Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200728001**
Release Date: 7/12/2007

CC:ITA:B07:GDAnderson
POSTS-101338-07

UILC: 446.04-01

date: July 05, 2007

to: Andrew M. Tiktin
Associate Area Counsel (Miami)
(Large & Mid-Size Business)

from: Grant D. Anderson
Senior Counsel, Branch 7
(Income Tax & Accounting)

---

subject: Changes in Method of Accounting under sections 446 and 481

This non-taxpayer specific Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Is a change in treatment of a sale from the installment method to the cash method a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations?

2. More specifically, is a change in treatment of a portion of the taxpayer's sale (specifically, the portion attributable to the § 751(c)(2) unrealized receivables) from the installment method to the cash method a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations?

3. If the change in treatment of the portion of the sale attributable to the § 751(c)(2) unrealized receivables constitutes an accounting method change, may Examination impose such change in Taxable Year 2, and if so, under what terms?

CONCLUSIONS

1. A change in treatment of a sale from the installment method to the cash method is a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations.

2. A change in treatment of a portion of the taxpayer's sale (specifically, the portion attributable to the § 751(c)(2) unrealized receivables) from the installment method to the cash method is a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations.

3. Examination may impose a change in method of accounting in Taxable Year 2; the adjustment under § 481 will be taken into account entirely in the year of change.

FACTS

The following facts are representative of a general pattern that has come to the Service's attention over the past several months. The taxpayer, an individual, reports income on the cash receipts and disbursements method (cash method). In exchange for a promissory note (Note), the taxpayer sold taxpayer's interest in Partnership A to Corporation B in Taxable Year 1. Other partners of Partnership A also sold their interests in Partnership A to Corporation B under similar terms as part of the same overall transaction.

The stated principal amount of the Note was greater than $250,000, and was payable in Taxable Year 6 on the five-year anniversary of the issuance date of the Note. The Note also provided for semiannual cash payments of interest each year at a per annum interest rate equal to the semiannual mid-term applicable federal rate (AFR). The Note generally could not be prepaid prior to its stated maturity date. However, the taxpayer had the right to convert all or any portion of the unpaid stated principal amount of the Note into common stock of the corporation any time after the first anniversary of closing.

At the time of the sale, Partnership A held receivables for services rendered by Partnership A which were "unrealized receivables" within the meaning of § 751(c)(2) (§ 751(c)(2) unrealized receivables). Part of the income the taxpayer realized from the sale was attributable to these § 751(c)(2) unrealized receivables. The taxpayer did not realize any income attributable to a sale of inventory within the meaning of § 751(d).

Partnership A provided the taxpayer with information about the details of the sale and the expected tax consequences of the sale. In sum, a partner of Partnership A that sold his or her partnership interest to Corporation B in exchange for the Note generally would not recognize any gain on the sale until principal payments were received on the Note or the Note was converted into shares of Corporation B; however, a selling partner would be currently taxed on gain realized on the sale to the extent that such gain was attributable to certain ordinary income items (including unrealized receivables).

Partnership A also provided the taxpayer with a schedule itemizing Section 751 income into depreciation recapture income, income attributable to unrealized receivables, and income attributable to inventory. The schedule stated that it was unclear whether income attributable to unrealized receivables and inventory could be reported under the installment method of accounting, and that using the installment method to report income attributable to the unrealized receivables would be contrary to IRS published guidance.

On the taxpayer's federal income tax return for Taxable Year 1, the taxpayer reported the entire sale of the interest in Partnership A to Corporation B (including the portion of the sale attributable to the § 752(c)(2) unrealized receivables) using the installment method of accounting. A Form 6252, Installment Sale Income Form, was attached to the return for Taxable Year 1. Accordingly, the taxpayer recognized no income from the sale of the partnership interest on the tax return for Taxable Year 1.

Examination audited the taxpayer's federal income tax return for Taxable Year 2. At the time this audit commenced, Taxable Year 1 was closed under the statute of limitations. Examination concluded that the portion of the sale of the partnership interest attributable to the §751(c)(2) unrealized receivables could not be reported using an installment method of accounting.

Examination proposed the following adjustments: (i) for the portion of the sale of the partnership interest attributable to the § 751(c)(2) unrealized receivables, the taxpayer's method of accounting would be changed from the installment method to the cash method in Taxable Year 2 (year of change); (ii) pursuant to such change in method, an adjustment (increase to taxable income) would be imposed under § 481(a) to prevent the omission of taxable income; and (iii) the § 481(a) adjustment would be taken into account entirely in the year of change.

<u>LAW</u>

Section 446(a) provides that taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income keeping his books. <u>See</u> <u>also</u> § 1.446-1(a)(1).

Clear reflection of income

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. <u>See</u> <u>also</u> § 1.446-1(b)(1).

The Commissioner has broad discretion in determining whether a taxpayer's method of accounting 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), cert. denied 457 U.S. 1133 (1982).

Service-imposed accounting method changes

Using professional judgment in accordance with auditing standards, an examining agent will make findings of fact and apply Service position on issues of law to determine whether an issue is an accounting method issue and whether the taxpayer's method of accounting 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 method of accounting. See Rev. Proc. 2002-18, 2002-1 C.B. 678, §§ 3.01, 5.01.

An examining agent who determines that a taxpayer's method of accounting is impermissible may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting. Except as provided in § 2.06 of Rev. Proc. 2002-18 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under § 446(e)), an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method contrived to reflect the hazards of litigation. See Rev. Proc. 2002-18, § 5.02, 5.03.

Once the Commissioner has determined that the taxpayer’s method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner’s selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (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.), cert. denied, 342 U.S. 860 (1951).

An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will 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, § 5.04(1).

An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See § 1.448-1(c)(3); Rev. Proc. 2002-18, § 5.04(2), (3).

Taxpayer-initiated accounting method changes

Section 446(e) provides that, except as otherwise provided, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary. Such consent must be secured whether or not the taxpayer's existing method is proper or is permitted under the Internal Revenue Code or the regulations thereunder. See § 1.446 1(e)(2)(i). For procedures to obtain the consent of the Commissioner to change a method of accounting for federal income tax purposes, see Rev. Proc. 97-27, 1997-2 I.R.B. 11 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432) and Rev. Proc. 2002-9, 2002-1 C.B. 327, (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432). See also § 1.446-1(e)(3)(ii).

A taxpayer that has adopted a method of accounting cannot change the method by amending its prior income tax return(s). Rather, a taxpayer that wants to change its method of accounting must follow either the automatic method change procedures of Rev. Proc. 2002-9 (or its successor), if applicable, or the advance consent procedures of Rev. Proc. 97-27 (or its successor). Although the Commissioner is authorized to consent to a retroactive accounting method change, a taxpayer does not have a right to a retroactive method change, regardless of whether the change is from a permissible or impermissible method. See Rev. Rul. 90-38, 1990-1 C.B.57; Rev. Proc. 2002-18, §§ 2.01(2) and 2.03; Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 682 (1980); Diebold, Inc. v. U.S., 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied 498 U.S. 823.

What constitutes a change in method of accounting?

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting 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." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See

Rev. Proc. 97-27, § 2.01(1); Rev. Proc. 2002-9, § 2.01(1); Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

Although a method of accounting may exist under the definition in § 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See § 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 § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38.

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting 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 § 1.446-1(e)(2)(ii)(b).

Where the correction of an error results in a change in accounting method, the requirements of § 446(e) are applicable. Huffman v. Commissioner, 126 T.C. 322, 354 (2006); First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987); Diebold, Inc. v. United States, 16 Cl. Ct. 193, 203-205 (1989), 891 F.2d 1579 (Fed. Cir. 1989), cert. denied 498 U.S. 823 (1990).

Section 481(a) adjustments

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable 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 taxable 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 § 1.448-1(a).

A change in method of accounting to which § 481(a) applies includes a change in treatment of a single material item. See § 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder v. United States, 743 F.2d at 798;

Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Graff Chevrolet Co. v. Campbell, 343 F.2d at 571-572; Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); 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).

ANALYSIS

ISSUE 1: Does the change in treatment of a sale from the installment method to the cash method constitute a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations?

The cash receipts and disbursements method (cash method) is a method of accounting for purposes of §§ 446 and 481. See § 446(c)(1); §§ 1.446-1(a)(1), 1.446-1(c)(1)(i). Changes from the cash method to another treatment, or vice verse, are changes in method of accounting. See §§ 1.446-1(e)(2)(ii)(a), 1.446-1(e)(2)(iii), Example 1.

Similarly, the reporting of income under the § 453 installment method is a method of accounting. See § 1.446-1(c)(1)(iii); Wang v. Commissioner, T.C. Memo. 1998-127; Perry v. Commissioner, T.C. Memo. 1990-228.

A change in method of accounting 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." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See § 1.446-1(e)(2)(ii)(a); Rev. Proc. 97-27, § 2.01(1); Rev. Proc. 2002-9, § 2.01(1); Rev. Proc. 91-31; Primo Pants; Knight Ridder; Peoples Bank & Trust Company.

The treatment of a sale under either the installment method or the cash method is a "material item" used in the taxpayer's overall plan of accounting because such treatment involves the proper time for the inclusion of gain (or loss) from the sale into income. Further, such treatment does not permanently affect the amount of taxpayer's lifetime taxable income; it merely affects the taxable year(s) in which income attributable to the sale is recognized. Accordingly, the change in treatment of a sale from the installment method to the cash method is a change in a material item used in the taxpayer's overall plan of accounting for gross income and deductions, and thus constitutes a change in method of accounting under § 1.446-1(e)(2)(ii)(a).

ISSUE 2: More specifically, does the change in treatment of a portion of the taxpayer's sale (specifically, the portion attributable to the § 751(c)(2) unrealized receivables) from the installment method to the cash method constitute a change in method of accounting within the meaning of §§ 446 and 481 and the associated regulations?

Beginning in Taxable Year 1, the taxpayer reported the entire sale of the Partnership A interest using the installment method. For purposes of this analysis, we will assume that it was improper for the taxpayer to use the installment method to report that portion of the income of the sale that was attributable to the § 751(c)(2) unrealized receivables. Improper tax treatments such as the one used by the taxpayer for the § 751(c)(2) unrealized receivables fall into two general categories, each of which has different procedural characteristics.

Error corrections and accounting method changes

The first category of improper tax treatments are those that constitute improper *methods of accounting* because they are consistent, albeit erroneous, practices for determining the time for recognizing income and expense. Rev. Rul. 80-190, 1980-2 C.B. 161; §§ 1.446-1(e)(2)(i), 1.446-1(e)(2)(iii), Examples (6)-(8); Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6th Cir.), cert. denied, 385 U.S. 822 (1966); Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961).

For example, assume that a taxpayer consistently takes a deduction for its insurance liabilities when the fact of such liabilities is fixed and the amount can be determined with reasonable accuracy. This treatment is a *method of accounting* under §§ 446 and 481 because it is a consistent practice to determine the timing of deductions for insurance expense. This accounting method is *improper* because it violates the economic performance regulations, which do not allow a deduction for payment liabilities (including insurance) until economic performance – namely, payment – has occurred. See § 1.461-4(g)(5).

The second category of improper tax treatments are treatments that are *errors*, rather than improper methods of accounting, because they are not timing practices and/or they are not consistently followed. Thus, a taxpayer that improperly but consistently treats a certain type of payment as a nondeductible dividend rather than deductible interest expense has made a series of errors because this improper treatment permanently affects this taxpayer's lifetime taxable income by understating its lifetime deductions. See § 1.446-1(e)(2)(ii)(b). Similarly, an isolated instance where taxpayer deducts the premium for an insurance policy in a way that is inconsistent with the timing treatment that taxpayer has historically applied to that policy and other insurance policies is an error, rather than an improper method of accounting; although the improper treatment does not affect taxpayer's lifetime taxable income (deductions are not permanently understated or overstated), the treatment is not a consistent practice because it is confined to one year and one policy.

The distinction between improper accounting methods and errors has significant procedural consequences. *Improper accounting methods* are rectified by a change to a proper method of accounting. Examining agents proposing an adjustment with respect to an improper treatment constituting an accounting method are required to rectify the improper treatment by imposing a change to a proper method of accounting. Rev. Proc. 2002-18, § 5. A taxpayer using an improper method of accounting is required to obtain the consent of the Commissioner under § 446(e) and associated guidance and to implement the accounting method change on a prospective basis. Rev. Proc. 97-27, § 2.04; Rev. Proc. 2002-9, § 2.04; Rev. Proc. 2002-18, § 2.03; Rev. Rul. 90-38; § 1.446-1(e)(3)(ii). In most cases, a change in method of accounting is made with an adjustment under § 481(a); the calculation of the § 481(a) adjustment is not limited to amounts attributable to open taxable years.

By contrast, *errors* are corrected on a retroactive basis by filing amended returns or by adjustments imposed by Examination. Such amended returns and Examination adjustments can only be made with respect to errors that occurred in open taxable years. No adjustment under § 481(a) is allowed. Accordingly, amounts attributable to errors in closed taxable years cannot be reached by either the taxpayer or Examination.

Timing and consistency

A change in method of accounting includes a change in the treatment of any material item used in an overall plan of accounting. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. <u>See</u> § 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 income or merely changes the taxable year in which taxable income is reported. <u>See</u> Rev. Proc. 97-27, § 2.01(1); Rev. Proc. 2002-9, § 2.01(1); Rev. Proc. 91-31; <u>Primo Pants</u>; <u>Knight Ridder</u>; <u>Peoples Bank & Trust Company</u>.

Under the foregoing principles, the change in treatment of the income from the sale of the taxpayer’s § 751(c)(2) unrealized receivables from the installment method to the cash method constitutes a change in method of accounting under §§ 446 and 481. The income from taxpayer’s § 751(c)(2) unrealized receivables is a material item because it involves the proper time for the inclusion of such income in gross income. The alternative treatments – the installment method and the cash method – both recognize the same amount of taxable income with respect to the § 751(c)(2) unrealized receivables over the lifetime of the taxpayer; only the amounts and taxable years in which the income are reported are different.

Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. <u>See</u> § 1.446-1(e)(2)(ii)(a). The taxpayer has evidenced the requisite consistency in applying the installment method to the income from the sale of taxpayer's § 751(c)(2) unrealized receivables by treating such income under the installment method in its federal income tax return filed for Taxable Year 1 and by filing federal income tax returns consistent with such treatment for the two successive taxable years. See Rev. Rul. 90-38.

Because the twin requirements of timing and consistency are both satisfied, the change in treatment of the income from the sale of taxpayer's § 751(c)(2) unrealized receivables clearly satisfies the basic definition of a change in method of accounting under §§ 446 and 481. We will now consider whether application of any regulations or judicial precedent would yield a contrary result.

Divergent treatments of an item

The distinction between 'improper accounting method' and 'error' discussed above also applies to situations where a taxpayer purports or attempts to report an item using a method of accounting that it has adopted, established or elected, but fails to apply the accounting method with perfect consistency. As a result, the item is treated in two different ways; part of the item is reported under the principal method of accounting, while the remainder of the item is reported using a treatment that diverges from the principal method of accounting (divergent treatment). If the divergent treatment is a timing practice used on a consistent basis, then conforming the divergent treatment to the principal method of accounting is a change in method of accounting because it constitutes a change in treatment of a material item. See § 1.446-1(e)(2)(ii)(a). If the divergent treatment is not a consistent practice and/or is not a timing practice (has a permanent impact on lifetime taxable income), then it is an error (or series of errors). See Huffman v. Commissioner, 126 T.C. 322 (2006).

Although the foregoing analysis of divergent treatments is consistent with well established principles of § 446, it has not been followed in every instance. Some cases have occasionally held that conforming a divergent but consistently used timing treatment to a principal method of accounting was not a change in method of accounting even though such change in treatment qualified as a change in treatment of a material item under § 1.446-1(e)(2)(ii)(a). Broadly speaking, these cases view a divergent treatment as a series of errors in the implementation of the principal method that do not constitute a method of accounting even where the series of errors affects only timing and is applied on a systematic and consistent basis.

In Gimbel Brothers v. U.S., 535 F.2d 14 (Ct. Cl. 1976), the taxpayer elected to use the installment method in 1952. The Court of Claims 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 the accrual method.[1]

The taxpayer in Gimbel Brothers filed amended returns to change its reporting of revolving credit sales to the installment method, characterizing its original treatment of such sales as an error. The Service rejected the amended returns as constituting a retroactive change in method of accounting made without the requisite consent under § 446(e). The Court of Claims, 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.

Similarly, in Standard Oil (Indiana) v. Commissioner, 77 T.C. 349, 381-84 (1981), 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 which originally had been capitalized into the depreciable basis of such platforms. The Tax 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.[2]

Additional cases with similar results and rationales include Korn Industries v. United States, 209 Ct.Cl. 559, 532 F.2d 1352 (1976)[3](holding that taxpayer did not change its method of accounting 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); Thompson-King-Tate, Inc. v. United States, 296 F.2d 290 (6th Cir. 1961)(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 v. United States, 151 F.3d 876 (1998)(holding that change from capitalizing losses on nuclear fuel contracts to deducting such losses as incurred was not a change in method of accounting where taxpayer deducted losses on other fuel contracts as incurred).

These divergent treatment cases are clearly distinguishable from the taxpayer's fact pattern. Divergent treatment cases involve situations where the change in treatment is made in order to account for certain revenues or expenditures in the same manner that taxpayer accounts for similar revenues or expenditures, or to correct the omission of certain revenues or expenses from a method of accounting that taxpayer applies to similar revenues or expenses. See Diebold, Inc. v. United States, 891 F.2d at 1582. Such changes in treatment constitute the "correction of internal inconsistencies" within

---

[1] The Service declined to follow Gimbel Brothers in AOD 1976-345 and Rev. Rul. 90-38. The reasoning was rejected in TAM 200043010.

[2] The Service acquiesced in Standard Oil (Indiana) only with respect to the characterization of the drilling platforms as IDCs. The reasoning was rejected in TAM 200043010.

[3] The Service declined to follow Korn Industries in Rev. Rul. 77-134, 1977-1 C.B. 132.

an accounting method as contemplated by the Tax Court in Standard Oil (Indiana), 349 T.C. at 383.

In the case of the taxpayer, however, the change in treatment of the income attributable to the § 751(c)(2) unrealized receivables (from the installment method to the cash method) is not imposed to conform the treatment of installment method income to the installment method; instead, the change in treatment removes the income from the sale of taxpayer's § 751(c)(2) unrealized receivables from the installment method altogether and places it under the taxpayer's overall cash method. (For additional decisions distinguished from the divergent treatment cases on the basis that they did not involve the correction of "internal inconsistencies" within an accounting method, see Hitachi Sales Corporation of America v. Commissioner, T.C. Memo. 1994-159; Sunoco, Inc. v. Commissioner, T.C. Memo. 2004-29; Texas Instruments v. Commissioner, T.C. Memo. 1992-306; Huffman v. Commissioner, 126 T.C. at 351-2).

Stated another way, the taxpayer's sale of the partnership interest resulted in two relevant classes (or subclasses) of income: sales income that is eligible for the installment method and sales income that is not eligible for the installment method (such as the income from the sale of the taxpayer's § 751(c)(2) unrealized receivables). The divergent treatment cases might be apposite to situations where the taxpayer treated certain income that was eligible for the installment method in a manner that was not proper under the installment method, or where the taxpayer used the cash method to report certain income that was eligible for the installment method. Instead of these scenarios, the taxpayer is simply reporting a separate class of income (income ineligible for the installment method) on an improper method (the installment method).

An additional basis for distinguishing the taxpayer's fact pattern from many of the divergent treatment cases is that the taxpayer's treatment of the income attributable to the § 751(c)(2) unrealized receivables was not attributable to inadvertence, ignorance or mistake of fact. The information received by the taxpayer in connection with the sale of Partnership A breaks out the sale consideration received by the taxpayer into separate components, including the amount of income attributable to § 751(c)(2) unrealized receivables. The information further indicates that reporting income attributable to the § 751(c)(2) unrealized receivables under the installment method would be contrary to published IRS position. These disclosures strongly suggest that the taxpayer made a conscious and informed decision regarding the reporting of the income attributable to the § 751(c)(2) receivables on the taxpayer's returns. Accordingly, the change in treatment of such income imposed by Examination was not "necessitated by the discovery of an error, as opposed to 'a discretionary choice'" by the taxpayer. See Sunoco, Inc. v. Commissioner. (For additional decisions distinguished from the divergent treatment cases by lack of inadvertence or mistake of fact, see Hooker Industries, Inc. v. Commissioner, T.C. Memo. 1982-357; Color Arts, Inc. v. Commissioner, T.C. Memo. 2003-95; Cargill, Inc. v. United States, 91 F.Supp.2d at 1300; FPL Group, Inc. v. Commissioner, 115 T.C. 554, 571 (2000)).

Even if they were closer on point to the facts at issue, the divergent treatment cases have become anomalies and anachronisms within the law of § 446 in several crucial respects. First, the divergent treatment cases rely heavily upon the proposition that the consent of the Commissioner under § 446(e) is not required where the taxpayer's existing treatment is improper. This proposition is expressly rejected by § 1.446-1(e)(2)(i), which provides in part that consent to change an existing method of accounting "must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder." See also § 1.446-1(e)(2)(iii), Examples (6)-(8); Rev. Rul. 80-190, 1980-2 C.B. 161; Rev. Rul. 77-134, 1977-1 C.B. 132. The vast majority of judicial opinion agrees that § 446(e) consent is required even for improper treatments. See, for example, Convergent Technologies v. Commissioner, T.C. Memo. 1995-320; Pacific Entertainment and Subs. v. Commissioner, 101 T.C. 1, 23 (1993); Wayne Nut and Bolt Co. v. Commissioner, 93 T.C. 500, 511 (1989); Witte v. Commissioner, 513 F.2d 391, 393-95 (D.C. Cir. 1975); U.S. v. Helmsley, 941 F.2d 71, 87 (2nd Cir. 1991); Commissioner v. O. Liquidating Corp., 292 F.2d 225, 230-31 (3rd Cir. 1961), cert. denied 368 U.S. 898 (1961); Wright Contracting Co. v. Commissioner, 316 F.2d 249, 254 (5th Cir. 1963); Rankin v. Commissioner, 138 F.3d 1286, 1289 (9th Cir. 1998); Diebold, Inc. v. U.S., 16 Cl. Ct. 193, 202-204, aff'd 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied 111 S. Ct. 73.

Second, the divergent treatment cases rely on the proposition that conforming the divergent treatment to the principal method of accounting is not a change in method of accounting because the taxpayer has not altered the principal method of accounting for the item; the taxpayer merely made adjustments to apply the principal method across the item on a correct and uniform basis. See Northern States Power Co., 151 F.3d at 884-885; Korn Industries, Inc., 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 § 446(e): 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 a change in method of accounting under § 446. See § 1.446-1(e)(2)(ii)(a); Huffman, 126 T.C. at 354-355.

Third, the divergent treatment 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 principal method of accounting. 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." § 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 taxable year in which taxable income is reported. See Primo Pants Co. v. Commissioner; Knight Ridder v. United States; Peoples Bank & Trust Co. v. Commissioner. 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 principal method of accounting would be an accounting method change because the inquiry tells us nothing about whether the divergent treatment involves timing.

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

The conclusions of Example 2 of § 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 method as its overall method of accounting, but reported bonus compensation expenses using an accrual method. The Tax Court concluded that changing the treatment of bonus compensation from the accrual method to the cash 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. Similar results were reached in Miele v. Commissioner, 72 T.C. 284 (1979), Pierce Ditching Co. Inc. v. Commissioner, 73 T.C. 301 (1979) and Brunton v. Commissioner, T.C.Memo. 1982-166.

If changing the divergent treatment of real estate taxes or bonuses to conform to an overall method of accounting (either cash or accrual) constitutes a change in method of accounting, 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 principal method of accounting (installment method) is not a change in method of accounting, or, for that matter, why conforming the taxpayer's treatment of the income from the § 751(c)(2) receivables to taxpayer's overall cash method is not also a change in method of accounting.

Finally, the divergent treatment cases embody the highly counterintuitive notion that the computations of taxable income shown on filed returns do not necessarily reflect or determine the methods of accounting 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 the accrual method on its returns to compute and report taxable income from such sales for more than a decade. Similarly, the conclusion that changing the treatment of the taxpayer's income from the sale of its § 751(c)(2) unrealized receivables is merely an error correction implies that taxpayer was really on the cash method for such income all along, even though it filed several tax returns clearly indicating that the installment method was being applied to such income.

In light of the foregoing serious problems, it is not surprising that the persuasive force of the divergent treatment cases is severely limited in numerous respects. First, the courts frequently distinguish these cases using a narrow reading of their facts. As discussed above, numerous cases have been distinguished because they did not involve correction of "internal inconsistencies" or reflect inadvertence or mistake of fact. As a further example, the Tax Court concluded that Pacific Enterprises v. Commissioner, 101 T.C. 1, 21 (1993) was distinguishable from Gimbel Brothers and Standard Oil (Indiana) merely because these cases "do not involve inventory identification or valuation," which are specifically mentioned in § 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 § 446. Thus, Cargill, Inc. v. United States, 91 F.Supp.2d 1293, 1298 (D.Minn. 2000) concludes that the divergent treatment 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 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 (10^{th} Cir. 1975), cert. denied 423 U.S. 1087 (1976), for example, taxpayers accounted for self-constructed assets by capitalizing only the direct costs of those assets; the remaining indirect costs were deducted as part of the cost of goods sold. The 10^{th} Circuit upheld the holding of the Tax Court that conforming the divergent treatment of the indirect costs (deduction) to the primary method (capitalization) was a change in method of accounting under § 446 that triggered an adjustment under § 481. See also Sartor v Commissioner, T.C.Memo. 1977-327 (divergent accrual treatment of interest by individual using overall cash method).

Impermissible treatments

Some opinions have concluded that a change in treatment was an error correction, rather than an accounting method change, on the basis that the treatment being changed was contrary to the requirements of statutes or regulations. See, for example, Thompson-King-Tate, Inc. v. United States, 296 F.2d 290 (6^{th} Cir. 1961); North Carolina Granite Corp. v. Commissioner, 43 T.C. 149 (1964). This rationale overlaps the divergent treatment cases discussed above in fact patterns where the deviation from the overall method of accounting is considered to be improper because the divergent treatment is inconsistent with a statute or regulation or is contrary to a binding election to use the overall method.

The most widely cited case in this group is Thompson-King-Tate, Inc., in which the taxpayer had established a method of recognizing income from long-term contracts in the year in which the contract was finally completed and accepted (completed contract method). The taxpayer subsequently reported income from a long-term contract in 1953 (the year in which the contract was substantially completed) and in 1955 (the year of final completion and acceptance of the contract), rather than 1955 alone. The Sixth Circuit Court of Appeals centered its analysis on the doctrine of election:

> "We recognize that where a taxpayer is authorized under the income tax statutes to treat income from a transaction in either of two ways, his election to treat it in one of those ways is binding upon him. But the principle of election does not apply where the taxpayer has no legal opportunity to choose. If, under the statutes, income must be reported in a certain way and the taxpayer erroneously reports it in a different way, such treatment is not binding upon either the taxpayer or the Commissioner. The taxpayer has made an error, not an election, which error, in the absence of estoppel, is subject to correction if timely challenged by either the taxpayer or the Commissioner, Crosley Corporation v. United States, 229 F.2d 376, 379-380, C.A.6th; Ross v. Commissioner, 169 F.2d 483, 493, C.A.1st." 296 F.2d at 294.

The Court noted that the taxpayer had originally been free to choose between the percentage-of completion and completed contract treatments for its contracts, but once the choice had been made, it was binding on the income tax returns for 1953 and thereafter. Accordingly, taxpayer could not elect to report its contract income in 1953 and this improper and unauthorized treatment could and should be corrected by a timely amended return

After seeming to resolve the issue on the basis of the taxpayer's lack of a "legal opportunity to choose," the Court further observed that (i) the Service had not invoked the authority of the Commissioner under § 41 of the 1939 Internal Revenue Code (1939 Code) to change taxpayer's method of accounting in 1953 because it did not clearly reflect income, and (ii) the taxpayer had made no request to change its method of accounting for the contract under § 39.41-2 of the Treasury Regulations under the 1939 Code. "Under these circumstances," the Court concludes, "the taxpayer was required to return its profit from the long-term contract in the year 1955, consistent with the method previously used by it, and it had no election to return it in 1953 instead of in 1955."

These remarks imply that the Court believed that a change to conform the taxpayer's errant treatment of the long-term contract to its established completed contract method would have been a change a method of accounting. This severely undermines Thompson-King-Tate as authority for the proposition that changes to conform an impermissible treatment to a required accounting method are always error corrections rather than accounting method changes. Further, if the Court believed that the change in treatment constituted a change in method of accounting, then upholding the taxpayer's refund claim for the 1953 taxable year amounted to allowing the taxpayer to make a retroactive change in method of accounting without the consent of the Commissioner under § 446(e), which is clearly improper under more current authorities. See Rev. Proc. 2002-18, § 2.03, Rev. Rul. 90-38, Diebold, Inc. v. United States, 891 F.2d 1579, 1583 (Fed. Cir. 1989); Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 682 (1980); Pacific National Co. v. Welch, 304 U.S. 191, 194 (1938)

Viewed in light of these concerns, Thompson-King-Tate holds little authority for the contemporary issue of determining whether a given change in treatment is an error correction or an accounting method change; the case seems to stand primarily for the distinct proposition that an election can only exist where the law poses a choice.

Despite its uncertain force, Thompson-King-Tate is frequently cited as supporting the general proposition that where the law prescribes or proscribes a specific method of accounting for an item, any change to conform the taxpayer's treatment of such item to the legally required method of accounting is the correction of an error rather than a change in method of accounting.[4] This asserted proposition cannot stand, however, because it contradicts two basic principles established by the regulations and endorsed by the overwhelming majority of case law.

The first such principle is simply that impermissible methods of accounting do exist. In other words, the consistent treatment of a material item (involving the proper time for the recognition of income or deduction) is a method of accounting under §§ 446 and 481 even if such treatment is impermissible.

This principle is reflected in § 1.446-1(e)(2)(i), which provides that § 446(e) consent to change an existing method of accounting "must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder," which clearly implies the existence of improper or impermissible methods of accounting. This principle is also illustrated in the very first example of § 1.446-1(e)(2)(iii):

> "Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting."

[4] GCM 39469 (Jan. 20, 1983) concludes in part that "Thompson-King-Tate does not stand for the legal proposition that section 446(e) is not applicable when the law specifically prescribes or proscribes a method of accounting or computation."

The cash receipts and disbursements method (cash method) used by the jewelry retailer is a method of accounting. See §§ 1.446-1(a)(1), 1.446-1(c)(1)(i). The Code and Regulations, however, prohibit the jeweler from using the cash method. See § 471; §§ 1.446-1(c)(2)(i), 1.471-1; Huffman, 126 T.C at 352-3. In other words, Example 1 clearly shows the taxpayer using an impermissible method of accounting and expressly states that a change to the correct treatment is a change in method of accounting under §§ 446 and 481, as do other examples in the same regulation, such as Examples 6, 7 and 8. See also H.F. Campbell Co. v. Commissioner, 53 T.C. 439, 447 (1969), affd. 443 F.2d 965 (6th Cir. 1971); Bank One Corp. v. Commissioner, 120 T.C. 174, 282 (2003).

These commonsense conclusions are directly contradicted by a Thompson-King-Tate analysis of the Example 1 fact pattern, which begins with the observation that the jeweler "had no legal opportunity to choose" the cash method of accounting. Accordingly, the jeweler was not really using the cash method of accounting, no matter how consistently the timing principles of the cash method were applied; rather, the jeweler was making a series of errors (albeit suspiciously comprehensive and methodical errors) in applying an accrual method as required by law. Accordingly, bringing the jeweler into compliance with the legal requirement to use an accrual method of accounting is the correction of an error rather than a change in method of accounting. The Thompson-King-Tate analysis of the Example 1 fact pattern is thus utterly inconsistent with the results announced in the regulation. Similar inconsistencies arise with respect to Examples 6, 7 and 8 in § 1.446-1(e)(2)(iii).

The second basic principle that contradicts the asserted holding of Thompson-King-Tate is that the advance consent requirement of § 446(e) applies even where the taxpayer's existing method of accounting is impermissible, which is expressly recognized by § 1.446-1(e)(2)(i) and accepted by the vast majority of judicial opinion. See, for example, Pacific Entertainment and Subs. v. Commissioner, 101 T.C. 1, 23 (1993); Wayne Nut and Bolt Co. v. Commissioner, 93 T.C. 500, 511 (1989); Witte v. Commissioner, 513 F.2d 391, 393-95 (D.C. Cir. 1975); U.S. v. Helmsley, 941 F.2d 71, 87 (2nd Cir. 1991); Commissioner v. O. Liquidating Corp., 292 F.2d 225, 230-31 (3rd Cir. 1961); Wright Contracting Co. v. Commissioner, 316 F.2d 249, 254 (5th Cir. 1963); Rankin v. Commissioner, 138 F.3d 1286, 1289 (9th Cir. 1998); Diebold, Inc. v. U.S., 16 Cl. Ct. 193, 202-204, aff'd 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied 111 S. Ct. 73.

This well accepted principle would be rendered meaningless or void by a Thompson-King-Tate analysis. If a taxpayer cannot have an incorrect method of accounting because it never has "the legal opportunity to choose" an incorrect treatment, how would changes from incorrect methods of accounting ever exist, let alone be subject to a consent requirement under § 446(e)?

As its incompatibility with the foregoing bedrock principles of § 446 would suggest, the Thompson-King-Tate analysis retains little contemporary authority on the issue of whether a change in treatment is an accounting method change or an error correction. The Tax Court, for example, will occasionally cite the Thompson-King-Tate line of cases with approval, or invoke their rationale to conclude that a change in treatment is an error correction rather than an accounting method change. See Sicard v. Commissioner, T.C. Memo. 1996-173; Gibson v. Commissioner, 89 T.C. 1177. More frequently, however, the Tax Court concludes that a change in consistent timing treatment constitutes a change in method of accounting even though the treatment being changed was an improper one that the taxpayer had no “legal opportunity to choose.”

For example, in Hitachi Sales Corporation of America v. Commissioner, T.C. Memo. 1994-159, the Tax Court concluded that an Examination-imposed change in the manner of determining ‘market’ for a taxpayer using a lower of cost or market inventory valuation method was a change in method of accounting, even though taxpayer determined ‘market’ on an impermissible basis. Similarly, in Sunoco, Inc. v. Commissioner, T.C. Memo. 2004-29, the Tax Court held that taxpayer’s attempted change in treatment of overburden removal costs from developmental expenditures to production costs was a change in method of accounting, even though treating the overburden removal costs as developmental expenditures was improper. For examples of similar outcomes, see Miele v. Commissioner, 72 T.C. 284 (1979)(correcting cash method law firm’s improper treatment of receipts to include amounts constructively received but not yet transferred from trust account was change in method of accounting); Sartor v. Commissioner, T.C. Memo. 1977-327 (overall cash method taxpayer changed its method of accounting when it improperly reported interest deductions for certain discounted loans on an accrual basis).

The Tax Court and the Claims Court have stated that “where the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable.” Huffman, 126 T.C. at 354; First National Bank of Gainesville, 88 T.C. 1085; Diebold, Inc., 16 Cl. Ct. at 203-205. The phrase “correction of an error” here cannot logically refer to changes in treatments that do not constitute accounting method changes, as this would result in an internally contradictory proposition; rather, “correction of an error” must mean any change to rectify an erroneous treatment. Accordingly, the principle articulated by these courts envisions that changes in treatment to rectify erroneous treatments and changes in treatment that constitute accounting method changes are distinct but overlapping sets; in the area where they overlap – where a change in treatment is both the rectification of an erroneous treatment and a change of accounting method – the principles of § 446 control. The Thompson-King-Tate cases suggest just the opposite: that § 446 does not apply in the area of overlap. Accordingly, Thompson-King-Tate seems inconsistent with the basic approach of the Tax Court and Claims Court.

The Tax Court’s most recent consideration of the Thompson-King-Tate analysis occurs in Huffman v. Commissioner, in which the taxpayers elected to use the link-chain, dollar-value LIFO method to account for inventories, but from their election years onward they omitted a required step in the calculations under such method until the incorrect methodology was noticed during an examination of their returns. As with the cases discussed above, the Thompson-King-Tate analysis would suggest that the taxpayers never had a legal opportunity to choose the improper version of the link-chain, dollar-value LIFO method that they actually implemented, and thus the adjustments made by the examining agents must be error corrections rather than accounting method changes. Nevertheless, the Tax Court held that the adjustments were accounting method changes, noting that the weight of Thompson-King-Tate and North Carolina Granite was uncertain because they were decided before T.D. 7073, 1970-2 C.B. 98, amended § 1.446-1 to clarify the importance of timing and consistency.

The Court of Federal Claims most recently addressed the Thompson-King-Tate line of cases in General Dynamics Corporation v. United States, 69 Fed. Cl. 180 (2005). The taxpayer, a government contractor, filed amended returns seeking to change its treatment of the completed contract method (CCM) portion of a federal contract to recognize losses in 1991 (when the contract was cancelled) rather than a subsequent taxable year. Citing Thompson-King-Tate, the taxpayer argued that this change in treatment was the correction of an erroneous application of its CCM and thus did not require consent under § 446(e). The Court of Federal Claims concluded that the taxpayer's new treatment of recognizing losses in 1991 was improper, and further opined that the change in treatment of the CCM losses was a change in the timing of a deduction and thus required consent under §§ 446 and 1.446-1(e)(2)(ii)(a).

The impact of General Dynamics upon the Thompson-King-Tate rationale is ultimately uncertain. The impropriety of the taxpayer's new treatment of recognizing CCM losses in 1991 is sufficient to distinguish the General Dynamics fact pattern from the rationale of Thompson-King-Tate; a change in treatment can hardly be justified as the correction of an improper implementation of CCM when the proffered correction is itself incorrect. As a result, General Dynamics is not, strictly speaking, irreconcilable with Thompson-King-Tate. It is significant, however, that the Court did not rest its decision solely on the apparently sufficient basis that the taxpayer's amended returns contained an impermissible treatment of CCM losses; rather, the Court continued its analysis to conclude that the change in treatment was an accounting method change requiring § 446(e) consent. The Court further noted that this additional holding was consistent with the Federal Circuit decision in Diebold, 891 F.2d at 1579, "a precedent which is controlling on this matter, unlike a decision by the Sixth Circuit" such as Thompson-King-Tate. These factors strongly suggest that the Court of Federal Claims would have found that the change in treatment was an accounting method change requiring § 446(e) consent even if the new treatment of CCM losses proposed by the taxpayer had been permissible.

In sum, the general proposition perceived in the Thompson-King-Tate line of cases – roughly, that the principles and requirements of §§ 446 and 481 regarding methods of accounting are somehow inapplicable where a taxpayer's treatment violates a legal prescription or proscription – is flatly inconsistent with the Code, the Regulations and the overwhelming weight of judicial authority. Accordingly, such proposition cannot support the contention that the taxpayer’s change in treatment of the income from the sale of taxpayer’s § 751(c)(2) unrealized receivables is not a method of accounting because the taxpayer’s initial treatment – the installment method – was impermissible.

Posting, mathematical and analogous errors

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not occur when a taxpayer seeks to correct a mathematical error, a posting error, or an error in the computation of tax liability. The terms “mathematical error” and “posting error” are not defined within the regulations. The Tax Court has concluded that “mathematical error” is limited to errors in arithmetic (addition, subtraction, multiplication and division); the term does not include such errors as the omission of a mathematical step (multiplication) in a sequence of calculations. Huffman at 343-345. Similarly, the Tax Court has interpreted “posting error” to be an error in the act of transferring an original entry to a ledger. Wayne Bolt & Nut Co., v. Commissioner, 93 T.C. at 510-511 (quoting Black's Law Dictionary 1050 (5th ed.1979).

In addition to these relatively narrow judicial constructions, the courts have sometimes concluded that a change in treatment did not constitute a change in method of accounting because it was ‘analogous’ or ‘akin’ to the correction of a posting error. See Korn Industries v. United States, 209 Ct. Cl. 559, 532 F.2d 1352 (1976); Northern States Power v. United States, 151 F.3d 876 (8th Cir. 1998); Evans v. Commissioner, T.C.Memo. 1988-228. Although the fact patterns in these cases vary, they do share a few common characteristics: (i) the treatment at issue does not conform to the taxpayer’s established or elected method of accounting for the relevant item; (ii) the taxpayer is not aware of this nonconformity; and (iii) the nonconformity results either from an inadvertent mistake of a mechanical or clerical nature (such as omitting cost elements from the computation of inventories in Korn), or from an ignorance or mistake of relevant facts (such as the tax department being unaware that certain amounts contained net unrecouped contract losses in Northern States Power).

On the other hand, the courts have been disinclined to analogize a nonconforming treatment to the correction of a posting error to the extent that (i) taxpayer was aware of what it was doing (Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983); Hooker Industries, Inc. v. Commissioner, T.C. Memo. 1982-357; Texas Instruments, Inc. v. Commissioner, T.C. Memo. 1992-306); (ii) the impact of the nonconforming treatment was significant rather than incidental (FPL Group, Inc. v. Commissioner, 115 T.C. 554, 571-2 (2000); Wayne Nut and Bolt v. Commissioner, 93 T.C. 500, 511-2 (1989), Firetag v. Commissioner, T.C. Memo. 1999-355); and (iii) the treatment was systematic and consistent (Wayne Nut and Bolt; Firetag; Color Arts v. Commissioner, T.C. Memo. 2003-95).

Viewed in light of these broad principles, imposing a proper tax accounting treatment onto the income from the sale of taxpayer’s § 751(c)(2) unrealized receivables cannot constitute the correction of a posting or mathematical error under § 1.446-1(e)(2)(ii)(b), or anything analogous thereto. There is no indication that the taxpayer applied the installment method to the § 751(c)(2) unrealized receivables income because of a mechanical, clerical or mathematical error. Further, the taxpayer was neither ignorant nor mistaken with respect to the relevant facts: the information received by the taxpayer from Partnership A clearly indicated that the gain on the sale was attributable in part to unrealized receivables, and indicated that this portion of the gain might be ordinary income subject to current taxation. In light of such information, the taxpayer was clearly conscious of the position taken with respect to the income from the sale of taxpayer's § 751(c)(2) unrealized receivables. Finally, the taxpayer applied its divergent treatment on a consistent basis for more than two years by (i) filing a federal income tax return and associated Form 6252 for Taxable Year 1 that treated the income from the sale of its § 751(c) unrealized receivables as being subject to the installment method, and (ii) subsequently filing federal income tax returns consistent with this position.

Incidental deviations from an accounting method

The courts have sometimes concluded that a change in treatment to conform to an existing method did not constitute a change in method of accounting because the change in treatment was sufficiently 'incidental' or 'minor.' This rationale can be independent of, although it often overlaps with, the conclusion that the change in treatment is a posting or mathematical error. See Huffman, 126 T.C. at 354, fn. 19 (short-lived deviation from an established method of accounting need not be viewed as establishing a new method of accounting, even where deviation does not constitute posting or mathematical error).

The cases invoking the 'incidental' or 'minor' deviation rationale have given various meanings to these terms. First, courts concluding that a deviation from an established method does not establish a method of accounting have often observed that the dollar amounts involved in the deviation are immaterial, either in absolute amount or relative to the amounts treated under the established method. See, e.g., Southern Pacific Transportation Company v. Commissioner, 75 T.C. 497, 680-687 (1980). The significance of this consideration has been considerably muted by T.D. 7073, 1970-2 C.B. 98, which clarified that the concept of materiality in "material item" is "the proper time for inclusion of the item in income or the taking of a deduction." See § 1.446-1(e)(2)(ii)(a).

Second, a court may sometimes determine that a deviation from an established method is incidental if the deviation is perceived to be a mere variation (typically an improper one) of the established method for the item, rather than a clearly different methodology. In Exxon Mobil Corp. v. Commissioner, 114 T.C. 293 (2000), for example, the Tax Court concluded that changing the treatment of dismantlement, removal and restoration (DRR) costs from deducting the costs when the DRR work is performed to capitalizing such costs into a capital asset (with attendant depreciation, investment tax credit and intangible drilling costs consequences) would constitute a "substantial deviation" from the taxpayer's existing methodology of deducting DRR costs as DRR work was performed, and would thus constitute a change in method of accounting requiring consent under § 446(e). In dicta, the Tax Court wondered, without deciding, whether the taxpayer's alternative claim, which involved changing from deducting DRR costs when the DRR work was performed to deducting the DRR costs when the wells were first drilled, would constitute a mere "correction" in taxpayer's application of the all-events test for which § 446(e) consent was not required. The apparent rationale for the differing results is that in the first case the divergent treatment (capitalization) appears to be distinctly different from the established method (a §162 deduction under the all-events test), whereas in the second case the divergent treatment can be viewed as merely an improper variation or implementation of the established method.

Third and fourth, the likelihood that a deviation will be treated as a mere correction of an error not constituting an accounting method change increases to the extent that the divergent treatment impacts only the *timing* of income or deductions and is applied *consistently*. These considerations derive directly from the definition of change in method of accounting in § 1.446-1(e)(2)(ii)(b). Thus, a deviation that has a permanent impact on lifetime taxable income – such as between treating an item as deductible interest or salary and treating it as a nondeductible payment of a dividend – requires an error correction rather than a change in method of accounting, even if the deviation is applied on a consistent basis. Similarly, a partial deviation from an established method of accounting, as well as the subsequent reversion to such established method, do not constitute changes in method of accounting requiring § 446(e) consent to rectify if the divergence is not sufficiently consistent. Huffman, 126 T.C. at 354-5. For this purpose, consistency is established by applying the same treatment in two or more consecutive taxable years. See § 1.446-1(e)(2)(ii)(a), Rev. Rul. 90-38.

None of the considerations enumerated above support the conclusion that a change in the taxpayer's treatment of the income from the sale of its § 751(c)(2) unrealized receivables would be a correction of an error rather than a change in method of accounting under §§ 446 and 481. To the extent that materiality remains a relevant consideration, the income attributable to the § 751(c)(2) unrealized receivables cannot be said to be immaterial, either as an absolute amount or relative to the income attributable to the sale overall. The required adjustment – switching the treatment of the income from the sale of taxpayer's § 751(c)(2) unrealized receivables from the installment method to the cash method – represents a switch between two distinct methodologies, rather than a mere tweaking of the application of the installment method. The taxpayer's deviation from the installment method – improperly applying the method to the income from the sale of taxpayer's § 751(c)(2) unrealized receivables – affected only the timing of the income recognition. Finally, the taxpayer applied its divergent treatment on a consistent basis for more than two years by (i) filing a federal income tax return and associated Form 6252 for taxable year 1 that treated the income from the sale of its § 751(c) receivables as being subject to the installment method, and (ii) subsequently filing federal income tax returns consistent with this position.

One "item" or two?

The foregoing discussion has largely assumed that the fact pattern at issue presented two 'items' for purposes of §§ 446 and 481, namely (i) the transaction income that was attributable to the § 751(c)(2) unrealized receivables and was not eligible for reporting under the installment method, and (ii) the remaining transaction income that was eligible for the installment method. But there exists at least one obvious alternative analysis: that the transaction income constitutes a single item under § 446 and 481.

Intuitive arguments can be made for either alternative. On the one hand, the Partnership A interest was a distinct piece of property that was sold in a single transaction, which implies that the proceeds of the sale are also a single unit. On the other hand, the tax law perceives sufficient differences between the income attributable to the § 752(c)(2) unrealized receivables and the remaining income to prescribe different accounting treatments for these two classes of income, which implies that they should be treated as separate items under §§ 446 and 481.

Resolving the difficult issue of one item or two is not necessary in this particular case because the conclusions reached above remain the same whether income from the transaction constitutes one item or two. The basic elements of timing and consistency are equally well satisfied under either alternative. A change from treating transaction income entirely under the installment method to a combination of the cash method (for the income from the sale of taxpayer's § 752(c)(2) unrealized receivables) and the installment method (for the remaining income) would affect only timing and would not result in any permanent impact on lifetime taxable income. Similarly, the consistency of treatment evinced by the taxpayer is the same whether such treatment is deemed to apply to two items or one.

Finally, the distinction between one item or two simply has no impact on the relevant factors discussed in connection with posting errors and incidental deviations, and thus the conclusions reached in these sections would not be changed by the adoption of a one-item theory.

Summary

The change in treatment proposed by Examination satisfies the basic elements – timing and consistency – that are required of an accounting method change. This conclusion holds whether the method of accounting being changed is considered to be a method for the § 751(c)(2) receivables income only or a method of accounting for the entire sale. None of the potentially applicable exceptions – divergent treatment precedents, posting and mathematical errors, or incidental deviations – disturb this conclusion. Accordingly, the change in treatment proposed by Examination constitutes a change in method of accounting under §§ 446 and 481.

ISSUE 3: If the change in treatment of the portion of the sale attributable to the unrealized accounts receivable constitutes an accounting method change, may Examination impose such change in Taxable Year 2, and if so, under what terms?

Under § 446(b), Examination is empowered to change the taxpayer to a correct method of accounting if it determines that the existing method of the taxpayer (installment method) does not clearly reflect the income of the taxpayer with respect to the item (either § 751(c)(2) receivables income or total income from the sale). Rev. Proc. 2002-18, § 5.02. Examination ordinarily imposes the change in method of accounting in the earliest open year in which the improper accounting method is present – here, taxable year 2. The accounting method change would be made with an adjustment under § 481(a), and the § 481(a) adjustment would ordinarily taken into account entirely in the year of change. Rev. Proc. 2002-18, § 5.04.

Please call (202) 622-4930 if you have any further questions.