Office of Chief Counsel
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Memorandum

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subject: Request for Chief Counsel Advice

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

LEGEND

TAXPAYER =

COUNTRY =

FIRM =

LAW =

DEPOSIT =

FIRM SUB1 =

FIRM SUB2 =

JSC1 =

JSC2 =

JSC3 =

JSC4 =

AGREEMENT =

TAXPAYER SUB1 =

TAXPAYER SUB2 =

TAXPAYER SUB3 =

TAXPAYER SUB4 =

YEAR 1 =

YEAR 2 =

YEAR 3 =

YEAR 4 =

YEAR 5 =

YEAR 6 =

YEAR 7 =

YEAR 8 =

YEAR 9 =

YEAR 10 =

X =

Y =

ISSUES

1. Did TAXPAYER's changes in the United States income tax reporting of expenses

for its oil and gas operations located in COUNTRY represent changes in its methods of accounting or corrections of errors?

2. If the changes in reporting are determined to be changes in method of accounting, was TAXPAYER required to seek and obtain the Commissioner's consent before implementing such changes in its methods of accounting?

3. If the changes in reporting are determined to be changes in method of accounting, did TAXPAYER's failure to seek and obtain the Commissioner's consent before implementing the changes in accounting method preclude TAXPAYER from implementing these changes for the years claimed?

CONCLUSIONS

1. TAXPAYER's changes in the United States income tax reporting of expenses for its oil and gas operations located in COUNTRY represented changes in its method of accounting.

2. TAXPAYER was required to seek and obtain the Commissioner's consent before implementing such changes in method of accounting.

3. TAXPAYER's failure to seek and obtain the Commissioner's consent precluded TAXPAYER from implementing the accounting method changes for the years claimed.

FACTS

TAXPAYER is a energy company with worldwide operations in many countries, including COUNTRY. As explained below, TAXPAYER conducts its business in COUNTRY through wholly-owned domestic subsidiaries that are members of TAXPAYER's consolidated group.

FIRM is a corporation established by LAW and is responsible for all phases of the oil and gas industry in COUNTRY. FIRM manages operations on behalf of COUNTRY;

In YEAR 1, DEPOSIT was discovered in COUNTRY. FIRM devised a plan to produce from DEPOSIT and market the product to markets. The operations and activities of FIRM's endeavor in DEPOSIT were accomplished, in part, through FIRM SUB1 and FIRM SUB2.

FIRM SUB2 is a COUNTRY joint venture company established to produce and sell hydrocarbons from DEPOSIT. Furthermore, FIRM SUB2 serves as an operating company on behalf of the owners of certain exploration and development rights in DEPOSIT. The owners include companies C1, C2, C3 and C4

(collectively, the companies). These companies were formed under AGREEMENTS among COUNTRY, FIRM and TAXPAYER which granted FIRM and TAXPAYER permission to develop the resources of certain areas in exchange for the payment of royalties to COUNTRY. The companies are characterized as foreign partnerships for U.S. income tax purposes.

C1, C2 and C3 are owned by FIRM (roughly X%) and TAXPAYER (roughly Y%) through TAXPAYER SUB1, which is a member of TAXPAYER's consolidated group. TAXPAYER SUB1's % interest in C1 and C2 is directly owned, while it owns its % in C3 through TAXPAYER SUB2, a disregarded foreign entity.

C4 is owned by FIRM (majority shareholder), TAXPAYER, and various other foreign minority shareholders. C4 is treated as a partnership for U.S. tax purposes. TAXPAYER owns its interest in C4 through TAXPAYER SUB3, a member of Taxpayer's consolidated group. TAXPAYER SUB3's interest in C4 is in turn owned through TAXPAYER SUB4, a disregarded foreign entity.

The companies entered into Agreements (" As") with FIRM. The As establish the rights, responsibilities, terms and conditions that govern each party's conduct and operations in the development of COUNTRY's DEPOSIT under the applicable AGREEMENTS, including royalties payable in cash to COUNTRY. The first royalty payments made to COUNTRY by C1, C2, C3 and C4 occurred, respectively, in YEAR 2, YEAR 3, YEAR 7 and YEAR 7.

From their inception, TAXPAYER has treated the AGREEMENTs as oil and gas leases for United States federal income tax purposes. Accordingly, TAXPAYER has recognized its share of production from properties subject to the AGREEMENTs as gross income, and claimed its share of the royalty payments on such production which the companies made to COUNTRY as deductions or through cost of goods sold (Lease Method).

In YEAR 9 and YEAR 10, TAXPAYER submitted to Examination affirmative adjustments with regard to the following entities and taxable years: C1 and C2 (YEAR 4, YEAR 5, YEAR 6, YEAR 7), C3 (YEAR 7), and C4 (YEAR 7) (hereinafter the "Claims"). The adjustments in the Claims propose to change the U.S. income tax treatment of the AGREEMENTs from the Lease Method to a Contingent Purchase Price Method (CPP Method), under which TAXPAYER would treat each AGREEMENT as a purchase of its share of production in exchange for future payments equaling the royalty payments on its share of production. TAXPAYER asserts that these future payments should have been reported as deferred payments subject to section 483 of the Internal Revenue Code, resulting in a portion of each payment being treated as a payment of interest and the remainder of each payment being treated as a payment of principal. (This memorandum does not address whether the CPP Method is a permissible method of accounting. In particular, we express no opinion on TAXPAYER's assertions that (i) the

royalty payments should be reported as deferred payments of principal, and (ii) section 483 would apply to such deferred payments.)

Accordingly, the royalty payments which TAXPAYER previously deducted or treated as cost of goods sold under the Lease Method would be recast under the CPP Method as (i) part interest, and (ii) part payment of principal, which is subsequently recovered through deductions for depletion, abandonment and so on. For every dollar of royalty expense that TAXPAYER recognizes under the Lease Method, TAXPAYER would ultimately take a dollar of combined deductions for interest and cost recovery under the CPP Method. TAXPAYER would recognize the same amount of gross income under the CPP Method as it does under the Lease Method.

Results for C1, C2, C3 and C4 have been reported using the CPP Method for taxable year YEAR 8 and thereafter.

TAXPAYER has never requested the consent of the Commissioner to change its method of accounting for C1, C2, C3 or C4 under section 446(e) and the regulations and administrative procedures thereunder.

LAW

Section 446 of the Internal Revenue Code (IRC) provides the general rules for methods of accounting. Specifically, 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 its income in keeping its books. See also Treas. Reg. § 1.446-1(a)(1).

The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Treas. Reg. 1.446-1(a)(1). An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered an accounting method. FPL Group, Inc. v Commissioner, 115 T.C. 554, 562 (2000); General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C. Memo. 2003-95. An "item" is any recurring element of income or expense. Thus, a local tax is an "item" and the treatment it is given qualifies as an accounting method. American Can Co. v. Commissioner, 317 F.2d 604 (2nd Cir. 1963), cert. denied 375 U.S. 993 (1964). Likewise, a vacation pay accrual is an "item" and the treatment it is given qualifies as an accounting method. Color Arts. See also, Capital One Financial Corp. v. Commissioner, 130 T.C. 147, 159-161 (2008), *aff'd* 659 F.3d 316 (4th Cir. 2011)(late fee income was separate item from interest income, including original issue discount (OID)).

An accounting method may exist under the definition in Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) without the necessity of a pattern of consistent treatment, but in most instances, an accounting method is not established for an item without consistent treatment. See Treas. Reg. § 1.446-1(e)(2)(ii)(a). The treatment of a material item in

the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(*a*). However, if a taxpayer treats an item properly in the first return that reflects the item, it is not necessary for the taxpayer to treat the item consistently in two or more consecutively filed tax returns to have adopted an accounting method for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57, Rev. Proc. 2002-18, 2002-1 C.B. 678, § 2.01(2).

Under the consolidated return regulations each subsidiary establishes its own method of accounting. Treas. Reg. §1.1502-17(a) states that "the method of accounting to be used by each member of the [consolidated] group shall be determined in accordance with the provisions of section 446 as if such member filed a separate return." See Sunoco, Inc. v. Commissioner, T.C. Memo. 2004-29. Thus, each member of an affiliated group of corporations determines its method of accounting on a separate-company basis, and section 446 controls the determination of that member's method of accounting.

Consent to change method of accounting

Under section 446(e), a taxpayer which changes the method of accounting on the basis of which it regularly computes its income in keeping its books is generally required to secure the consent of the IRS before computing its taxable income under the new method. This is usually accomplished by filing a Form 3115, Request for Consent to Change Method of Accounting, pursuant to the appropriate administrative guidance (currently Rev. Proc. 97-27 and Rev. Proc. 2011-14, as amended). Treas. Reg. § 1.446-1(e)(2)(i),(3).

A taxpayer that has adopted a method of accounting cannot change the method by amending its prior income tax return(s). 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; Rev. Proc. 2002-18, §§ 2.01(2) and 2.03.

Consent of the Commissioner under section 446(e) to change a method of accounting must be secured whether or not the method to be changed is proper or is permitted under the Internal Revenue Code or the regulations thereunder. Treas. Reg. § 1.446-1(e)(2)(i). See also Treas. Reg. § 1.446-1(e)(2)(iii), Examples (6)-(8), Rev. Rul. 80-190, 1980-2 C.B. 161, Rev. Rul. 77-134. Although some cases have held that the consent requirement of section 446(e) does not apply where the method to be changed is improper, the vast majority of current judicial opinion agrees that section 446(e) consent is required even for changes from improper accounting methods. See, for example, O. Liquidating v. Commissioner , 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) cert. denied 375 U.S. 879 (1963), rehg. denied 375 U.S. 981 (1964); Witte v. Commissioner, 513 F.2d 391, 393-5 (D.C. Cir. 1975); Wayne Nut and Bolt v. Commissioner, 93 T.C. 500, 511 (1989); Diebold, Inc. v. United States, 16 Cl. Ct. 193,

211-212, affd. 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied 498 U.S. 823 (1990); Helmsley v. U.S., 941 F.2d 71, 87 (2nd Cir. 1991); Pacific Enterprises,101 T.C. 1, 23 (1993); Convergent Technologies, Inc., v. Commissioner, T. C. Memo. 1995-320, Rankin v. Commissioner, 138 F.3d 1286, 1289 (9th Cir. 1998).

What constitutes a change in accounting method?

Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) provides that a change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." Treas. Reg. § 1.446-1(e)(2)(ii)(a). In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the tax year in which taxable income is reported. See Rev. Proc. 2002-18, section 2.01; Rev. Proc. 91-31, 1991-1 C.B. 566, Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-724 (1982); Knight Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Huffman v. Commissioner, 126 T.C. 322, 343 (2006) affd. 518 F.3d 357, 364-5 (6th Cir. 2008); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

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

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes gross income for a type of revenue generally constitutes an accounting method, and a change from one such practice to another generally constitutes a change in accounting method. In Johnson v. Commissioner, 108 T.C. 448 (1997) affd. in part, revd. in part 184 F.3d 786 (8th Cir. 1999), for example, the Tax Court held that switching the time for recognizing escrowed customer payments as gross income from when the escrow agent released funds to the taxpayer to when the customer gave the sale price to the taxpayer was a change in accounting method. For further examples, see generally Rev. Proc. 2011-14, APPENDIX section 15.

Similarly, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes an accounting method, and a change from one such practice to another generally constitutes a change in accounting method. Thus, a change from deducting officers' bonuses in the year they are declared to deducting the bonuses in the year following the declaration year constitutes a change in accounting method. Summit Sheet Metal Co. v. Commissioner, T.C. Memo 1996-563. Similarly, a change from deducting real estate taxes when paid to deducting these taxes

when incurred is also a change in accounting method. Treas. Reg. § 1.446-1(e)(2)(iii), Example (2). Further, various courts have found accounting method changes in similar circumstances involving a variety of different types of expenses, including vacation pay (American Can), interest (Peoples Bank; Mulholland v. U.S., 28 Fed. Cl. 320 (1993) affd. 22 F.3d 1105 (Fed. Cir. 1994);, Prabel v. Commissioner, 882 F.2d 820 (3rd Cir. 1989)), customer rebates (Knight-Ridder), and related party payables (Bosamia v. Commissioner, 661 F.3d 250 (5th Cir. 2011) cert. denied 133 S.Ct. 105 (2012)).

Mathematical and posting errors

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. A "mathematical error" is defined by section 6213(g)(2) as "an error in addition, subtraction, multiplication, or division." See Capital One, 130 T.C. at 166; Huffman, 126 T.C. at 344 (accepting this definition for the purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(*b*)). But see Huffman, 518 F.3d at 363, where the Sixth Circuit refused to either adopt or reject the Tax Court's definition. A "posting error" is an error in "the act of transferring an original entry to a ledger." Wayne Bolt & Nut Co., 93 T.C. at 510-511 (quoting Black's Law Dictionary 1050 (5th ed. 1979)); see also Huffman 126 T.C. at 343 (accepting the definition of posting error provided by Wayne Bolt & Nut). But see Northern States Power Co. v. Commissioner, 151 F.3d 876, 884-885 (8th Cir. 1998) where the Eighth Circuit held that a posting error occurred when the taxpayer mistakenly capitalized certain costs while deducting similar costs under its accrual method.

Where the correction of an error results in a change in accounting method, the requirements of IRC § 446(e) are applicable. Huffman, 126 T.C. at 354, First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987), Diebold, 16 Cl. Ct. at 203-4.

Changes in character of revenue or deduction

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

that no such exception exists." Citing Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975)).

Moreover, numerous cases have held that a change in characterization can be a change in accounting method. See Diebold Inc. v. U.S., 891 F.2d at 1583 (a change in treatment from inventory to capital asset constituted an accounting method change), Cargill, 91 F. Supp. 2d at 1293 (re-characterization of interest from leasehold to ownership), Pacific Enterprises v. Commissioner (recharacterizing "working gas" (inventory) to "cushion gas" (capital asset)), Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) (IRC § 1250 property to IRC § 1245 property), Capital One (a change for late fees from not treating the fees as OID to treating the fees as creating or increasing OID), Humphrey, Fairington & McClain, T.C. Memo. 2013-23 (advanced litigation expenses from deductible business expenses to loans).

The automatic accounting method change procedures in Rev. Proc. 2011-14 set forth changes in characterization that constitute changes in method of accounting. See, for example, APPENDIX sections 2.01 (a change in treatment of amounts received from the Commodity Credit Corporation from gross income to loan constitutes an accounting method change), and 3.01 (a change in treatment of advanced litigation costs from deductible business expenses to loans constitutes an accounting method change). In particular, APPENDIX section 6.03(1)(a)(iv) provides that a change in method of accounting includes a change from "improperly treating property as leased by the taxpayer to properly treating property as purchased by the taxpayer," which mirrors TAXPAYER's assertions with respect to its attempted change in treatment of the AGREEMENTs.

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

Similarly, a change in accounting method reflecting a change in the characterization can also involve a change in the character of taxable income from capital gain (loss) to ordinary income (loss), or *vice versa*. For example, in Witte, the taxpayer's shift from the cost recovery accounting method to the completed transaction method constituted a "change in the accounting method" within the meaning of the Treasury Regulations. While the Witte Court found that the change involved the proper timing of a material item, the deficiency determination at issue was based on the finding that the amounts reported as long-term capital gain should be taxed as ordinary income since such amounts were in part interest income and income from the sale of properly held primarily for sale. Diebold and Pacific Enterprises also involved changes between

capital and ordinary taxable income. See also Mingo v. Commissioner, T.C.Memo. 2013-149 (change in accounting method for the proceeds from a partnership interest sale attributable to unrealized receivables from the installment method resulting in capital gain to the cash receipts and disbursements method yielding ordinary income).

Divergences from established methods

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

When the divergent treatment is discovered by the taxpayer or Field Operations, the issue arises whether adjustments to conform the divergent treatment to the primary accounting method should be treated as the correction of errors in open tax years or as a change in accounting method under sections 446 and 481. Under current law, we believe that the proper classification of a divergent treatment depends upon whether the divergent treatment is a timing practice that is used on a consistent basis. If it is, then the divergent treatment is a material item, and conforming the divergent treatment to the primary accounting method is a change in the treatment of a material item that constitutes an accounting method change. See Treas. Reg. § 1.446-1(e)(2)(ii)(*a*). In contrast, if the divergent treatment is not a timing practice and/or is not a consistent practice, it will have a permanent impact on lifetime taxable income, and the divergent treatment is an error (or series of errors).

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

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

The taxpayer in Gimbel Brothers filed amended returns to change its reporting of the revolving credit sales to the installment method, characterizing its original treatment of such sales as an error. The Internal Revenue Service rejected the amended returns as

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

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

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

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

First, the divergent treatment as error cases rely heavily upon the proposition that the consent of the Commissioner under section 446(e) is not required where the taxpayer's existing treatment is improper. As discussed above, this proposition is expressly rejected by Treas. Reg. § 1.446-1(e)(2)(i) and the preponderance of judicial decisions.

Second, the divergent treatment as error cases rely on the proposition that conforming the divergent treatment to the primary accounting method is not a change in accounting method because the necessary adjustments have not altered the primary accounting method for the item; rather, the adjustments merely apply the primary accounting method across the item on a correct and uniform basis. See Northern States Power, 151 F.3d at 884-885, Korn, 532 F.2d at 1355-1356, Beacon Publishing Co. v.

Commissioner, 218 F.2d 697, 702 (10th Cir. 1955). This proposition is overly broad and simplistic because it neglects the critical analytical test required by section 446(e), that is, whether the divergent treatment is a material item (a timing practice applied on a consistent basis). If the divergent treatment is not a material item, it constitutes an error (or group of errors); if the divergent treatment is a material item, then a change in the treatment of such material item is an accounting method change under section 446. See Treas. Reg. § 1.446-1(e)(2)(ii)(*a*), Huffman, 126 T.C. at 354-355.

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

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

The conclusions of Example 2 of Treas. Reg. § 1.446-1(e)(2)(iii) were echoed by the Tax Court in Connors, Inc. v. Commissioner, 71 T.C. 913 (1979), whose facts are essentially the inverse of the facts of Example 2. The taxpayer in Connors used the cash receipts and disbursements method as its overall accounting method but reported bonus compensation expenses using an accrual method. The Court concluded that changing the treatment of bonus compensation from the accrual method to the cash receipts and disbursements method "is a change in method of accounting because such

change is a change in the treatment of a material item, that is, this is a change in the proper time for the taking of a deduction from the year incurred to the year paid." 71 T.C. at 919. See also, Miele v. Commissioner, 72 T.C. 284 (1979), Pierce Ditching Co. Inc. v. Commissioner, 73 T.C. 301 (1979), Brunton v. Commissioner, T.C. Memo. 1982-166, affd. 723 F.2d 914 (7th Cir. 1983).

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

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

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

Second, the courts question or outright reject the divergent treatment cases on the basis of their inconsistencies (discussed above) with the well-established requirements of section 446. Thus, Cargill, 91 F.Supp.2d at 1298 concludes that the divergent treatment as error cases "all ultimately rest on the erroneous premise that consent is not required if the taxpayer's previous treatment of the item was improper." See also Huffman, 126 T.C. at 347, and Capital One, 130 T.C. at 167 (divergent treatment cases decided prior to 1970 revision of Treas. Reg. 1.446-1(e) have "uncertain" weight because they fail to address consistency and timing considerations emphasized in revision).

Finally, in cases where the divergent treatment as error cases are not invoked or expressly considered, the courts often fail to apply the principle of these cases. In Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir. 1975) cert. denied 423

U.S. 1087 (1976), for example, only the direct costs of self-constructed assets were capitalized as error while indirect costs were deducted as part of the cost of goods sold. The 10th Circuit upheld the holding of the Tax Court that conforming the divergent treatment of the indirect costs (deduction) to the primary accounting method (capitalization) was an accounting method change under section 446 that triggered an adjustment under section 481(a). See also Sartor v Commissioner, T.C. Memo. 1977-327 (divergent accrual treatment of interest by an individual using the overall cash receipts and disbursements method).

ANALYSIS

1. Did TAXPAYER's changes in the United States income tax reporting of expenses for its oil and gas operations located in COUNTRY represent changes in its methods of accounting or corrections of errors?

In YEAR 9 and YEAR 10, TAXPAYER filed Claims attempting to amend filed returns to change its reporting of the AGREEMENTs at issue from the Lease Method to the CPP Method. TAXPAYER also began to report the AGREEMENTs under the CPP Method in tax returns filed for YEAR 8 and thereafter.

TAXPAYER stated that this change in reporting would correct the "inconsistent treatment" of the AGREEMENTs, and cited Treas. Reg. §1.446-1(e)(2) and Standard Oil for the proposition that "a taxpayer's alignment of an item of income to its previously established method of accounting is not a change in method of accounting." In response to Information Document Requests issued by the Examination team, TAXPAYER stated that it had an established business practice of treating acquisition of oil and gas interests as either a lease or a purchase, depending on the underlying characteristics of the transaction. TAXPAYER claimed it had consistently implemented this practice, and therefore established a method of accounting. TAXPAYER asserted that it mistakenly placed the AGREEMENTs at issue in the lease category when these AGREEMENTs properly belonged in the purchase category.

A change in the treatment of an AGREEMENT is a change in method of accounting under section 446 if the AGREEMENT is a material item, which is defined by Treas. Reg. 1.446-1(e)(2)(ii)(a) to be an item that involves the proper time for the inclusion of the item into income or the taking of a deduction. Under the lifetime income test, an item generally involves timing if the tax reporting practices for the item do not permanently impact the lifetime taxable income of a taxpayer but merely determine the timing (amounts and taxable years) of recognizing such taxable income.

A taxpayer would report the same cumulative amount of gross income over the lifetime of an AGREEMENT whether it used the Lease Method or the CPP Method. Similarly, a taxpayer would recognize the same cumulative amount of reductions to taxable income over the lifetime of an AGREEMENT under the Lease Method or the CPP Method because the cumulative amount of hypothetical purchase price under the CPP Method

(which is entirely recovered over the lifetime of the AGREEMENT as deductions for interest expense, depletion, abandonments and so on) is equal to the cumulative amount of royalty expense recovered as deductions or cost of goods sold under the Lease Method.

Accordingly, an AGREEMENT constitutes a material item under Treas. Reg. § 1.446-1(e)(2)(ii)(a) and the lifetime taxable income test, and the change in treatment of such a material item constitutes a change in method of accounting under sections 446 and 481 unless the change falls within one of the recognized exceptions.

The purported "errors" in reporting the AGREEMENT as a lease rather than a sale do not involve any of the exceptions listed in Treas. Reg. § 1.446-1(e)(2)(ii)(b). The errors are not mathematical errors, posting errors, or errors in the computation of tax liability. The correction of these "errors" does involve timing of income and deductions. Finally, the "errors" do not result from a change in the underlying facts since the facts have remained the same; only TAXPAYER's tax interpretation of those facts has changed.

Accordingly, TAXPAYER's position that it is merely correcting errors must rest upon two alternative but overlapping arguments. First, TAXPAYER argues that the claims cannot be an accounting method change because they represent a mere change in the characterization of the AGREEMENTs. Second, TAXPAYER asserts that the claims represent the correction of an erroneous divergence from an established accounting method rather than a change from one accounting method to another.

With respect to the first argument regarding change in character, TAXPAYER apparently bases its claims on its purportedly belated realization that the AGREEMENTs were more in the nature of a purchase than a lease, and thus the AGREEMENTs should have been reported under the CPP Method rather than the Lease Method. What is really being changed, TAXPAYER implicitly argues, is the characterization of the AGREEMENTs; the revision of the tax reporting simply follows as an automatic consequence of the recharacterization.

As discussed above, however, the fact that a change in accounting practice for an item may involve or reflect a change in the characterization of the item does not preclude that change in practice from constituting an accounting method change if it involves timing and would otherwise qualify as an accounting method change under sections 446 and 481. Similarly, the fact that the Lease Method and the CPP Method report differently labeled items of deduction or cost recovery does not disqualify the change between such methods from qualifying as a change in method of accounting.

TAXPAYER's second argument is that the changes contained in its claims constitute corrections of erroneous divergences from its established CPP Method. This argument logically requires that TAXPAYER actually have an established method of treating mineral contracts such as the AGREEMENTs at issue as purchases under the CPP Method. You have indicated that TAXPAYER has provided no evidence that any

agreements similar to the AGREEMENTs at issue were ever treated as purchases for federal income tax purposes. In fact, TAXPAYER seems to have consistently treated AGREEMENTs as leases for tax purposes.

TAXPAYER relies heavily upon Standard Oil to support its theory of divergence from an established method. In Standard Oil, however, the taxpayer had clear evidence of the accounting method (deducting IDC) from which the asserted divergence (capitalization) occurred. The taxpayer had expressly elected to deduct IDC and had deducted most, but not all, of its IDC. By contrast, TAXPAYER has shown little or no evidence that it customarily (or ever) treated AGREEMENTs as purchases, and thus fails to establish the essential factual core of Standard Oil, Gimbel Brothers and other divergent treatment as error cases: an established method from which the erroneous divergence has occurred.

In contrast to Standard Oil, TAXPAYER's taxable income was always calculated treating each AGREEMENT as a lease for tax purposes, and TAXPAYER never had any AGREEMENT that was not treated as a lease for tax purposes. No aspect of the AGREEMENTs were treated as anything other than a lease, in contrast to Standard Oil where some items were capitalized in violation of the elected method of accounting. It is not as if certain components of the AGREEMENTs were erroneously accorded lease treatment for tax purposes; lease treatment was the only treatment. There is no inconsistent treatment of the AGREEMENTs as there was with expensing and capitalizing IDC in Standard Oil. See also Diebold, 891 F.2d at 1582 ("Diebold does not seek to account for the replacement modules in the same manner that it accounts for other similar items or to correct the omission of an item from a method of accounting that it otherwise consistently applies to a single category of related items.").

In other words, TAXPAYER's use of the Lease Method is not an error in the implementation of the CPP Method because TAXPAYER apparently made no attempt to implement such method. On the contrary, TAXPAYER consciously implemented and consistently used the Lease Method for all of the AGREEMENTs at issue until TAXPAYER's abrupt discovery in YEAR 9 that it was purportedly making errors in its implementation of the CPP Method. C1 and C2 were reported under the Lease Method through YEAR 7 (ten and six continuous taxable years, respectively), thereby evidencing sufficient consistency to establish the Lease Method as the method of accounting for these AGREEMENTs, whether or not such method is permissible. Consistent with this well-established practice, TAXPAYER reported C3 and C4 under the Lease Method for YEAR 7 when these AGREMENTs began operations. Treas. Reg. § 1.446-1(e)(2)(ii)(a).

Furthermore, the absence of an established CPP Method means that TAXPAYER's fact pattern can be distinguished from the divergent treatment as error cases discussed above. TAXPAYER's multiyear use of the Lease Method for its AGREEMENTs at issue cannot plausibly be described as being an "internal inconsistency" in its (apparently nonexistent) use of the CPP Method or as a series of errors occurring within the

"context of a broader compliance" with the CPP Method. Sunoco; Huffman, 126 T.C. at 351-52.

Even if TAXPAYER were to produce some evidence of treating similar AGREEMENTs as purchases, however, TAXPAYER would still fall short of a convincing argument that its adjustments constitute correction of erroneous divergences from an established method. The insufficiency of the deviation as error arguments in the Claims is clearly illustrated by Huffman v. Commissioner, in which the Service imposed an involuntary accounting method change on the taxpayer's calculation of its inventory. For over 10 years, the taxpayer's accountant had consistently omitted a step in the link-chain LIFO method of accounting, which resulted in an understatement of the LIFO values of the inventories and as a result income from sales was underreported. The taxpayer argued that the Service's adjustment was a correction of an error which did not require a section 481 adjustment; the Service argued that the adjustment was a change in accounting method which required a section 481 adjustment.

As in the present case, the court in Huffman stressed that the error involved timing. The court stated:

> Consequently, the accountant's error would, if applied consistently (as, in fact, it was), self correct, at least in the sense that, if the error were continued over the life of the inventory pool, the total gain reported on account of the sale of items in the pool would be correct. Huffman, 126 T.C. at 343.

Citing Treas. Reg. § 1.446-1(e)(2)(ii)(a), the court further stated "[b]y consistently repeating the same error, the accountant established a pattern, which (although not determinative of) is indicative of a method of accounting." Id.

Having established that the error was a timing issue, the Tax Court addressed the situation in which a taxpayer elects a method of accounting and adheres to that method for some time, then deviates from the established method, and then returns to the established method. The Court noted that "a short-lived deviation from an already established method of accounting need not be viewed as establishing a new method of accounting." Id. at 354. The Court went on to say:

> The question, of course, is what is short-lived. The Commissioner's position is that consistency is established for purposes of section 1.446-1(e)(2)(ii)(a), Income Tax Regs., by the same treatment of a material item in two or more consecutively filed returns. Rev. Proc. 2002-19, 202-1 C.B. 678. We have said something similar. Johnson v. Commissioner, supra at 494. Here, even if we were to assume that the members elected the link-chain method and adopted it, see supra pp. 46-48, no member deviated from the link-chain method for less than 10 years. This is not a short-lived deviation. [emphasis added] Id. at 354.

The Tax Court also noted that "[w]hile, in some circumstances, a taxpayer deviating

from its previously established method of accounting may again adhere to its established method before the deviation has time to harden into a method of its own, the accountant's consistent error for no less than 10 years rules out that possibility." Huffman, 126 T.C. at 355. For an instance of an alleged deviation hardening into a method of accounting in a far shorter two taxable years, see Capital One, 659 F.3d 316 at 326 (treatment of late-fee income consistently for 1998 and 1999 under the current-inclusion method nullified taxpayer argument that such treatment was an erroneous deviation from a method of accounting to treat late-fee income as OID which the taxpayer allegedly had received consent to use beginning with 1998).

In the instant case, C1 and C2 were consistently treated as leases for ten and six continuous taxable years, respectively, before TAXPAYER concluded that such treatment was an erroneous deviation. Therefore, even if TAXPAYER had an established CPP Method from which to deviate, it would be absurd to argue that the lengthy treatment of C1 and C2 as leases was a "brief" deviation. As in Huffman, TAXPAYER's consistent treatment of C1 and C2 as leases over extended periods of time had hardened any purported deviation into a method of accounting. Any attempt to change such treatment must constitute a change in method of accounting under sections 446 and 481.

By contrast, C3 and C4 were only reported on the Lease Method for a single taxable year in YEAR 7. Beginning with YEAR 8, TAXPAYER reported C3 and C4 on the CPP Method, and filed the Claims to amend YEAR 7 returns to the CPP Method. The use of a permissible method of accounting for one taxable year is sufficient to constitute adoption of such method. See Rev. Rul. 90-38; Rev. Proc. 2002-18, § 2.01(2). Moreover, in light of TAXPAYER's extended use of the Lease Method for C1 and C2 prior to Year 7, it is far more plausible to treat the use of the Lease Method for C3 and C4 for the YEAR 7 return as the adoption of what TAXPAYER considered to be a proper method of accounting for AGREEMENTs rather than as an "error" in the implementation of the CPP Method. Because C3 and C4 adopted the Lease Method by using it for the YEAR 7 taxable year, this method could not be changed retroactively by the Claims.

For the foregoing reasons, we conclude that the adjustments asserted in the Claims for the four companies constitute an attempt to change their methods of accounting from the Lease Method to the CPP Method on a retroactive basis.

Finally, we note that a second set of changes in method of accounting occurred when the four companies reported on the CPP Method for YEAR 8 and subsequent taxable years. All the companies had an established or adopted Lease Method of accounting for the YEAR 7 taxable year, and had reported on the Lease Method for that taxable year. These changes in method of accounting between YEAR 7 and YEAR 8 as reflected on the original returns would effectively disappear if effect were given to the attempt by the Claims to impose a retroactive accounting method change in YEAR 7 or prior taxable years.

2. If the changes in reporting are determined to be changes in method of accounting, was TAXPAYER required to seek and obtain the Commissioner's consent before implementing such changes in its method of accounting?

TAXPAYER was required to obtain the consent of the Commissioner under section 446(e) prior to implementing the changes in method of accounting discussed above. Such consent was required even if (as has not been established) TAXPAYER's existing Lease Method were impermissible.

3. If the changes in reporting are determined to be changes in method of accounting, did TAXPAYER's failure to seek and obtain the Commissioner's consent before implementing the changes in accounting method preclude TAXPAYER from implementing these changes for the years claimed?

A taxpayer cannot implement an accounting method retroactively by filing amended returns. Treas. Reg. § 1.446-1(e)(3)(i); Rev. Rul. 90-38; Rev. Proc. 2002-18, § 2.06, 2002-1 C.B. 678.

In a case in which the taxpayer does not obtain the Commissioner's consent before implementing the change, the question is whether the change constitutes a change of accounting method that is subject to section 446(e). See Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 682 (1980); Wright Contracting Co., 36 T.C. at 635-636; cf. Poorbaugh v. United States, 423 F.2d 157, 163 (3d Cir. 1970); Hackensack Water Co. v. United States, 173 Ct. C1. 606, 352 F.2d 807 (1965); FPL Group, Inc., 115 T.C. 554, 573-575 (2000). If the change constitutes a change of accounting method that is subject to section 446(e), then the taxpayer is foreclosed from making the change by section 446(e) and the regulations promulgated thereunder without regard to whether the new method would be proper. See Southern Pacific Transportation Co., 75 T.C. at 682; Wright Contracting Co., 36 T.C. at 635-636.

If a taxpayer changes a method of accounting without first obtaining consent, the Commissioner can assert section 446(e) and require the taxpayer to abandon the new method of accounting and to report taxable income using the old method of accounting. See, e.g., Lattice Semiconductor v. Commissioner, T.C.Memo. 2011-100; FPL Group, Inc.; O. Liquidating Corp.; Wright Contracting Co. v. Commissioner; Drazen v. Commissioner, 34 T.C. 1070, 1076 (1960); Advertisers Exchange, Inc. v. Commissioner, 25 T.C. 1086, 1093 (1956), affd. per curiam 240 F.2d 958 (2nd Cir. 1957).

Accordingly, the failure of TAXPAYER to request the required consent to change its method of accounting for the AGREEMENTSs at issue precludes TAXPAYER from implementing such change.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-4657 if you have any further questions.