June 6, 2024

The value of an estate for estate tax purposes equals the gross estate minus liabilities of the estate at the time of the decedent's death. In this case, the executor argued that the corporation's obligation to redeem the shares of a deceased shareholder were a liability that reduced the value of the corporation's stock and thus reduced the value of the decedent's stock in the corporation.

Two brothers were the sole shareholders in Crown C Supply, a small building supply corporation. The brothers entered into an agreement to ensure that Crown would stay in the family if either brother died. Under that agreement, the surviving brother would have the option to purchase the deceased brother's shares. If he declined, Crown itself would be required to redeem the shares.

To ensure that Crown would have enough money to redeem the shares if required, it obtained \$3.5 million in life insurance on each brother. After one brother died, the surviving brother elected not to purchase his brother's shares, thus triggering Crown's obligation to do so.

The deceased brother's son and the surviving brother agreed that the value of the deceased brother's shares was \$3 million, and Crown paid that amount to the deceased brother's estate. The executor then filed a federal estate tax return which reported the value of the decedent's shares as \$3 million.

The IRS audited the estate return. During the audit, the executor obtained a valuation from an outside accounting firm. That firm determined that Crown's fair market value at the time of death was \$3.86 million, an amount that excluded the \$3 million in insurance proceeds used to redeem the decedent's shares on the theory that their value was offset by the redemption obligation.

Because the decedent had held a 77.18% ownership interest in Crown, the analyst calculated the value of his shares as approximately \$3 million ($\$3.86 \text{ million} \times 0.7718$). The IRS disagreed. It insisted that Crown's redemption obligation did not offset the life-insurance proceeds, and accordingly, assessed Crown's total value as \$6.86 million ($\$3.86 \text{ million} + \3 million). The IRS then calculated the value of the decedent's shares as \$5.3 million ($\$6.86 \text{ million} \times 0.7718$).

Based on this higher valuation, the IRS determined that the estate owed an additional \$889,914 in taxes. The estate paid the deficiency and the executor sued the United States for a refund. The District Court granted summary judgment to the government. The court held that, to accurately value the decedent's shares, the \$3 million in life-insurance proceeds must be counted in Crown's valuation. The Eighth Circuit Court of Appeals affirmed.

The U.S. Supreme Court ruled that a corporation's contractual obligation to redeem shares is not necessarily a liability that reduces a corporation's value for purposes of the federal estate tax.

When calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value. And, life-insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value. The question here is whether Crown's contractual obligation to redeem the decedent's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption. The answer is no.

Because a fair-market-value redemption has no effect on any shareholder's economic interest, no hypothetical buyer purchasing the decedent's shares would have treated Crown's obligation

to redeem his shares at fair market value as a factor that reduced the value of those shares. At the time of the deceased brother's death, Crown was worth \$6.86 million—\$3 million in life-insurance proceeds earmarked for the redemption plus \$3.86 million in other assets and income-generating potential. Anyone purchasing the decedent's shares would acquire a 77.18% stake in a company worth \$6.86 million, along with Crown's obligation to redeem those shares at fair market value.

A buyer would therefore pay up to \$5.3 million for the decedent's shares ($\$6.86 \text{ million} \times 0.7718$)—i.e., the value the buyer could expect to receive in exchange for the decedent's shares when Crown redeemed them at fair market value.

Crown's promise to redeem the decedent's shares at fair market value did not reduce the value of those shares. The executor's efforts to resist this straightforward conclusion fail. He views the relevant inquiry as what a buyer would pay for shares that make up the same percentage of the less-valuable corporation that exists after the redemption. For calculating the estate tax, however, the whole point is to assess how much the decedent's shares were worth at the time that he died—before Crown spent \$3 million on the redemption payment. [IRC §2033]

A hypothetical buyer would treat the life-insurance proceeds that would be used to redeem the decedent's shares as a net asset.

The executor's argument that the redemption obligation was a liability also cannot be reconciled with the basic mechanics of a stock redemption. He argues that Crown was worth only \$3.86 million before the redemption, and thus that the decedent's shares were worth approximately \$3 million ($\$3.86 \text{ million} \times 0.7718$). But he also argues that Crown was worth \$3.86 million after the decedent's shares were redeemed. Both cannot be right: A corporation that pays out \$3 million to redeem shares should be worth less than before the redemption.

Finally, the executor asserts that affirming the decision of the court will make succession planning more difficult for closely held corporations. But the result here is simply a consequence of how the brothers chose to structure their agreement.

Shoebox Method Does Not Substantiate a Deduction

Cross References

- *Wright*, T.C. Summary 2024-9

The taxpayers owned an S corporation and a couple of Schedule C businesses. After an audit, the IRS allowed some deductions for each business and disallowed other deductions. In court, the taxpayers were asked to provide evidence that the disallowed deductions were ordinary and necessary business expenses, that the full amount reported was paid, and that any special requirement was satisfied. For example, a deduction for a business meal requires the names of all attendees at the business meal and the purpose for the business meal. The court suggested that the taxpayers prepare a spreadsheet listing the disputed deductions, and where in the record the court could find such evidence substantiating the disputed deductions.

The taxpayers provided the court with 44 exhibits that contained 1,882 pages. Those pages reproduced thousands of photocopied bills, receipts, and other claimed evidence of payments. Some of the photocopies showed handwritten annotations on the copied document. Some of the exhibits contained copies of adding machine tapes, although many of those tapes were only partially complete.

By the conclusion of the trial, the court noted it was clear that the taxpayer's thousands of individual receipts and other evidence of payments were insufficient by themselves to prove that they had incurred any amount greater than what the IRS allowed.

Questions arose about the genuineness of certain meal checks and credit card receipts offered as evidence for business meal deductions. For example, the taxpayer would add the tip, sign the document, give the restaurant its copy, and keep the copy he had annotated as a business record. However, some deductions for meals appeared to be the same meal charge (total for food, beverage, and tax) with both an itemized meal check received from the restaurant and a copy of a credit card receipt, except that the meal check and the corresponding receipt listed different attendees and different tip amounts for the same meal charge.

In another example, the taxpayers provided documents to support their cost of goods sold deduction, which comprised 47 pages reproducing more than 100 photocopied receipts from various vendors and included adding machine tapes copied to the first page of the exhibit to substantiate the sum of \$8,614. However, the adding machine tapes only added up to \$4,411.

Other inconsistencies were pointed out by the court in the pages submitted as purported evidence to substantiate the deductions in dispute.

The court stated, in support of the taxpayer's claim that they have adequately substantiated the deductions that the IRS disallowed, the taxpayers have presented us with just the situation we told them to avoid. They offer a hodgepodge of receipts that left the IRS unconvinced. They ask us to accept the receipts, bundled into separate exhibits for each disallowed expense, as substantiation that they spent some stated amount for the disallowed expense and that the expenditure constituted an ordinary and necessary business expense for the related activity.

The court stated the taxpayer's approach brings to mind the shoebox method of presenting evidence. The shoebox method is the unacceptable method of attaching photocopies of numerous cash register tapes and of similar bits of paper to the taxpayer's return, without making any effort to link any item to a deductible trade or business expense transaction.

The court stated we will not undertake the task of sorting through the voluminous exhibits the taxpayers have provided in an attempt to see whether they have provided adequate substantiation to counter the IRS's adjustments. The court did not accept the taxpayer's exhibits as evidence substantiating the business expenses that were disallowed by the IRS.

New Self Employment Tax Credit Scam

Cross References

- IR-2024-187

The Internal Revenue Service has issued a consumer alert following bad advice circulating on social media about a non-existent "Self Employment Tax Credit" that's misleading taxpayers into filing false claims.

Promoters and social media are marketing something they describe as the "Self Employment Tax Credit" as a way for self-employed people and gig workers to get big payments for the COVID-19 pandemic period. Similar to misleading marketing around the Employee Retention Credit, there is inaccurate information suggesting many people qualify for the tax credit and payments of up to \$32,000 when they actually do not.

In reality, the underlying credit being referred to in social media isn't called the "Self Employment Tax Credit," it's a much more limited and technical credit called Credits for Sick Leave and Family Leave. Many people simply do not qualify for this credit, and the IRS is closely reviewing claims coming in under this provision so people filing claims do so at their own risk.

“This is another misleading social media claim that’s fooling well-meaning taxpayers into thinking they’re due a big payday,” said IRS Commissioner Danny Werfel. “People shouldn’t be misled by outlandish claims they see on social media. Before paying someone to file these claims, taxpayers should consult with a trusted tax professional to see if they meet the very limited eligibility scenarios.”

People who were self-employed can claim Credits for Sick and Family Leave only for limited COVID-19 related circumstances in 2020 and 2021; the credit is not available for 2023 tax returns. The IRS is seeing repeated instances where taxpayers are incorrectly using Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*, to incorrectly claim a credit based on income earned as an employee and not as a self-employed individual.

To qualify for the Sick and Family Leave Credits, self-employed workers have to meet a variety of technical reasons in 2020 and 2021 that didn’t allow them to work, including caring for an individual subject to a quarantine or isolation order.

The IRS is seeing some similarities to marketing around this “Self Employment Tax Credit” similar to aggressive promotion of the Employee Retention Credit. Both are technical credits that have been mischaracterized by some as a way for average taxpayers to get a big government payment. In reality, these are very limited credits that have a variety of complex requirements before people can qualify.

The IRS urges people to check with a trusted tax professional before filing for any “Self Employment Tax Credit” or any other questionable tax claim circulating on social media.

The IRS has previously warned taxpayers about misuse of the Sick and Family Leave Credits stemming from various tax scams and inaccurate social media advice that led thousands of taxpayers to file inflated refund claims during the past tax season.

In addition to the Sick and Family Leave Credit, the IRS warned taxpayers not to fall for these scams centered around the Fuel Tax Credit and household employment taxes. The IRS has seen thousands of dubious claims come in where it appears taxpayers are claiming credits for which they are not eligible, leading to refunds being delayed and the need for taxpayers to show they have legitimate documentation to support these claims.

The IRS continues to urge taxpayers to avoid these scams as myths continue to persist that these are ways to obtain a huge refund.

“These improper claims have been fueled by social media and people sharing bad advice,” Werfel said. “Scam artists constantly prey on people’s hopes and try to use the complexity of the tax system to convince people there are secret ways to get a big refund. All of these scams illustrate that it’s important to carefully review the tax return for accuracy before filing and rely on the advice of a trusted tax professional, not someone trying to make a quick buck or a questionable source on social media.”

Multi-Factor Authentication Now Required for Tax Professionals

Cross References

- IR-2024-201

The Internal Revenue Service is reminding tax professionals that using multi-factor authentication is now more than just an important protection for their businesses and their clients—it’s now a federal requirement.

All tax professionals are now required under the Federal Trade Commission’s safeguards rule to use multi-factor authentication, or MFA, to protect clients’ sensitive information. The June 2023 change mandates MFA to strengthen account security by

requiring more than just a username and password to confirm an identity when accessing any system, application, or device.

“Multi-factor authentication is now more than just a good idea for tax professionals; it’s a requirement,” said IRS Commissioner Danny Werfel. “This is an effective way to increase security and protect tax professionals and their clients from a data breach. Multi-factor authentication is a little like a deadbolt on a door; it’s additional security supplementing the doorknob lock. This is an important step to protect not just tax professionals and their firms, but also the sensitive taxpayer information from their clients.”

In upcoming weeks, news release series and the IRS Tax Forums will provide timely tips to help protect sensitive taxpayer data that tax professionals hold while also protecting their own businesses from identity thieves.

A key part of tax pro security now revolves around MFA. The extra layers of different authentication factors include something only a user knows, like a username and password; something they have, like a token or random number sequence sent to their cell phone; or something unique, like biometric information. These provide extra assurance that a tax pro’s client, not an impostor, is gaining access.

The Summit partners noted that implementing MFA is one of the most cost-effective ways to increase security and reduce a tax pro’s fraud and data breach risks. Once in place, MFA helps protect against phishing, social engineering and other types of technology attacks that exploit weak or stolen passwords.

Common MFA Examples

The general public makes wide use of MFA these days, so tax pro clients shouldn’t be surprised by the extra scrutiny asked of them.

For example, many smartphone users are accustomed to fingerprint or facial recognition that authenticates their identity before unlocking their device. Certain smartphone applications can also rely on that biometric factor along with a PIN or password for app-level MFA.

Many online banks, financial applications, and payroll services use MFA to verify account holders’ identities before granting access or allowing high-risk transactions, such as money transfers.

In addition, taxpayers connecting to the IRS will be asked to set up MFA to create an IRS Online Account. After that, to sign in, they will first log in with an email address and password, then receive a one-time passcode by text or call to one’s chosen device and finally enter the passcode into the account to complete sign-in. A bad actor cannot access one’s account without also having their passcode.

MFA required by law. Under the new FTC MFA rules, there’s a requirement to use at least two of the following factors for anyone accessing customer information: something a user knows like a username; something sent to them like numbers texted to a cell phone; or a physical part of them like a fingerprint or facial scan.

In addition, MFA should be used to secure client information on a tax pro’s computer or network, but it should also be used to access client information stored within their tax preparation software. MFA is required by law for all companies—not just tax professionals. The size of the company does not matter. Opting out of using MFA in tax prep software is a violation of the FTC safeguards rules.

Best implementation practices. Tax pros should implement MFA across all their services and data access points.

In addition, they should regularly evaluate current MFA methods, standards and new technologies to stay protected against the latest threats, and they should offer a variety of authentication factors to suit the needs of different users.

Finally, tax pros should always enable MFA within tax software products and cloud storage services containing sensitive client data, and they should never share usernames.

Additional resources. If a tax pro or their firm are the victim of data theft, they should:

- Report the incident to their local IRS Stakeholder Liaison. Speed is critical. IRS stakeholder liaisons will ensure all the appropriate IRS offices are alerted. If reported quickly, the IRS can take steps to block fraudulent returns in the clients' names and assist tax pros through the process.
- Visit the Federation of Tax Administrators to find state contact information. Tax professionals can share information with the appropriate state tax agency by visiting the special Report a Data Breach.
- Review IRS Publication 5293, *Data Security Resource Guide for Tax Professionals*, which provides an overview and resources about how to avoid data theft.
- Tax professionals can also get help with security recommendations by reviewing IRS Publication 4557, *Safeguarding Taxpayer Data*, and the IRS' Identity theft information page for tax pros.
- Read *Small Business Information Security: The Fundamentals*, by the National Institute of Standards and Technology.

Tax professionals should also stay connected to the IRS through subscriptions to e-News for tax professionals and its social media sites.

Unauthorized Distributions Do Not Create a Second Class of Stock

Cross References

- *Maggard*, T.C. Memo. 2024-77

IRC section 1361(b)(1)(D) allows a corporation to be an S corporation only if it has no more than one class of stock. That code section doesn't say what that means, but the regulations do state that a corporation has only one class of stock so long as all the shares confer equal rights to dividends and liquidation proceeds. The regulations also state that identical rights to distributions and liquidation proceeds are determined based on the corporation's governing provisions, such as a corporate charter, articles of incorporation, and bylaws. The IRS has stated it won't treat any disproportionate distributions made by a corporation as violating the one-class-of-stock requirement if the governing provisions provide for identical rights. (Rev. Proc. 2022-19)

The taxpayer in this case was an innovator and inventor with special talents in chemical engineering. He used his knowledge to form an engineering group with a friend who was an investor, and organized their company as an S corporation.

In July of 2003, the investor sold his interest to Maggard and left the company. Maggard then sold a 60% interest to two individuals, LL and WJ.

LL and WJ joined the board of directors and took on executive roles. Maggard remained the company's lead engineer.

By 2005, Maggard owned 40% of the company, LL owned 40%, and WJ owned the remaining 20%. Per the company's governing documents, each was entitled to a proportionate share of distributions. The three men never changed the S corporation's articles of incorporation or its bylaws to allow for disproportionate distributions or liquidation rights under this new regime.

LL almost immediately began to misappropriate funds by inflating reimbursements for his expense accounts. He and WJ also began a process of making disproportionate distributions of the company's earnings to themselves at the expense of Maggard.

LL also stopped filing Form 1120S, *U.S. Income Tax Return for an S Corporation*, with the IRS as the company's CFO. He also stopped sending Schedules K-1 (Form 1120S) to Maggard.

By 2012 Maggard had caught on to LL and WJ and hired a CPA to reconcile the corporation's accounts. They discovered that LL overdistributed \$160,800 from the corporation to himself. They also discovered that LL failed to distribute nearly \$165,000 of profits to Maggard, to whom it was owed. Maggard eventually accused LL and WJ of embezzling more than \$1 million from the company which include an estimated \$250,000 in 2012 and \$300,000 in each of 2013, 2014, and 2015. A state court settlement was eventually reached.

Maggard also filed a tax court petition arguing that LL and WJ were looting the company when they made unauthorized and grossly unequal distributions to themselves. He claimed that the unauthorized unequal distributions created a second class of stock which should have revoked the S corporation status, causing the corporation to be taxed as a C corporation. The IRS argued that doesn't matter, because the regulation tells the IRS to focus on shareholder rights under a corporation's governing documents, not what shareholders actually do.

The tax court agreed with the IRS. The court stated it recognizes that this can create a serious problem for a taxpayer who winds up on the hook for taxes owed on an S corporation's income without actually receiving his just share of its distributions. This is especially problematic when the taxpayer relies on the S corporation distributions to pay these taxes. Worse yet is when a shareholder fails to receive information from the corporation that he needs to accurately report his income.

The court ruled that income from the corporation flowed through to Maggard, and the S corporation is not subject to taxation as a C corporation. Maggard must include in income for these years the proportionate share of the corporation's income despite the disproportionate distributions made to LL and WJ at Maggard's expense.

FinCEN BOI Scam Alert

Cross References

- <https://fincen.gov/boi>

Alert: FinCEN has learned of fraudulent attempts to solicit information from individuals and entities who may be subject to reporting requirements under the Corporate Transparency Act.

These fraudulent scams may include:

- Correspondence requesting payment. There is NO fee to file BOI directly with FinCEN. FinCEN does NOT send correspondence requesting payment to file BOI. Do not send money in response to any mailing that claims to be from FinCEN or another government agency.
- Correspondence that asks the recipient to click on a URL or to scan a QR code. Those e-mails or letters are fraudulent. Do not click any suspicious links or attachments or scan any QR codes in emails, on websites, or in any unsolicited mailings.
- Correspondence that references a "Form 4022," or an "Important Compliance Notice." This correspondence is fraudulent. FinCEN does not have a "Form 4022." Do not send BOI to anyone by completing these forms.
- Correspondence or other documents referencing a "United States Business Regulations Department" This correspondence is fraudulent; there is no government entity by this name.

Prior Year Depreciation Does Not Establish Basis Under Cohan Rule

Cross References

• *Pak*, T.C. Memo. 2024-86

Under the *Cohan* rule, if a taxpayer demonstrates that he or she actually incurred a trade or business expense but is unable to adequately substantiate the amount, the court should estimate the amount and allow a deduction to that extent. To estimate a deduction, the court must have some reasonable evidentiary basis upon which to form the estimate. The court should make as close an approximation as it can, bearing heavily upon the taxpayer “whose inexactitude is of his own making.” (*Cohan*, 2nd Circuit Court of Appeals, 1930)

The taxpayer in this case had little to no records. He owned and operated a Japanese steak house restaurant. Both the taxpayer and IRS agreed that it was a “high end” restaurant with hibachi grills, a 25-foot-long sushi bar, and a 16-foot-long martini bar.

The restaurant commenced operations in 2008 in a shopping mall leased space that required substantial, custom “build-out” real property improvements. The improvements were permanent and would be retained by the mall owner in the event the lease ended.

The taxpayer contended that he paid \$1,150,000 for the build-out improvements, and \$400,000 for the purchase and installation of the hibachi tables. He also claimed he paid \$100,000 for other fixtures and equipment, including the sushi bar, martini bar, tables, chairs, and kitchen equipment.

At the time of the tax court trial, the taxpayer did not have records to substantiate these expenditures. However, on his federal income tax return for the 2008 tax year, Form 4562, *Depreciation and Amortization*, was attached which included 7-year property with a basis of \$285,000 and nonresidential real property with a basis of \$1,380,000, both being placed in service in that year. The 2008 return claimed a \$14,605 depreciation deduction.

The taxpayer’s 2009 tax year claimed a \$113,903 depreciation deduction. A paid preparer prepared the taxpayer’s 2008 and 2009 tax returns.

The taxpayer untimely filed his tax returns for tax years 2010 through 2012. He did not use a paid preparer for 2010 or 2011. A depreciation deduction of \$2,411 was claimed on his 2010 return and no depreciation deduction was claimed for 2011.

A CPA prepared his 2012 tax return on which no depreciation deduction was claimed.

The taxpayer failed to file returns for tax years 2014 through 2016. The IRS prepared substitute returns for those years in which no depreciation deductions were claimed.

On January 31, 2018, the IRS issued a Notice of Deficiency to the taxpayer for tax years 2010 through 2012 and tax years 2014 through 2016. After receiving the Notices, the taxpayer hired a CPA to evaluate his tax liabilities for those years. In August of 2018, the CPA prepared and submitted to the IRS amended returns in which additional depreciation deductions were claimed in the amount of \$190,106 for 2010, \$160,679 for 2011, and \$137,171 for 2012. The CPA computed those depreciation amounts by extrapolating from the basis figures that was reported on the taxpayer’s 2008 tax return for property placed in service in that year. He did not independently investigate any records supporting the basis figures reported on the 2008 return.

In November of 2018, the CPA prepared Form 1040 returns for the 2014 through 2016 tax years and claimed depreciation deductions of \$121,173 for 2014, \$106,866 for 2015, and \$155,265 for 2016. The CPA computed those amounts in the same manner as with the 2010 through 2012 amended returns.

The IRS did not accept any of the amended returns for tax years 2010 through 2012 or the Form 1040 returns for the 2014 through 2016 tax years.

In court, the taxpayer argued that the IRS accepted his 2008 tax return which contained the correct basis of the property placed in service in that year in which depreciation was claimed, and that the court should invoke the *Cohan* rule to allow the depreciation at issue for tax years 2010 through 2012, and 2014 through 2016.

The court stated it was satisfied that the taxpayer had shown that he incurred expenditures giving rise to the depreciation deduction claimed in 2008, and the IRS did not dispute that the taxpayer incurred expenses in that year to make the build-out improvements. The IRS also conceded that the taxpayer’s restaurant was a “high end” restaurant and that it had a 25-foot-long sushi bar and a 16-foot-long martini bar, and that it commenced operations in 2008. Thus, according to the court, the taxpayer had shown that he was entitled to some deduction, as he acquired real and personal property in building out a shell structure and furnishing it in a manner that was sufficient to commence operation of the restaurant in 2008. Such property had a useful life extending to some or all of the tax years at issue in this case.

The court noted that the IRS accepted the taxpayer’s 2008 return as filed, and that the statute of limitations had expired for that year. Thus, the IRS is now bound by those basis figures for purposes of the taxpayer’s 2008 federal income tax liability. However, those figures do not bind the IRS, or otherwise establish the taxpayer’s depreciable basis for purposes of the later years that are at issue in this case. Instead, the court must examine the facts pertaining to the 2008 tax liability as may be necessary to correctly re-determine any deficiency for the tax years 2010 through 2012, and 2014 through 2016 (the years at issue in this case).

The court stated a tax return itself does not establish the truth of the matters. The court is unwilling to attach significance to a taxpayer’s prior year returns to establish a basis estimate under the *Cohan* rule “in the absence of corroborating evidence.” In this case, there is evidence to corroborate the basis figures claimed on the 2008 return; namely, the undisputed fact that the taxpayer undertook the build-out of a shell structure into a “high end” restaurant that commenced operations in 2008. The 2008 return was prepared by a paid return preparer. While the return preparer was under no obligation to verify the amounts the taxpayer indicated that he had paid to create the nonresidential real property and 7-year property associated with the restaurant, the court stated it believes the figures nonetheless constitute roughly contemporaneous estimates by the taxpayer of the amounts expended.

The figures on the 2008 return appear reasonable. They did not attract the IRS’s attention and trigger and audit, nor do they appear unreasonable for a restaurant with its reported gross receipts for that year.

Nevertheless, the court stated the most that can be said for the basis figures on the 2008 return is that they are unsubstantiated estimates. And under the *Cohan* rule, the court “makes as close an approximation as it can, bearing heavily upon the taxpayer whose inexactitude is of his own making.”

The court ruled the taxpayer was entitled to depreciation deductions for the years at issue based upon one-half the basis amounts that were reported on the 2008 return.

Author’s Comment: This case illustrates the importance of retaining records for closed tax years when those records are needed to substantiate carry forward items to future tax years, such as depreciation, capital loss carry forwards, business credit carry forwards, the non-deductible basis in an IRA, and NOL carry forward deductions. The tax return itself does not establish the basis of items that are carried forward.

New Form 7217 for Partnership Distributions

Cross References

- Form 7217, *Partner's Report of Property Distributed by a Partnership*
- IRC §732, *Basis of distributed property other than money*

A current distribution from a partnership to a partner is any distribution that does not completely retire a partner's interest in the partnership. A current distribution can either reduce the partner's capital account or can reduce the partner's ownership interest in the partnership.

Gain will not be recognized by a partner in a current distribution unless money is distributed. Gain is recognized only if the amount of money received exceeds the partner's adjusted basis in the partnership.

A partner's basis for property (other than money) received in a current distribution is the partnership's adjusted basis in the property. The property's basis is limited to the partner's adjusted basis in the partnership reduced by any money received in the same transaction. [IRC §732(a)]

A liquidating distribution retires a partner's interest in the partnership. A series of payments made as part of a liquidation plan are all treated as liquidating distributions. A partner will recognize gain on a liquidating distribution to the extent that money distributed exceeds the partner's adjusted basis in his or her partnership interest.

A loss on a liquidating distribution can be recognized if cash, unrealized receivables, or inventory items are received by the partner, and the total amount received is less than the partner's adjusted basis. If any other property is distributed to the partner, the partner cannot recognize a loss. The partner's entire interest in the partnership must be liquidated to recognize a loss on the distribution.

Beginning for tax year 2024, Form 7217, *Partner's Report of Property Distributed by a Partnership*, must be filed by any partner receiving a distribution of property from a partnership in a non-liquidating or liquidating distribution to report the basis of the distributed property, including any basis adjustment to such property as required by IRC section 732(a)(2) or (b). The form must be filed regardless of whether there is a basis adjustment in the hands of the partner as a result of the distribution.

Form 7217 is not filed if the distribution consisted only of money or marketable securities treated as money. Also, a partner should not file Form 7217 to report payments for services under IRC section 707 (guaranteed payments) or for transfers that are treated as disguised sales.

Form 7217 must be attached to the partner's tax return for the tax year the partner actually received (not constructively received) distributed property subject to IRC section 732.

Cohan Rule Not Allowed If Taxpayer Could Have Produced Documentation

Cross References

- *Anderson*, T.C. Memo. 2024-95

When a taxpayer fails to keep records of his deductible expenditures, the tax court has discretion in appropriate circumstances to estimate those expenditures where there is evidence that deductible expenses were incurred. (*Cohan*, 2nd Circuit Court of Appeals, 1930)

However, where the evidence presented at trial is insufficient to support the deductibility of a particular expense, the tax court must sustain the IRS's determinations and disallow the deduction. (*Rogers*, T.C. Memo. 2014-141)

The taxpayer in this case was self-employed, engaged in a number of various businesses. Each entity was registered as an LLC and disregarded for federal income tax purposes. For the tax years at issue, the taxpayer failed to file any income tax returns. The IRS prepared substitute returns and issued notices of deficiencies.

The taxpayer then petitioned the tax court and submitted to the IRS income tax returns for each year at issue. The IRS did not process the returns.

To substantiate his reported expenses, the taxpayer submitted to the IRS and the tax court a 218 page accounting ledger, divided into seven sections, one for each of his seven business entities. The taxpayer did not claim that the accounting ledgers were original accounting records, but rather, "likely the mix up of more than a dozen unsuccessful attempts [to reconstruct each described document] from multiple electronic files emailed [to the IRS]." The two documents providing the particulars of each entity's alleged expenditures are the Cash Disbursements Journal and the Account Register.

The Cash Disbursements Journal lists expenditures day by day, referencing a date, a check number or account number, payee, a description, and an amount. The Account Register shows cash disbursements by payee, grouping the year's disbursements to the payee. The taxpayer also submitted bank statements to the tax court.

Other than what was indicated on the bank statements, the taxpayer provided no documentary evidence of payment of any of the reported expenses, nor any loan document, contract, or other evidence of an obligation to pay any expense.

Author's Comment: In addition to a canceled check, bank statement, or credit card statement, substantiation requires a receipt, loan document, or contract that verifies the expense was an obligation the business was required to pay. Journal entries and bank statements showing that expenses were paid do not in themselves substantiate the expense.

At trial, in response to the Court's observation that it could not in the record identify such documentary evidence, the taxpayer explained that the relevant documents were in "so many boxes" that he "wouldn't be able to bring [them] into the courtroom." Later in the trial the taxpayer claimed that the bank statements and records that would substantiate the expenditures recorded in the Cash Disbursements Journal were in storage, and he added: "I have no access to them...it's the subject of another pending legal matter."

The court noted, however, that in the taxpayer's petition, he claimed that "at trial" he will offer "sufficient accounting records [to] support their actual income...for the audited years."

The court noted that on its own, it discovered some bank statement entries supporting entries in the Register. However, it stated it is not our duty to undertake the laborious task of combing the various bank statements for information to support entries in the Journals and Registers. To give the taxpayer a chance to cure his failure to direct the court to page references in the bank statements to support Register or Journal entries, the court ordered the taxpayer to file a supplemental brief proposing findings of fact in tabular form identifying those expenses reported on any of the Schedules C or E that are traceable to bank statements in the record and to identify the page in the record of the bank statement entry. The taxpayer then provided a table of expenses, but that too was insufficient in directing the court to anything in the record evidencing actual payment.

The taxpayer testified that he has many boxes containing substantiation documents, but was either unwilling or unable to produce the substantiation to the court. The court noted the taxpayer's first excuse describes his choice on how to present his case, not a circumstance beyond his control. His second excuse lacks particulars that might convince the court that the stored records are unavailable because of circumstances beyond his control. Moreover, the taxpayer's failure to direct the court to evidence supporting claimed expenditures contradicts his representation in his petition that, "at trial," he will offer "sufficient...records to support his actual income...for the audited years."

The taxpayer requested that the tax court make an estimate of his expenses under the Cohan rule. The IRS argued that the tax court lacks discretion to apply the Cohan rule because there exists no evidentiary basis upon which to make an estimate.

The taxpayer's circumstances, however, gave the court grounds to decline to rely on the Cohan rule to estimate the amounts of his deductible expenses. The appeals court in Cohan said that not only did the taxpayer in that case fail to keep account of his travel expenses, he probably could not have done so. That observation suggests a limit on the Cohan rule's scope, under which estimating unsubstantiated expenses would be inappropriate when proper recordkeeping is feasible and can reasonably be expected. Thus, the Cohan rule cannot be invoked where the claimed but unsubstantiated deductions are of a sort for which the taxpayer could have and should have maintained the necessary records.

The tax court stated it takes the taxpayer's word in the petitions that he possessed, and would offer at trial, sufficient evidence of his income. The court was not persuaded by the taxpayer's testimony at trial as to why he did not do so. Because the taxpayer could have produced documentation and did maintain records that would substantiate expenses, the court ruled it will not estimate any of those expenses under the Cohan rule.

Write-Offs for Damaged Inventory

Cross References

- *IQ Holdings, Inc.*, T.C. Memo. 2024-104,

The taxpayer was a manufacturer of aerosol consumer products, including products for personal and home care, and automotive products. The taxpayer made a seller financed sale of its aerosol products and raw packaging materials to a related corporation that had applied for status as a tax-exempt private foundation. The taxpayer had intended to forgive the loan once the related corporation received its IRC section 501(c)(3) approval to become a tax-exempt organization.

However, by the time the related corporation got that approval in 2014, some or all of the aerosol products and packaging materials were found to be rusted, leaking, broken, or otherwise damaged. As a result, the taxpayer and the related corporation decided to reverse the sale. After reversal, the taxpayer wrote off the cost of the aerosol products and the raw packaging materials on its books and records and on its 2014 tax return, which increased its cost of goods sold deduction. During a 2016 audit by the IRS, the taxpayer was still in the process of decommissioning the aerosol cans by puncturing the bottom of each can, collecting the liquid contents, and preparing the cans and liquid for disposal or recycling.

Also for the 2014 tax year, the taxpayer wrote off aerosol can inventory that was originally manufactured for the WD-40 company. The taxpayer had discovered a design defect in the cans that left them in violation of Department of Transportation regulations.

The IRS disallowed the increase to cost of goods sold on account of damaged or obsolete inventory. In court, the IRS cited Regulation section 1.471-2(a) that states there are two tests to which each inventory must conform.

- 1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
- 2) It must clearly reflect the income.

The Supreme Court has remarked that "best accounting practice" is synonymous with generally accepted accounting principles (GAAP) and that IRC section 471 "vests the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income."

The taxpayer argued that its write-off of inventory for 2014 was consistent with GAAP. The IRS did not dispute that contention but supports its deficiency determination by arguing that the write-off does not clearly reflect the taxpayer's income. The IRS pointed to Regulation section 1.471-2(c), which general provides that businesses may value inventory at either:

- 1) Cost, or
- 2) The lower of cost or market price.

However, that regulation then sets forth the following.

Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition...or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

The IRS noted that the taxpayer never offered for sale the damaged aerosol products or WD-40 cans, and he therefore concludes that the taxpayer's write-off did not comply with the regulations.

The court noted that the cited regulation encompasses inventory "unsalable at normal prices" but does not explicitly deal with inventory that is unsalable at any price, as the taxpayer contends was the case with its aerosol products and WD-40 cans. The Supreme Court did not address a situation in which the inventory is completely obsolete, hazardous, or illegal to sell, or in which the inventory's scrap value is zero.

The taxpayer argued that those are instances to which the regulation's general requirement to hold the property out for sale cannot apply, since holding such items out for sale would be nonsensical.

The court agreed with the taxpayer that the cited regulation cannot be read to require a taxpayer to offer for sale items that, in their current condition, would be tortious or illegal to sell. The court denied the IRS's summary judgement in this case and held off making a final ruling until more evidence is provided as to whether the taxpayer's inventory could be feasibly rehabilitated.