Office of Chief Counsel
Internal Revenue Service
memorandum

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from R. Hirschhorn
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subject
TL-N-1051-13

This memorandum responds to your recent inquiry that we decide whether an accounting method change occurs when T ceases to deduct its commission expenses twice and begins to deduct those expenses only once.

Conclusion Based on the Available Facts

We conclude that when T discontinues deducting its commission expenses twice and begins to deduct those expenses once, T has not changed an accounting method as defined by IRC § 446(e).

Disclaimers

We offer no opinion as to (i) whether T is entitled to take a deduction for any of its commissions and (ii) if T is so entitled, when T should take this deduction. Further, this memorandum and its conclusion are based on the currently available facts. We understand that you are still developing the facts and thus, consequently, our analysis and conclusion may change as you acquire additional relevant facts.

Available Facts

T pays commissions to its employees. Currently, T is deducting these commissions twice for federal income tax purposes. First, T deducts the amount of the commissions at the time its employees earn these commissions. Subsequently, T again deducts the amount of the commissions when it pays the commissions to the employees. Accordingly, T's practice has been to take two deductions in lieu of one deduction for its commission expense. This practice has been in effect for several years.

For example, in December 2013, employee A earns a commission of $100 and receives the $100 from T in January 2014. T deducts $100 in 2013 and it also deducts the same $100 in 2014.

Law

Treas. Reg. § 1.446-1(a)(1) defines the term "method of accounting" to include not only the over-all method of accounting of a taxpayer but also the accounting treatment of any item of gross income or deduction.

Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) states that an accounting method change 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 of accounting. Moreover, Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) provides that 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. The key characteristic of a material item "is that it determines the timing of income or deductions." Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984).

Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) also requires a pattern of consistent treatment. That regulation states, "(a)lthough a method of accounting may exist under this definition 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." Rev. Proc. 97-27 section 2.01(2) expands on this by stating that:

> [t]he treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed 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, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting.

Treas. Reg. § 1.446-1(e)(2)(ii)(*b*) states that a change in accounting method does not include adjustments 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, corrections of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in accounting methods.

Analysis

In considering the issue of whether a taxpayer is changing an accounting method as defined by IRC § 446 when its accounting practices are changed, we use the "lifetime income" test. As described in our various pronouncements, including Rev. Procs. 97-27, 1997-1 C.B. 680 and 2011-14, 2011-4 I.R.B. 330, under this test, changing from a current accounting practice to another accounting practice constitutes a change in accounting method under IRC § 446 if the current and proposed accounting practices would result in the same amounts of cumulative income over the lifetime of the taxpayer. Expressed differently, when the difference between the current and another accounting practices only involves the timing of income or deduction, the lifetime income test is satisfied and a change from one practice to the other is a change in accounting method as defined by IRC § 446.

In this case, when T discontinues deducting its commission expenses twice and begins to deduct those expenses once, T will permanently affect its lifetime income. Under its current practice, T is reporting less income than it should. For example, if T's commission expense is $100, and its income for the year is $1000, using its current practice, T will report income of $800 and not the correct amount of $900. Because T's lifetime income will change when T ceases to take two deductions for one expense, the change in T's accounting practice is not a change in accounting method. T's situation is similar to the example provided in Treas. Reg. § 1.446-1(e)(2)(ii)(*b*) where it stated that when a taxpayer ceases to deduct items as business expenses because the items were in fact personal expenses, it is not changing its accounting method. Here, T has deducted too many costs and is correcting this error so that it deducts only the proper amount. This change is not an accounting method change.

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