



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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MEMORANDUM FOR Bonny Dominguez, TA, Accounting Method Changes

FROM: Heather Maloy
Associate Chief Counsel CC:ITA

SUBJECT: Change in Accounting Method

This Technical Assistance responds to your memorandum requesting advice, which we received on June 1, 2001. Technical Assistance is not binding on Examination and Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUES

- 1) What is the Service's tax law position pursuant to I.R.C. § 446(e) in each of the following circumstances?
- 2) Before proposing compliance with I.R.C. § 446(e) in any of the following circumstances is it necessary for Service personnel (e.g., examiners, appeals officers, field counsel) to establish "tax avoidance"?
- 3) What is the precedential value to taxpayers and Service personnel of FSA 200102004 relative to the I.R.C. § 446(e) issues outlined below?

CONCLUSIONS

- 1) In each of the factual situations outlined below, the taxpayers are required to obtain the Service's permission under I.R.C. § 446(e) prior to changing their methods of accounting. Even when changing from an improper to a proper method of accounting, the failure to obtain the Service's permission under I.R.C. § 446(e) allows the Service to return the taxpayer to the previously adopted improper method of accounting during an examination. Rev. Proc. 97-27, 1997-1 C.B. 680, requires the taxpayers in each

situation to apply for consent to change their method of accounting no later than the end of the year for which they wish to make the change.

2) The Service is not required to show that the taxpayers had a “tax avoidance” purpose before requiring compliance with section 446(e) and Rev. Proc. 97-27 in any of the situations.

3) Field Service Advice has no precedential value.

FACTS

Situation 1: A was under examination for Years 3-6 and A provides the examiner with claims or amended returns for Years 3-6. A’s basis for the claims is that A is using an impermissible accounting method and wants the examiner to effectuate the method change in the RAR for years 3-6. The examiner had not previously addressed the claimed items during the examination. The examiner disallows the claims on the basis that they are accounting method changes that require the prior consent of the Service.

Situation 2: B for Years 1-5 was using an improper method of accounting. In Year 6, B filed amended returns for Years 3, 4, and 5 to change its method of accounting from an improper to a permissible method. B used the new permissible method on its original returns for Years 6-8. In Year 8, Years 6-7 are placed under examination. Year 5 and prior remain open under the statute of limitations. The examiner proposes to return B to its previous method in Year 6 because B made an accounting method change without permission.

Situation 3: C for years 1-3 was using an improper method of accounting. In Year 4, C changed without permission to a new permissible method. C used the new method in Years 4-7. In Year 7, Year 4 is placed under examination. The examiner proposes to return C to its previous method in Year 4 because C made an accounting method change without permission.

Situation 4: D for years 1-3 was using an improper method of accounting. In Year 4, D changed without permission to a permissible method. D used the new method in Years 4-8. In Year 8, Year 5 is placed under examination. Year 4 and prior are closed by statute. The examiner proposes to return D to its previous method in Year 5 because D made an accounting method change without permission.

LAW

Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that a change in the 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 is any item which 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)(b) provides that a change in method of accounting 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 which does not involve the proper time for the inclusion of the item of income or the taking of a deduction.... A correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

Treas. Reg. § 1.446-1(e)(2)(i) provides that a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Code or regulations. In order to secure the Commissioner's consent to a change in method of accounting, the taxpayer must file an application on Form 3115, Application for Change in Accounting Method, within 180 days after the beginning of the tax year in which the taxpayer desires to make the change. Treas. Reg. § 1.446-1(e)(3)(i).

Except in certain limited circumstances, a change in method of accounting may only be made prospectively. Id. Furthermore, a taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing an amended return. Rev. Rul. 90-38, 1990-1 C.B. 57. Section 446(e) authorizes the Commissioner to consent to a retroactive change in method of accounting, whether the change is from a permissible method or an impermissible method, but a taxpayer has no right to demand that a change in method be made retroactively. Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989); Rev. Rul. 90-38, supra. In Diebold, the court stated: "[A] central policy underlying the consent requirement is that the Commissioner should have an opportunity to review consent requests in advance. With advance notice, the Commissioner has leverage to protect the fisc...." Diebold, Inc. v. United States, 16 Cl.Ct. 193, 208 (Cl.Ct. 1989); aff'd, 891 F.2d 1579 (Fed. Cir. 1989). Furthermore, the court also held in Diebold that seeking to change a method of accounting by filing an amended return is impermissible. 891 F.2d at 1581.

If the taxpayer's method of accounting clearly reflects income, the Commissioner may not require the taxpayer to change to a method that, in the Commissioner's view, more clearly reflects income. W.P. Garth v. Commissioner, 56 T.C. 610, 618 (1971), acq. 1975-1 C.B. 1 (Commissioner has broad powers to determine whether accounting method clearly reflects income but does not have authority to force a change from a method which does clearly reflect income to a method which in the Commissioner's opinion more clearly reflects income).

Rev. Proc. 97-27, 1997-1 C.B. 680 provides the general procedures for obtaining the consent of the Commissioner to change a method of accounting.

DISCUSSION

ISSUE ONE

Situation One: By providing the examiner with claims or amended returns for years 3-6, A is attempting to retroactively change its method of accounting. Section 446(e) and Reg. § 1.446-1(e)(3) preclude a taxpayer from making a retroactive change in method of accounting by amending prior tax returns without the Service's consent. Although section 446(e) authorizes the Service to consent to a retroactive change in method of accounting, whether the change is from a permissible method or an impermissible method, section 446(e) does not give the taxpayer a right to demand that a change in method be made retroactively. See Diebold, 891 F.2d at 1583.

Furthermore, Reg. § 1.446-1(e)(3)(i) specifically provides that "the taxpayer must file an application on Form 3115 with the Commissioner during the taxpayer year in which the taxpayer desires to make the change in method of accounting." (emphasis added) Thus, except in certain limited circumstances, and as specifically provided by revenue procedure or other administrative pronouncement, a taxpayer that seeks to change its method of accounting in accordance with Reg. § 1.446-1(e) may only request to change the method of accounting prospectively, regardless of whether the change is from a permissible method or an impermissible method. Section 2.04, Rev. Proc. 97-27, 1997-1 C.B. 680; Rev. Rul. 90-38, 1990-1 C.B. 57.

A has not followed the procedures for changing its method of accounting for Years 3-6, as set forth in section 446(e), the underlying regulations, Rev. Proc. 92-27, and other administrative guidance provided by the Service. Consequently, the examiner is justified in disallowing the claims.

Situation Two: B has not followed the procedures for changing its method of accounting for Year 6, as set forth in section 446(e), the underlying regulations, Rev. Proc. 97-27, and other administrative guidance provided by the Service. Consequently, B has not secured the Service's consent for its change in accounting method. The Service may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. Diebold, supra; Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993). The Service may do so even when the taxpayer changed from an impermissible to a permissible method. Thus, the examiner may return B to its previous method in Year 6.

Situation 3: Even though C's change in accounting method was not retroactive, C has not followed the procedures for changing its method of accounting method for Year 4, as set forth in section 446(e), the underlying regulations, Rev. Proc. 97-27, and other administrative guidance provided by the Service. Consequently, C has not secured the Service's consent for its change in accounting method. The Service may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. Diebold, supra; Pacific Enterprises v.

Commissioner, 101 T.C. 1 (1993). The Service may do so even when the taxpayer changed from an impermissible to a permissible method. Thus, the examiner may return C to its previous method in Year 4.

Situation Four. Even though D's change in accounting method was not retroactive, D has not followed the procedures for changing its method of accounting method for Year 5, as set forth in section 446(e), the underlying regulations, Rev. Proc. 97-27, and other administrative guidance provided by the Service. Consequently, D has not secured the Service's consent for its change in accounting method. The Service may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. Diebold, supra; Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993). The Service may do so even when the taxpayer changed from an impermissible to a permissible method. Thus, the examiner may return D to its previous method in Year 5, presumably the earliest open year. The examiner may then make an adjustment to D's taxable income under section 481. See section 2.05, Rev. Proc. 97-27, supra.

ISSUE TWO

Nothing in section 446(e), the underlying regulations, or the Service's administrative guidance in this area indicates that the absence of a "tax avoidance" purpose will excuse a taxpayer's failure to obtain the Service's consent for a change in the taxpayer's method of accounting or otherwise legitimate an impermissible change in a method of accounting.

ISSUE THREE

FSA 200102004 has no precedential value. Under section 6110(k)(3), a "written determination," which includes Chief Counsel advice, "may not be used or cited as precedent."

Please call if you have any questions.

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Branch Two