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CCA 201426025 - Section 446 - General Rule for Methods of Accounting

Office of Chief Counsel
Internal Revenue Service
Memorandum

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from: Senior Counsel, Branch 7
(Income Tax and Accounting)

subject: Change in Accounting Method and IRC § 481(a) Adjustment

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Bank =
Years =

ISSUES

1. Does a change in accounting method under IRC § 446 occur when Taxpayer no longer treats certain securities transactions as "options?"

2. If a change in accounting method does occur when these transactions that were treated as options no longer are treated as such, does IRC § 481(a) apply and if it does, how should the adjustment be computed?

CONCLUSIONS

1. A change in accounting method under IRC § 446 occurs when Taxpayer no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions.

2. The computation and recognition of an appropriate adjustment under IRC § 481(a) is needed to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change.

FACTS

Taxpayer (a limited liability company that is treated as a partnership for federal tax purposes) purchases and disposes of positions in securities. Taxpayer generally engages in daily trading of such positions. Taxpayer has conducted much of its securities trading under various "Barrier Basket Transactions" (Basket Transactions) with Bank, a broker and investment bank. In a typical Basket Transaction, Taxpayer makes an upfront payment of 10 percent of the notional amount referenced in the Basket Transaction. Bank provides the remaining 90 percent, the total amount of which is used to acquire a 'basket' of securities that is actively traded and managed by Taxpayer's affiliate on an ongoing basis. The contract between Taxpayer and Bank describes Taxpayer's investment as a "premium" that gives Taxpayer the "option" to receive a cash settlement amount from Bank when the

contract expires or is otherwise terminated. Each contract is for at least a year. The cash settlement amount is determined by a formula that generally [equals] reflects the increase (decrease) in the value of the securities, including expense and income payments made or received with respect to the securities held and traded within the Basket Transaction and the interest and fees payable to Bank for its services and capital. Taxpayer does not recognize gains, losses, income, or deductions as it trades the securities within the Basket Transaction. Instead, Taxpayer defers recognition of any tax consequences until the Basket Transaction expires or otherwise terminates, when Taxpayer recognizes gain equaling the difference between the cash settlement amount and the upfront payment made.

Taxpayer's federal income tax returns for Years are currently under examination by the Internal Revenue Service. Based upon its review, Field Operations has determined that the Basket Transactions lack the requirements to be treated as options to purchase property for tax purposes. Further, Field Operations has determined that Taxpayer had the burdens and benefits of ownership of the securities underlying the Basket Transactions, and thus held the beneficial ownership of these securities for tax purposes. This Advice assumes that Field Operations is correct in its determinations.

Accordingly, Field Operations has challenged Taxpayer's deferral of gains, losses, income, or deductions associated with the Basket Transactions. Field Operations intends to place Taxpayer on a correct accounting method consistent with its ownership of the securities. This accounting method will not permit Taxpayer to defer reporting the relevant gains, losses, income, or deductions until the Taxpayer identified Basket Transactions expire or terminate but will instead require Taxpayer to recognize these gains, losses, income, or deductions at a much earlier time, consistent with Field Operations' conclusion that Taxpayer, and not Bank, was the owner of each asset held within the basket. Pursuant to this accounting method change, Field Operations intends to impose an adjustment under IRC § 481(a) in the first tax year under examination.

LAW AND ANALYSIS

IRC § 446(b) provides that if no accounting method 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. See also Treas. Reg. § 1.446-1(b)(1).

The Commissioner has broad discretion in determining whether a taxpayer's accounting method clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-3 (1979), RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981).

IRC § 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under an accounting method different from the method used to compute taxable income for the preceding tax year.

General rules for accounting method changes
imposed by the Internal Revenue Service.

Using professional judgment in accordance with auditing standards, an examining agent will make findings of fact and apply the Internal Revenue Service's position on issues of law to determine whether an issue is an accounting method issue and if so, whether the taxpayer's accounting method is permissible. For this purpose, the term "accounting method issue" means an issue regarding whether the taxpayer's accounting treatment of an item is proper, but only if changing the taxpayer's treatment of such item could constitute a change in accounting method. See Rev. Proc. 2002-18, 2002-1 C.B. 678, sections 3.01 and 5.01. An accounting method is permissible only when it clearly reflects income.

An examining agent who determines that a taxpayer's accounting method is not permissible may propose an adjustment with respect to that method only by changing the taxpayer's accounting method. The agent has broad discretion in selecting a new accounting method and, except as provided in section 2.06 of Rev. Proc. 2002-18 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under IRC § 446(e)), the examining agent will select an accounting method that properly reflects the income of the taxpayer by applying the law to the facts as determined by the agent. The selected method must be a permissible accounting method and cannot be a method contrived to reflect the hazards of litigation. See Rev. Proc. 2002-18, sections 5.02 and 5.03. A taxpayer may challenge the selected method only upon showing an abuse of discretion. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 353 (1st Cir. 1970), Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970), Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir. 1951).

An examining agent changing a taxpayer's accounting method will ordinarily make the change in the earliest tax year under examination, or, if later, the first tax year the method is considered impermissible, although an examining agent may defer the year of change to a later tax year in appropriate circumstances. An examining agent may not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent may not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See Rev. Proc. 2002-18, section 5.04(1).

An examining agent changing a taxpayer's method of accounting ordinarily will impose an adjustment under IRC § 481(a). The IRC § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See Treas. Reg. § 1.481-1(c)(3), Rev. Proc. 2002-18, section 5.04(2), and (3). When there is a change in accounting method to which IRC § 481(a) is applied, income for the tax year preceding the year of change must be determined under the accounting method that was then used, and income for the year of change and the following tax years must be determined under the new accounting method as if the new method had always been used. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, section 2.05(1).

What constitutes a change in accounting method?

Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that a change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." Treas. Reg. 1.446-1(e)(2)(ii)(a). In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the tax year in which taxable income is reported. See Rev. Proc. 2002-18, section 2.01; Rev. Proc. 91-31, 1991-1 C.B. 566, Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-724 (1982), Knight Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984), Huffman v. Commissioner, 126 T.C. 322, 343 (2006), Peoples Bank & Trust Co.
v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered an accounting method. General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999), Color Arts, Inc. v. Commissioner, T.C. Memo. 2003-95. An "item" is any recurring element of income or expense. Thus, a local tax is an "item" and the treatment it is given qualifies as an accounting method. American Can Co. v. Commissioner, 317 F.2d 604 (2nd Cir. 1963). Likewise, a vacation pay accrual is an "item" and the treatment it is given qualifies as an accounting method. Color Arts. See also, Capital One Financial Corp. v. Commissioner, 130 T.C. 147, 159161 (2008), aff'd 659 F.3d 316 (4th Cir. 2011)

An accounting method may exist under the definition in Treas. Reg. § 1.4461(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, but in most instances, an accounting method is not established for an item without consistent treatment. See Treas. Reg. § 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(a). If however, a taxpayer treats an item properly in the first return that reflects the item, it is not necessary for the taxpayer to treat the item consistently in two or more consecutively filed tax returns to have adopted an accounting method for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57, Rev. Proc. 2002-18, section 2.01(2).

In addition, a change in accounting method does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. See Treas. Reg. § 1.446-1(e)(2)(ii)(b).

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes gross income for a type of revenue generally constitutes an accounting method, and a change from one such practice to another generally constitutes a change in accounting method. In Johnson v. Commissioner, 108 T.C. 448 (1997), for example, the Tax Court held that switching the time for recognizing escrowed customer payments as gross income from when the escrow agent released funds to the taxpayer to when the customer gave the sale price to the taxpayer was a change in accounting method. See generally Rev. Proc. 2011-14, APPENDIX section 15.

Similarly, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes an accounting method, and a change from one such practice to another

generally constitutes a change in accounting method. Thus, a change from deducting officers' bonuses in the year they are declared to deducting the bonuses in the year following the declaration year constitutes a change in accounting method. Summit Sheet Metal Co. v. Commissioner, T.C. Memo 1996-563. Similarly, a change from deducting real estate taxes when paid to deducting these taxes when incurred is also a change in accounting method (Treas. Reg. § 1.446-1(e)(2)(iii), Example (2)). Further, various courts have found accounting method changes in similar circumstances involving a variety of different types of expenses, including vacation pay (American Can), interest (Peoples Bank, Mulholland v. U.S., 28 Fed. Cl. 320 (1993), Prabel v. Commissioner, 882 F.2d 820 (3rd Cir. 1989)), customer rebates (Knight Ridder), and related party payables (Bosamia v. Commissioner, 661 F.3d 250 (5th Cir. 2011)).

Mathematical and posting errors

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. A "mathematical error" is defined by IRC § 6213(g)(2) as "an error in addition, subtraction, multiplication, or division." See Huffman, 126 T.C. at 344 (accepting this definition for the purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(b)). But see Huffman, 518 F.3d 357, 363 (6th Cir. 2008) where the Sixth Circuit refused to either adopt or reject the Tax Court's definition. A "posting error" is an error in "the act of transferring an original entry to a ledger." Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 510-511 (1989)(quoting Black's Law Dictionary 1050 (5th ed. 1979)), see also Huffman 126 T.C. at 343 (accepting the definition of posting error provided by Wayne Bolt & Nut). But see Northern States Power Co. v. Commissioner, 151 F.3d 876, 884-885 (8th Cir. 1998) where the Eighth Circuit held that a posting error occurred when the taxpayer mistakenly capitalized certain costs while deducting similar costs under its accrual method.

Where the correction of an error results in a change in accounting method, the requirements of IRC § 446(e) are applicable. Huffman, 126 T.C. at 354, First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987), Diebold.

Changes in character of revenue or deduction

If the change in accounting practice does involve timing, then it is an accounting method change, even if it also arguably involves a change in how the item of revenue or expense is characterized, such as changing from treating transactions as sales to treating the transactions as leases. Certain cases, such as Underhill v. Commissioner, 45 T.C. 489 (1966), are sometimes read to stand for the proposition that changes involving a change in the "characterization" of an item cannot be accounting method changes under IRC § 446. This reading, however, is not supported by the regulations. In particular, Treas. Reg. § 1.446-1(e)(2)(ii)(b) enumerates numerous adjustments that do not constitute changes in accounting method, but contains no exception for changes that alter the characterization of an item. In fact, the Treasury Regulations include corrections of erroneous characterizations among examples of changes in accounting methods. See Example 11 of Treas. Reg. § 1.446-1(e)(2)(iii) (inventory to depreciable asset). See also Cargill Inc. v. U.S. 91 F.Supp.2d 1293, 1298 (D. Minn., 2000) ("Like the petitioner in Witte, Cargill has not directed the Court to any provision of the Code that sets forth such a "characterization" exception. Accordingly, the Court concludes that no such exception exists." Citing Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975)).

Moreover, numerous cases have held that a change in characterization can be a change in accounting method. See Diebold Inc. v. U.S., 891 F.2d 1579, 1583 (Fed. Cir. 1990)(a change in treatment from inventory to capital asset constituted an accounting method change), Cargill, 91 F. Supp. 2d at 1293 (re-characterization of interest from leasehold to ownership), Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993)(re-characterizing "working gas" (inventory) to "cushion gas" (capital asset), Standard Oil Co. v. Commissioner, 77 T.C. 349, (1981)(IRC § 1250 property to IRC § 1245 property), Capital One Financial Corp. (late fees from income to original issue discount), Humphrey, Farrington & McClain, P.C. v. Commissioner, T.C. Memo. 201323 (advanced litigation expenses from deductible business expenses to loans). See also Rev. Proc. 2011-14, APPENDIX sections 2.01 (a change in treatment of amounts received from the Commodity Credit Corporation from gross income to loan constitutes an accounting method change), 3.01 (a change in treatment of advanced litigation costs from deductible business expenses to loans constitutes an accounting method change), 6.03 (changes from treating property as sold or leased, or vice versa, are method changes).

The foregoing cases illustrate that the change in characterization of an asset, liability, or overall transaction typically alters the tax characterization of the associated income and expense. Thus, for changes between inventory and capital assets, as in Diebold and Pacific Enterprises, the income and cost recovery elements change characterizations between gross receipts/cost of goods sold and amount realized/adjusted basis. Such change in classification does not, in itself, impact the amount of lifetime taxable income recognized, and thus does not preclude changes that embody such reclassifications from qualifying as changes in method of accounting.

Similarly, a change in accounting method reflecting a change in the characterization can also involve a change in the character of taxable income from capital gain (loss) to ordinary income (loss), or vice versa. For example, in Witte, the taxpayer's shift from the cost recovery accounting method for gain derived from the sale of real estate properties to the completed transaction treatment constituted a "change in the accounting method" within the meaning of the Treasury Regulations. While the Witte Court found that the change involved the proper timing of a material item, the deficiency determination at issue was based on the finding that the amounts reported, as long-term capital gain should be taxed as ordinary income since such amounts were in part interest income and income from the sale of properly held primarily for sale. Diebold and Pacific Enterprises also involved changes between capital and ordinary taxable income. See also Mingo v. Commissioner, T.C.Memo. 2013-149 (change in accounting method for the proceeds from a partnership interest sale attributable to unrealized receivables from the installment method resulting in capital gain to the cash receipts and disbursements method yielding ordinary income).

Divergences from established methods

A taxpayer is generally required to apply the same accounting method to all instances of a particular item. On occasion, however, a taxpayer purports or attempts to report an item using the accounting method that it has adopted, established, or elected, but fails to apply the accounting method with perfect consistency. As a result, the taxpayer treats the item in two different ways; part of the item is reported under the primary accounting method, while the remainder of the item is reported using a treatment that diverges from the primary accounting method (divergent treatment).

When the divergent treatment is discovered by the taxpayer or Field Operations, the issue arises whether adjustments to conform the divergent treatment to the primary accounting method should be treated as the correction of errors in open tax years or as a change in accounting method under IRC §§ 446 and 481. Under current law, we believe that the key to deciding whether an accounting method change occurs is whether the divergent treatment is a timing practice that is used on a consistent basis. If so, then the divergent treatment is a material item, and conforming the divergent treatment to the primary accounting method is a change in the treatment of a material item that constitutes an accounting method change. See Treas. Reg. § 1.4461(e)(2)(ii)(a). In contrast, if the divergent treatment is not a timing practice and/or is not a consistent practice, it will have a permanent impact on lifetime taxable income, and the divergent treatment is an error (or series of errors).

A number of older cases, however, have held that conforming a divergent treatment to the primary accounting method is error correction and not an accounting method change, even where the divergent treatment was a timing practice that would otherwise qualify as an accounting method under IRC § 446, and even where the divergent treatment has been consistently followed over many tax years. Examples of these cases (divergent treatment as error cases) include Gimbel Brothers, Inc. v. U.S., 535 F.2d 14 (Ct. Cl. 1976) and Standard Oil, 77 T.C. at 381-84.

In Gimbel Brothers, the taxpayer elected to use the installment method in 1952. The Court concluded that this election included both traditional installment sales and revolving credit sales. For many years, after the election was made, however, the taxpayer consistently reported only its traditional installment sales on the installment method, but reported its revolving credit sales on an accrual method.

The taxpayer in Gimbel Brothers filed amended returns to change its reporting of the revolving credit sales to the installment method, characterizing its original treatment of such sales as an error. The Internal Revenue Service rejected the amended returns as constituting a retroactive change in accounting method made without the requisite consent under IRC § 446(e). The Court, however, concluded that taxpayer's use of accrual reporting for revolving credit sales was an error because it was inconsistent with its installment method election. The Internal Revenue Service non-acquiesced to the Court's decision in AOD 1976-345. See also, Rev. Rul 90-38 and I.R.S. Tech. Adv. Mem. 200043010 (June 9, 2000).

Similarly, in Standard Oil, the taxpayer made an election to write off intangible drilling costs (IDCs). Thereafter, the taxpayer filed amended returns seeking to deduct as IDCs certain offshore oil platform construction costs that it had originally capitalized into the depreciable basis of such platforms. The Court concluded that taxpayer's claim of additional deductions on its amended returns constituted "an attempt to remedy its failure to report similar items consistently under a fixed method of accounting. Such correction of internal inconsistencies does not constitute a change in accounting method." 77 T.C. at 383. While the Internal Revenue Service did acquiesce to the Court's decision that the drilling platforms were properly characterized as IDCs, the Court's reasoning as to the accounting change was rejected in I.R.S. Tech. Adv. Mem. 200043010 (June 9, 2000).

Additional cases with similar results and rationales include Korn Industries, Inc. v. United States, 532 F.2d 1352 (Ct. Cl. 1976)(holding that taxpayer did not change its accounting method when it included three previously omitted classes of costs in finished good inventory because this was consistent with how taxpayer treated similar items in that class of expenditures. But see, Rev. Rul. 77-134, 1977-1 C.B. 132), ThompsonKing-Tate, (holding that changes to correct the application of taxpayer's existing completed contract method to a new contract were not an accounting method change), and Northern States Power (holding that a change from capitalizing losses on nuclear fuel contracts to deducting such losses as incurred was not a change in accounting method because the taxpayer was deducting losses on other fuel contracts as incurred).

The divergent treatment as error cases have become anomalies and anachronisms within the law of IRC § 446 in several crucial respects.

First, the divergent treatment as error cases rely heavily upon the proposition that the consent of the Commissioner under IRC § 446(e) is not required where the taxpayer's existing treatment is improper. This proposition is expressly rejected by Treas. Reg. § 1.446-1(e)(2)(i), which provides in part that consent to change an existing accounting method "must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder." See also Treas. Reg. § 1.446-1(e)(2)(iii), Examples (6)-(8), Rev. Rul. 80-190, 1980-2 C.B. 161, Rev. Rul. 77134. The vast majority of judicial opinion agrees that IRC § 446(e) consent is required even for improper treatments. See, for example, O. Liquidating v. Commissioner , 292 F.2d 225, 230-31 (3rd Cir. 1961), Wright Contracting Co. v. Commissioner, 316 F.2d 249, 254 (5th Cir. 1963), Witte, 513 F.2d at 393-95, Wayne Nut and Bolt, 93 T.C. at 51; Diebold, Helmsley v. U.S., 941 F.2d 71, 87 (2nd Cir. 1991), Pacific Enterprises,101 T.C. at 23; Convergent Technologies, Inc., v. Commissioner, T. C. Memo. 1995-320, Rankin v. Commissioner, 138 F.3d 1286, 1289 (9th Cir. 1998).

Second, the divergent treatment as error cases rely on the proposition that conforming the divergent treatment to the primary accounting method is not a change in accounting method because the necessary adjustments have not altered the primary accounting method for the item; rather, the adjustments merely apply the primary accounting method across the item on a correct and uniform basis. See Northern States Power, 151 F.3d at 884-885, Korn, 532 F.2d at 1355-1356, Beacon Publishing Co. v. Commissioner, 218 F.2d 697, 702 (10th Cir. 1955). This proposition is overly broad and simplistic because it neglects the critical analytical test required by IRC § 446(e), that is, is the divergent treatment a material item (a timing practice applied on a consistent basis)? If the divergent treatment is not a material item, it constitutes an error (or group of errors); if the divergent treatment is a material item, then a change in the treatment of such material item is an accounting method change under IRC § 446. See Treas. Reg. § 1.446-1(e)(2)(ii)(a), Huffman, 126 T.C. at 354-355.

Third, the divergent treatment as error cases rely upon the argument that a divergent treatment cannot be a "material item" because by its very nature a divergent treatment applies to only a portion of an item; the remainder of the item remains subject to the primary accounting method. This argument finds no support in the regulations, which define material item as "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." Treas. Reg. § 1.446-1(e)(2)(ii)(a). Further, the case law has generally concluded that the pertinent inquiry for determining whether timing is involved is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the tax year in which taxable income is reported. See Primo Pants, Knight Ridder, Peoples Bank & Trust. In other words, the lynchpin for determining whether an accounting practice is a "material item" is timing _ and the presence or absence of timing in an accounting practice is completely unrelated to how widely or narrowly the accounting practice is applied. Accordingly, the inquiry into whether a divergent treatment applies to an entire item or only a portion of an item tells us nothing about whether conforming the divergent treatment to the primary accounting method would be an accounting method change because the inquiry tells us nothing about whether the divergent treatment involves timing.

Fourth, the divergent treatment as error cases are incompatible with the existence of hybrid accounting methods and related accounting method changes as recognized in IRC § 446(c). Subject to certain limitations, any combination of accounting methods is permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. See Treas. Reg. § 1.446-1(c)(1)(iv)(a). Further, changes to or from a hybrid accounting method, or between one hybrid method and another, are changes in accounting method. This is clearly illustrated by Example (2) of Treas. Reg. § 1.446-1(e)(2)(iii), which states that a taxpayer that uses an overall accrual accounting method but uses the cash receipts and disbursements method for a single item (real estate taxes) requires consent under IRC § 446(e) to change its treatment of real estate taxes to the accrual method.

The conclusions of Example 2 of Treas. Reg. § 1.446-1(e)(2)(iii) were echoed by the Tax Court in

Connors, Inc. v. Commissioner, 71 T.C. 913 (1979), whose facts are essentially the inverse of the facts of Example 2. The taxpayer in Connors used the cash receipts and disbursements method as its overall accounting method but reported bonus compensation expenses using an accrual method. The Court concluded that changing the treatment of bonus compensation from the accrual method to the cash receipts and disbursements method "is a change in method of accounting because such change is a change in the treatment of a material item, that is, this is a change in the proper time for the taking of a deduction from the year incurred to the year paid." 71 T.C. at 919. See also, Miele v. Commissioner, 72 T.C. 284 (1979), Pierce Ditching Co. Inc. v. Commissioner, 73 T.C. 301 (1979), Brunton v. Commissioner, T.C. Memo. 1982-166.

If changing the divergent treatment of real estate taxes or bonuses to conform to an overall accounting method (either cash receipts and disbursements or accrual) constitutes an accounting method change, then it is difficult to understand why, in Gimbel Brothers, a change to conform the divergent treatment (accrual method) of the credit sales to the primary accounting method (installment method) is not a change in accounting method.

Finally, the divergent treatment as error cases embody the highly counterintuitive notion that the computations of taxable income shown on filed returns do not necessarily reflect or determine the accounting methods that a taxpayer is 'really' using. In other words, Gimbel Brothers implies that its taxpayer was 'really' on the installment method for its revolving credit sales, even though it used an accrual method on its returns to compute and report taxable income from such sales for more than a decade.

In light of the foregoing problems, the persuasive force of the divergent treatment as error cases is severely limited. First, the courts in more recent opinions have readily distinguished these older cases by using a narrow reading of their facts. Numerous newer cases have restricted the applicability of the older divergent treatment as error cases by emphasizing that the newer cases did not involve correction of "internal inconsistencies" or reflect inadvertence, or mistake of fact. See, for example, Hitachi Sales Corporation of America v. Commissioner, T.C. Memo. 1994-159, Hooker Industries, Inc. v. Commissioner, T.C. Memo. 1982-357, Color Arts, Cargill, 91 F. Supp. 2d at 1300, Huffman, 126 T.C. at 351-2. As a further example, the Tax Court concluded that Pacific Enterprises was distinguishable from Gimbel Brothers and Standard Oil merely because these cases "do not involve inventory identification or valuation," which are specifically mentioned in Treas. Reg. § 1.446-1(e)(2)(ii)(c).

Second, the courts question or outright reject the divergent treatment cases on the basis of their inconsistencies (discussed above) with the well-established requirements of IRC § 446. Thus, Cargill, 91 F.Supp.2d at 1298 concludes that the divergent treatment as error cases "all ultimately rest on the erroneous premise that consent is not required if the taxpayer's previous treatment of the item was improper."

Finally, in cases where the divergent treatment as error cases are not invoked or expressly considered, the courts often fail to apply the principle of these cases. In Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir. 1975), for example, only the direct costs of self-constructed assets were capitalized as error while indirect costs were deducted as part of the cost of goods sold. The 10th Circuit upheld the holding of the Tax Court that conforming the divergent treatment of the indirect costs (deduction) to the primary accounting method (capitalization) was an accounting method change under IRC § 446 that triggered an adjustment under IRC § 481(a). See also Sartor v Commissioner, T.C. Memo. 1977-327 (divergent accrual treatment of interest by an individual using the overall cash receipts and disbursements method).

IRC § 481(a) adjustment

IRC § 481(a) provides that in computing the taxpayer's taxable income for any tax year (year of change), if such computation is under an accounting method different from the method under which the taxpayer's taxable income for the preceding tax year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any tax year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also Treas. Reg. § 1.448-1(a).

A change in method of accounting to which IRC § 481(a) applies includes a change in treatment of a single material item. See Treas. Reg. § 1.481-1(a)(1); Graff Chevrolet Co. v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965), Knight-Ridder 743 F2d at 798, Peoples Bank & Trust 415 F2d at 1344, Ryan v. Commissioner, 42 T.C. 386, 392 (1964). Once the Commissioner has imposed a change in accounting method, the application of IRC § 481(a) to such change is mandatory. Primo Pants, Emert v. Commissioner, T.C. Memo. 1999-175, Hitachi Sales Corp. of America.

An adjustment under IRC § 481(a) can include amounts attributable to tax years that are closed by the statute of limitations. Suzy's Zoo v. Commissioner, 114 T.C. 1, 13 (2000), aff'd 273 F.3d 875, 884 (9th Cir. 2001); Huffman, Graff Chevrolet, Rankin, Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983), Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968), Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds 791 F.2d 906 (Fed. Cir. 1986).

Whether Field Operations' adjustment constitutes a change in accounting method under IRC § 446

Taxpayer has conducted extensive securities trading under the various Basket Transactions, but has not recognized the gains, losses, income, or expenses from such trading as they arose. Instead, Taxpayer has deferred any tax consequences from trading in a given basket until the Basket Transaction expires or otherwise terminates, when Taxpayer recognizes gain or loss reflecting the cash settlement amount received less Taxpayer's initial investment and related expenses not previously deducted. Consistent with its conclusions that the Basket Transactions do not constitute "options" qualifying for open transaction treatment and that Taxpayer is actually, the beneficial owner of the securities associated with each Basket Transaction, Field Operations has challenged this deferral.

The adjustments proposed by Field Operations will place Taxpayer on a correct accounting method consistent with its beneficial ownership of the securities associated with each Basket Transaction. The new method provides for more current recognition of the relevant gains, losses, income, and deductions resulting from securities trading and thereby disallows the effective deferral of these amounts occurring under Taxpayer's existing practice.

The adjustment proposed by Field Operations is a change in method of accounting under sections 446 and 481 because it impacts the timing (amounts and tax years) of taxable income, but does not change the total amount of taxable income recognized over the lifetime of Taxpayer. The amount of taxable income recognized by Taxpayer under its current practice when a Basket Transaction expires or otherwise terminates is the same as the cumulative amount of taxable income recognized for the basket over multiple taxable years under the practice imposed by Field Operations. Accordingly, a change between these practices is an accounting method change.

Taxpayer asserts that the adjustment proposed by Field Operations does create a permanent difference in lifetime taxable income, and thus flunks the lifetime income test, because the adjustments would require Taxpayer to recognize amounts for tax purposes that Taxpayer never intended to recognize, such as gains and losses from security transactions within the Basket Transactions and interest expense. The adjustment, Taxpayer argues, thus involves the issue of "whether" amounts are taxable, rather than "when" amounts are taxable, and is analogous to changes between treating an item as taxable or nontaxable, which are not accounting method changes.

This argument elevates form over substance and places undue significance on the labeling of amounts. While it may be strictly true that Taxpayer never intended to recognize gains, losses, income, or deductions from Basket Transactions, Taxpayer did intend to recognize an option gain (loss) whenever a Basket Transaction ended, and such gain (loss) effectively included the gains, losses, income, and deductions asserted in adjustment by Field Operations. Thus, Taxpayer intended to include (and actually did include) these amount in gross income, albeit under a different label. Further, the adjustment made by Field Operations does not merely consist of recognizing gains, losses, income, and deductions on Basket Transactions consistent with beneficial ownership of the basket securities; the adjustment also includes a corresponding removal of the gains recognized by Taxpayer when the Basket Transactions ended. Thus, when seen in its overall context, the adjustment merely impacts the time when taxable income would be recognized; it does not propose to recognize amounts that Taxpayer never intended to recognize.

Taxpayer has raised the possibility that it may have one or more established accounting methods for securities trading operations other than those associated with the Basket Transactions. Thus, Taxpayer argues, the adjustment proposed by Field Operations merely serves to conform its treatment of the securities trading within the Basket Transactions to its established methods of accounting for such trading outside of the Basket Transactions and this would constitute error correction rather than an accounting method change. However, even if Taxpayer's treatment of the Basket Transactions could be seen as a divergent treatment with respect to other established methods of accounting for securities trading, the open transaction treatment applied to the Basket Transactions is clearly a material item _ a timing practice that was employed by Taxpayer consistently over many years. Thus, any adjustment that conforms the practice to existing accounting methods would be an accounting method change, rather than error correction, under the analysis developed above.

Finally, as discussed above, the conclusion that the Field Operations adjustment constitutes an accounting method change is not altered by the fact the adjustment could be described as involving a "change in character" from option to non-option transactions. The conclusion is not affected by the fact that the adjustment effectively converts one form of taxable income (gain or loss on option transaction) into several different types of taxable income (gain or loss on securities transactions, interest expense, fees and so on).

Does IRC § 481(a) apply and if it does,
how should the adjustment be computed?

As concluded above, the adjustment contemplated by Field Operations constitutes a change in accounting method. Accordingly, once imposed, the computation and recognition of an appropriate adjustment under IRC § 481(a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

Field Operations must be clear as to what method it intends to require Taxpayer to use. This Advice takes a broad brush in describing the Internal Revenue Service mandated method as a non-deferral method. If this issue proceeds further either in the administrative channels or in litigation, this method must be clearly specified.

[redacted data]

Field Operations may use any reasonable information that is available to compute the IRC § 481(a) adjustment. It may be appropriate for estimates to be used for example. However, the adjustment is to reflect the amount that is duplicated or omitted when accounting methods are changed so Field Operations cannot merely guess at an amount. The adjustment is computed as of the moment the accounting methods changes, in this case, Field Operations will determine the adjustment as of [redacted data].

[redacted data]

No opinion is expressed or implied on whether Taxpayer's transactions constitute options under IRC § 1234.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine the ability of the Internal Revenue Service to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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