Hybrid Accounting Method is Allowed

Cross References

- *Aboui*, T.C. Memo. 2024-106, December 9, 2024

The taxpayer was the sole shareholder of HPPO Corp. Autoville Motors (HPPO) an S corporation that owned several used car dealerships. He contributed over $5 million of used cars to HPPO for its starting inventory.

Most of HPPO's customers had poor credit. Most paid in cash, and often HPPO would pay its employees and other expenses in cash without depositing the cash receipts into its checking account.

HPPO offered in-house financing to its customers. It financed approximately 90% to 95% of its sales and retained security interests in the cars. When HPPO financed a car purchase, it reported the sale price as income under the accrual accounting method in the year of sale.

Less than 10% of the loans were repaid by customers. HPPO repossessed approximately 25% of the cars within three to four months of purchase, and approximately 50% within one year. During the tax years at issue in this case, HPPO was unable to repossess over 250 cars after the buyers stopped making payments. When HPPO repossessed a car, it typically was in worse condition than when it was sold, sometimes with serious mechanical issues from the buyer's failure to service the car.

HPPO bartered with mechanics for repair services in exchange for rental of HPPO's garage space or as payment for the purchase of a used car. The mechanics submitted invoices for their services and HPPO reported the invoiced amounts as expenses and also reported the related barter income.

HPPO used specialized accounting software designed for car dealerships. It also maintained dealer jackets, a special filing system for car dealerships to maintain all paperwork relating to their sales.

Around 2014, the taxpayer decided to close HPPO because his family was experiencing serious health issues and because HPPO was unprofitable. He began to wind down the business. He reduced HPPO's staff by half and purchased less inventory than in prior years. He began to withdraw money from HPPO's bank accounts for his personal use and used HPPO's bank accounts to pay expenses unrelated to HPPO. These withdrawals and expenses totaled approximately $7.5 million during the year at issue.

During the year at issue, HPPO reported cost of goods sold (COGS) with a beginning and ending inventory using the accrual method of accounting for its sales.

During an IRS audit, HPPO gave a power of attorney to a new representative who erroneously told the IRS revenue agent (RA) that HPPO was a cash basis taxpayer and that HPPO did not include the total sale prices in gross receipts in the year of sale. The taxpayer later replaced the representative in an attempt to resolve the audit. However, by that time, the RA had closed the case.

Partly because of the representative's misstatement, the RA treated HPPO as a cash basis taxpayer. The RA used the bank deposit analysis and determined that HPPO reported nearly $3.25 million more gross income for 2013 through 2015 than was deposited into HPPO's bank accounts during those years, and that HPPO underreported its gross income for 2016 by $539,209. In the Notice of Deficiency, the IRS determined that HPPO under reported its 2016 income. However, it did not decrease HPPO's gross income for 2013 through 2015.

During the audit, the RA also did not access HPPO's accounting software. Instead, the RA went through the arduous process of reviewing thousands of pages of bank statements and canceled checks to determine whether the debits from HPPO's bank accounts were used to pay expenses related to HPPO's business. On the basis of this analysis, the IRS allowed only a portion of the COGS and business expense deductions claimed by the taxpayer.

When a taxpayer fails to maintain and keep accurate records, the IRS may reconstruct the taxpayer's income under any method that, in its opinion, clearly reflects income. However, the IRS's income reconstruction must be reasonable in the light of all surrounding facts and circumstances. A bank deposit analysis is a permissible method to reconstruct income in the absence of adequate books and records. The bank deposits method assumes that all money deposited into a taxpayer's bank account is taxable unless the taxpayer shows that the deposits are nontaxable or that he previously reported them as income.

During the Tax Court trial, the RA testified that she treated HPPO as a cash basis taxpayer. The court stated the Internal Revenue Code requires the IRS to use a taxpayer's chosen method of accounting as long as it clearly reflects income. It was clear to the court that HPPO used a hybrid method of accounting that reported its gross receipts from car sales using the accrual method and its expenses using the cash method. Taxpayers are permitted to use hybrid methods under IRC section 446(c)(4) and Regulation section 1.446-1(a)(1). The IRS did not argue in court that HPPO's hybrid method does not clearly reflect income. Rather, the IRS at trial tried to deny that the RA used the cash method even though the RA testified at trail that she used the cash method.

The court noted that the following facts support the fact that HPPO used the hybrid method and reported gross receipts under the accrual method. HPPO reported inventories on its returns and used inventories to compute COGS, which generally requires use of the accrual method for sales and purchases. Furthermore, the record established that HPPO included the entire sale price from a sale made on credit in its gross receipts in the year of sale.

The RA's decision to use the cash method to reconstruct HPPO's income caused her to determine that HPPO significantly over reported its income for 2013 through 2015. She determined that HPPO under reported income for only one year, 2016. The court found that the IRS's use of a bank deposit analysis to determine HPPO's 2016 gross income was incorrect. The RA's calculation that HPPO under reported its 2016 income likely resulted from her failure to make the required adjustments to account for amounts reported as income for prior years. The bank deposit analysis in fact proved the accuracy of HPPO's reporting over the years at issue. The IRS's use of the cash method distorted HPPO's income.

The taxpayer's credible testimony that he began winding down HPPO's business in 2014 explains why the deposits exceeded the reported gross income for 2016. He did not reinvest the proceeds in new inventory but deposited the funds into HPPO's bank accounts. HPPO's returns reported significant decreases in used car inventory from $3.4 to $3.6 million for 2011 through 2013, to $1.3 to $1.5 million for 2015 through 2016. The taxpayer also credibly testified that HPPO received significant amounts of cash from its customers, which explains why the RA's reconstruction shows over reporting for 2013 through 2015.

The court stated there is no reason for it to question the taxpayer's veracity especially in the light of the fact that the RA's reconstruction determined that HPPO over reported income for 2013 through 2015 in amounts far greater than its alleged under reporting for 2016.

The court ruled HPPO accurately reported its gross income under the Hybrid Method for 2016, the year at issue.

