Office of Chief Counsel
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memorandum

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from: Branch Chief, Branch 7 (CC:ITA:7)
(Income Tax & Accounting)

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subject: Change in Method of Accounting and Section 481(a) Adjustment

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

LEGEND

Taxpayer =

A =

B =

C =

D =

E =

F =

G =

H =

J =

K =

Taxable Year L =

Taxable Year M =

N =

DATE 1 =

DATE 2 =

ISSUES

1. Whether a change in the time for deducting an item of expenditure constitutes a change in method of accounting under section 446 of the Internal Revenue Code?

2. Whether a change from deducting an item of expenditure to capitalizing such item of expenditure constitutes a change in method of accounting under section 446?

3. If the foregoing do constitute changes in method of accounting under section 446, (i) whether a section 481(a) adjustment should be recognized in connection with such changes, and if so, (ii) whether the section 481(a) adjustment may reflect amounts previously deducted in closed taxable years?

CONCLUSIONS

1. A change in the time for deducting an item of expenditure constitutes a change in method of accounting under section 446.

2. A change from deducting to capitalizing an item of expenditure constitutes a change in method of accounting under section 446.

3. An adjustment under section 481(a) is imposed when a taxpayer's method of accounting for an item of expenditure is changed from earlier deduction to later deduction or capitalization. The 481(a) adjustment is computed with respect to relevant amounts in all taxable years preceding the year of change, whether the taxable years are open or closed under the period of limitations on assessment ("statute of limitations").

FACTS

Beginning in J, Taxpayer initiated a legal action against A and B. The litigation continued until Taxpayer and A executed a settlement agreement on DATE 1, TAXABLE YEAR L, resolving all pending litigation and disputes. The litigation involved two major issues: (1) the defendants' failure to honor Taxpayer's right of first refusal to purchase land; and (2) the defendants' failure to maintain property under the Management Agreement.

The settlement agreement awarded $C to Taxpayer. The proceeds consisted of $D through a line of credit to be used for the development plan, and $E in cash due on the date the agreement closed of which $F would be used to pay existing loan balances, $G could be used for immediate repairs and upgrades to existing facilities, and $H could be used for the development plan for proposed renovations, development, or redevelopment of Taxpayer's facilities.

On DATE 2, TAXABLE YEAR L, Taxpayer entered into a development agreement with A, whereby A would manage, supervise, and complete a plan for major improvements of Taxpayer's facilities. The development agreement obligated Taxpayer to use $D of the settlement proceeds toward the improvement plan.

Taxpayer reported the $C of settlement proceeds as income on its TAXABLE YEAR L tax return, and claimed an expense deduction of this same $C. Documents obtained from Taxpayer do not show the extent to which services (for repairs or improvements) were performed as of December 31, TAXABLE YEAR L. However, the documents show that as of December 31, TAXABLE YEAR M, Taxpayer had expended over $K of the settlement proceeds on the improvements under the development plan. Moreover, the documents indicate the expenditures under the development plan are capital in nature. Taxpayer has not proven that any expenditures made pursuant to the settlement and development agreements were for deductible repairs.

TAXABLE YEAR L is now a closed year. For TAXABLE YEAR M, Exam proposes to place Taxpayer on correct methods of accounting to capitalize expenditures and to deduct expenditures only when economic performance has occurred. Pursuant to the imposition of these changes in accounting method, Exam proposes to impose an adjustment under section 481(a) attributable to the $N expense deduction taken in TAXABLE YEAR L for the settlement proceeds (*i.e.*, $D for improvements under the development plan, $G for immediate repairs and upgrades to existing facilities, and $H for proposed renovations, development, or redevelopment of Taxpayer's facilities).

LAW AND ANALYSIS

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. See also section 1.446-1(b)(1) of the Income Tax Regulations.

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).

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 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 section 2.06 of Rev. Proc. 2002-18, 2002-1 C.B. 678 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under section 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, sections 3.01, 5.01 to 5.03.

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, section 5.04(1).

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

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, 1997-1 C.B. 680, section 2.01(1); Rev. Proc. 2002-9, 2002-1 C.B. 327, section 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).

An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting. General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C.Memo. 2003-95.

Although a method of accounting may exist under the definition in section 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 section 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 section 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, 1990-1 C.B. 57.

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 section 1.446-1(e)(2)(ii)(*b*).

Where the correction of an error results in a change in accounting method, the requirements of section 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).

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes a method of accounting, and a change from one such practice to another generally constitutes a change in method of accounting. 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 method of accounting [Summit Sheet Metal Co. v, Commissioner, T.C.Memo 1996-563], and a change from deducting real estate taxes when paid to deducting these taxes when incurred is also a change in method of accounting [section 1.446-1(e)(2)(iii), Example (2)]. Courts have found accounting method changes in similar circumstances involving a variety of different types of expenses, including vacation pay [American Can Co. v. Commissioner, 317 F.2d 604 (2nd Cir. 1963)], interest [Peoples Bank and Trust Co. v. Commissioner, 50 T.C. 750 (1968), aff'd 415 F.2d 1341 (7th Cir. 1969); Mulholland v. U.S., 28 Fed.Cl. 320 (1993); Prabel v. Commissioner, 882 F.2d 820 (3rd Cir. 1989)], customer rebates [Knight-Ridder Newspapers, Inc. v. U.S., 743 F.2d 781 (11th Cir. 1984)], and related party payables [Bosamia v. Commissioner, 661 F.2d 250 (5th Cir. 2011)].

Similarly, a change from deducting an expense when paid or incurred to capitalizing such expense, or vice versa, generally constitutes a change in method of accounting. Expensing and capitalization generally result in the same cumulative taxable income over the lifetime of the taxpayer. For example, an expenditure of $1,000 that is deducted in full when it is paid or incurred reduces a taxpayer's lifetime taxable income by $1,000. If the same expenditure is capitalized, taxpayer's lifetime taxable income will also be reduced by $1,000 through deductions for depreciation or amortization, recognition of basis resulting in a reduction of gain (or an increase of loss) on sale or disposition of the asset, or a combination of the foregoing.

Treating changes between expensing and capitalization as changes in method of accounting is supported by section 1.446-1(e)(2)(ii)(*d*)(*2*), which provides that "a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting." See also Exxon Mobil v. Commissioner, 114 T.C. 293, 321-323 (2000) (change in treatment of 'dismantlement, removal and restoration costs' from deduction when work is performed to capitalization constituted accounting method change); Pelaez and Sons, Inc. v. Commissioner, 114 T.C. 473, 487-489 (2000), aff'd 253 F.3d 711 (11th Cir. 2001) (change in treatment of preproductive citrus growing costs from deduction to capitalization); FPL Group, Inc. v. Commissioner, 115 T.C. 554 (2000) (change in treatment of asset costs from capitalizing and depreciating to deducting when incurred constituted accounting method change); Sunoco, Inc. v. Commissioner, T.C.Memo. 2004-29 (change in treatment of miner's 'overburden removal costs' from developmental costs (spread as deductions) to production costs (included in cost of goods sold) constituted a change in method of accounting); and Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 680-687 (1980), supplemented by 82 T.C. 122 (1984) (change in treatment of certain railway maintenance expenses from capitalization into embankments to deduction as work is performed constitutes a change in method of accounting).

Whether Exam's adjustments constitute changes in method of accounting under section 446

Exam's contemplated adjustments fall into two general categories. First, Exam proposes to correct the treatment of certain items of expense by changing the Taxpayer from claiming a deduction for the expense items before economic performance has occurred with respect to these items to claiming a deduction only when economic performance has occurred. Second, Exam proposes to correct the treatment of other items of expense by changing Taxpayer from deducting the expense items to capitalizing the expense items. Both categories of adjustments constitute changes in methods of accounting.

Taxpayer's first category of adjustments – changing the time when a deduction is claimed for an expense item – constitute changes in methods of accounting because these adjustments are changes in the treatment of items that involve the proper times for the taking of deductions. These changes do not permanently affect Taxpayer's lifetime taxable income; they merely change the taxable years in which deductions, and the attendant reductions in taxable income -- are reported.

Similarly, Taxpayer's second category of adjustments – changing from expensing to capitalization – also constitute changes in methods of accounting because these changes affect only the timing of taxable income recognition and have no permanent impact on the cumulative amount of taxable income. Claiming an immediate deduction for these expense items has the same impact upon Taxpayer's lifetime taxable income as capitalizing these costs and recovering them over time as depreciation, amortization or basis.

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 section 1.448-1(a).

A change in method of accounting to which section 481(a) applies includes a change in treatment of a single material item. See section 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).

Once the Commissioner has imposed a change in method of accounting, the application of section 481(a) to such change is patent and mandatory. Primo Pants Co. v. Commissioner, 78 T.C. 705, 720 (1982); Emert v. Commissioner, T.C.Memo. 1999-175; Hitachi Sales Corp. of America v. Commissioner, T.C.Memo. 1994-159, supp. T.C.Memo. 1995-84.

An adjustment under section 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Suzy's Zoo v. Commissioner, 114 T.C. 1, 12-13 (2000), aff'd 273 F.3d 875, 884 (9th Cir. 2001); Huffman v. Commissioner, 126 T.C. 322, 341-2 (2006), aff'd 518 F.2d 357, 363-4 (6th Cir. 2008); 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).

Should section 481(a) adjustments be recognized for the accounting method changes imposed by Exam? May such adjustments reflect amounts attributable to closed taxable years?

As concluded above, the adjustments contemplated by Exam constitute changes in method of accounting. Accordingly, once they are imposed, the computation and recognition of an appropriate adjustment under section 481(a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change.

The section 481(a) adjustment reflects relevant amounts from any taxable years preceding the year of change (Taxable Year M), even if such years are closed by the statute of limitations. Thus, if Taxpayer deducted certain amounts in Taxable Year L under its old method of accounting, and will be able to deduct or otherwise recover those same amounts again in the year of change or subsequent taxable year(s), then positive amounts (increases to taxable income) will be recognized under section 481(a) to eliminate the double deduction that would otherwise result, despite Taxable Year L being now closed under the statute of limitations. Compare Earthquake Sound Corp. v. Commissioner, T.C.Memo. 2000-112 (section 481(a) adjustment to eliminate duplicated deductions resulting from accounting method change could be imposed even though related years in which duplicate deductions were taken have been closed by the statute of limitations).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

No opinion is expressed or implied on (i) whether economic performance occurred in TAXABLE YEAR L with respect to any of the expenditures at issue, (ii) whether any of the expenditures at issue are capital expenditures, or (iii) the tax treatment of the settlement proceeds of $F received by Taxpayer for the repayment of a loan.

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