Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: June 20, 2014

to: Associate Area Counsel, Philadelphia (CC:LB&I:HMT:PHI1)
(Large Business & International)

from: Chief, Branch 1
(Passthroughs & Special Industries)

subject: Change in Accounting Method and IRC § 734(b) Adjustments

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

LEGEND

Taxpayer =

Bank =

Years =

ISSUE

Does an adjustment otherwise constituting a change in accounting method under IRC §§ 446 and 481 still constitute a change in accounting method if Taxpayer had an election under IRC § 754 in effect for taxable years prior to the year of change and its basis adjustments under IRC § 734(b) would have been different if the new accounting method had been used in all taxable years prior to the year of change?

CONCLUSION

An adjustment otherwise constituting a change in accounting method under IRC §§ 446 and 481 constitutes a change in accounting method regardless of whether Taxpayer

made an election under IRC § 754 and its IRC § 734(b) basis adjustments would have been different if the new accounting method had been used in all taxable years prior to the year of change.

FACTS

Taxpayer (a limited liability company that is treated as a partnership for federal tax purposes) purchases and disposes of positions in securities. Taxpayer generally engages in daily trading of such positions. Taxpayer has conducted much of its securities trading under various “Barrier Basket Transactions” (Basket Transactions) with Bank, a broker and investment bank. In a typical Basket Transaction, Taxpayer makes an upfront payment of 10 percent of the notional amount referenced in the Basket Transaction. Bank provides the remaining 90 percent, the total amount of which is used to acquire a “basket” of securities that is actively traded and managed by Taxpayer’s affiliate on an ongoing basis. The contract between Taxpayer and Bank describes Taxpayer’s investment as a “premium” that gives Taxpayer the “option” to receive a cash settlement amount from Bank when the contract expires or is otherwise terminated. Each contract is for at least a year. The cash settlement amount is determined by a formula that generally reflects the increase (decrease) in the value of the securities, including expense and income payments made or received with respect to the securities held and traded within the Basket Transaction and the interest and fees payable to Bank for its services and capital. Taxpayer does not recognize gains, losses, income, or deductions as it trades the securities within the Basket Transaction. Instead, Taxpayer defers recognition of any tax consequences until the Basket Transaction expires or otherwise terminates, when Taxpayer recognizes gain equaling the difference between the cash settlement amount and the upfront payment made.

During the period it engaged in the Basket Transactions, Taxpayer redeemed the interests of several withdrawing partners. In each case, the distribution exceeded the withdrawing partner's basis in its interest in Taxpayer, and as a result, the withdrawing partner recognized gain under IRC § 731. Because Taxpayer had an election under IRC § 754 in effect, Taxpayer increased its basis in its assets under IRC § 734(b) to account for the withdrawing partner’s IRC § 731 gain.

Taxpayer’s federal income tax returns for Years are currently under examination by the Internal Revenue Service. Based upon its review, Field Operations has determined that the Basket Transactions lack the requirements to be treated as options to purchase property for tax purposes. Further, Field Operations has determined that Taxpayer had the burdens and benefits of ownership of the securities underlying the Basket Transactions, and thus held the beneficial ownership of these securities for tax purposes. Accordingly, Field Operations has challenged Taxpayer’s deferral of gains, losses, income, or deductions associated with the Basket Transactions. Field Operations intends to place Taxpayer on a correct accounting method consistent with its ownership of the securities. This accounting method will not permit Taxpayer to defer reporting the relevant gains, losses, income, or deductions until the Taxpayer

identified Basket Transactions expire or terminate but will instead require Taxpayer to recognize these gains, losses, income, or deductions at a much earlier time, consistent with Field Operations' conclusion that Taxpayer, and not Bank, was the owner of each asset held within the basket. Pursuant to this accounting method change, Field Operations intends to impose an adjustment under IRC § 481(a) in the first taxable year under examination.

Previously, advice was provided to Field Operations that a change to no longer treating certain securities transactions as options and thus, stopping the deferral of the gains, losses, income, or deductions associated with those transactions, is a service imposed change in accounting method under IRC § 446. Further, the Advice noted that the computation and recognition of an appropriate adjustment under IRC § 481(a) was needed to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change.

If Taxpayer had correctly accounted for the securities under the new accounting method imposed by Field Operations, it would have recognized income attributable to the securities much earlier, and Taxpayer's resulting income would have been allocated to all partners, including those who were redeemed, increasing their basis in their interests in Taxpayer under IRC § 705. These basis increases would have resulted in the redeemed partners recognizing less § 731 gain upon redemption, and thus Taxpayer's IRC § 734(b) adjustments would have been smaller.

Taxpayer agrees that its IRC § 734(b) adjustments would have been smaller had it used the new accounting method in all prior taxable years. However, Taxpayer asserts that the proposed accounting method change would create a permanent difference in its lifetime taxable income because its IRC § 734(b) adjustments will be reduced, and that, therefore, Field Operation's proposed treatment of the Basket Transactions does not involve a change in accounting method. Field Operations has requested advice concerning whether its proposed treatment of the Basket Transactions is a change in accounting method notwithstanding Taxpayer's IRC § 734(b) adjustments.

LAW AND ANALYSIS

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

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

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 taxable year in which taxable income is reported. See Rev. Proc. 2002-18, 2002-1 C.B. 678, section 2.01, Rev. Proc. 91-31, 1991-1 C.B. 566, Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-724 (1982), Knight Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984), Huffman v. Commissioner, 126 T.C. 322, 343 (2006), Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969). If the accounting practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, it involves timing and is therefore an accounting method.

For purposes of section 446, lifetime taxable income is analyzed with respect to the item(s) at issue solely at the partnership level. See, e.g., Treas. Reg. § 1.481-2(c)(5)(i). Accordingly, it is appropriate to disaggregate the elective basis adjustments relating to a departing partner's recognition of partnership built-in-gain, and the change in a partner's basis resulting from the change in timing of the item's recognition, which are irrelevant to the determination of whether the change in the timing of recognition of gains, losses, income, or deductions resulting from trades of the securities within the Basket Transaction constitutes a method of accounting for purposes of sections 446 and 481.

Partnerships are flow-through entities that do not pay an entity-level income tax under IRC § 701. Instead, under IRC § 702, each partner must take into account in determining their income tax their distributive share of the partnership's income. IRC § 705 provides in part that each partner's basis in their partnership interest is increased by their distributive share of income from the partnership.

IRC § 731(a)(1) provides in part that in the case of a distribution by a partnership to a partner, gain shall be recognized by the partner to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Unless the partnership increases the basis of its assets to reflect the IRC § 731(a)(1) gain recognized by the withdrawing partner, there may be a temporary distortion in the income recognized by the remaining partners, who may be taxed on the built-in gain economically attributable to the redeemed partner.

To eliminate these timing distortions, IRC § 734(b)(1) provides in part that, if the partnership has an election under IRC § 754 in effect, the partnership shall increase the adjusted basis of partnership property by the amount of any gain recognized to the distributee partner under IRC § 731(a)(1). The partnership takes any IRC § 734(b) adjustments into account when calculating its gain or loss upon sale or disposition of property subject to an IRC § 734(b) adjustment. The purpose and effect of an election

under IRC § 754 and basis adjustments under IRC § 734(b) are to eliminate distortions in the timing of income and loss. An election under IRC § 754 does not affect the total income recognized by all the partners over the life of the partnership.

When there is a change in accounting method to which IRC § 481(a) is applied, income for taxable years preceding the year of change must be determined under the accounting method that was then used, and income for the year of change and the following taxable years must be determined under the new accounting method as if the new method had always been used. Accordingly, Taxpayer's IRC § 734(b) adjustments for years preceding the year of change must be computed using the accounting method that was then used. Taxpayer's IRC § 734(b) adjustments for the year of change and subsequent years must be redetermined consistent with the new accounting method.

In computing the net § 481(a) adjustment, a taxpayer must take into account all relevant accounts. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.05(1). Here, the IRC § 481(a) adjustment represents the difference in gain or loss for all of the underlying securities that would have been recognized under the new method, less the gain or loss that was recognized under the prior method as of the beginning of the year of change. Taxpayer's IRC § 734(b) adjustments for taxable years prior to the year of change, as calculated under the prior method, are fully taken into account in calculating the basis in the securities. In addition, beginning in the year of change, Taxpayer's basis in its securities will be modified to reflect the gain or loss recognized in connection with the change in accounting method.

The determination of whether a partnership has a change in accounting method does not depend on whether the partnership made an election under IRC § 754, whose only purpose and effect is to eliminate distortions caused by partnership distributions and sales of partnership interests. The partners of a partnership using a given accounting method ultimately recognize the same amount of cumulative taxable income over the life of the partnership whether or not the partnership makes an election under IRC § 754. A change in accounting method under IRC § 446 occurs when Taxpayer/partnership no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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

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

Please call Benjamin Weaver at (202) 317-6769 if you have any further questions.

Sincerely,

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David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)