INTERNAL REVENUE SERVICE

Dec. 24, 1998

Office Symbols: CC:DOM:FS:IT&A
Case Number:

UILC: 446.04-00

Number: **199923004**
Release Date: 6/11/1999

MEMORANDUM FOR:

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated September 18, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =)
B =
C =)
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
State X =

ISSUES:

1. Whether a method of accounting for
costs was established by A prior to or during the years at issue, which the petitioner is now attempting to change without the permission of the Commissioner.

2. Should costs be considered a material item within the meaning of the regulations.

3. Does the fact that A did not claim or report any amounts for future expenditures in the years at issue, in spite of the fact that under its own theory such amounts accrued, help to demonstrate that a method of accounting was established in those years.

4. Does the fact that prior to and during the years at issue B adopted and applied, on behalf of A, the accounting methods and policies already established by C, help to demonstrate that a method of accounting for was established by A in those years.

<u>CONCLUSIONS</u>:

1. A has established a method of accounting for which it is now attempting to change without the permission of the Commissioner.

2. costs in general are material items, and individual types of costs are also material items.

3. The fact that A did not claim or report any amounts for future expenditures in the years at issue, in spite of the fact that under its own theory such amounts accrued, demonstrates that its established method of accounting was to accrue upon the occurrence of the activities.

4. We believe that the continuity in applying accounting methods and policies through various divisions and subsidiaries of C may help to demonstrate that a method of accounting for was established by A.

<u>FACTS</u>:

A is a partnership for federal tax purposes and adopted an accrual method of accounting. The unit operator for A is B, a wholly owned subsidiary of C. B was incorporated to hold all of C's interests in State X.

A asserts that it is entitled to certain tax deductions based on its estimates of the future costs it will incur for

. A, an accrual basis taxpayer, maintains that, under the all events test of § 461, its obligation to incur these costs in the future became fixed under State X law at the time the land was disturbed and

. A further alleges that the minimum costs for which it is liable can be reasonably estimated.

A did not claim any deductions on its returns based on estimated future costs, either prior to, during or subsequent to the years at issue at least through Date 1. It now alleges that its failure to accrue and claim such deductions in the years of disturbance was a mistake or error which it is attempting to correct.

During Date 2, A accrued the costs it incurred, , at or near the time that the activities or services giving rise to those costs were actually performed. Accordingly, the Service has taken the position that A established a method of accounting for such costs, including , which it is now attempting to change, without the permission required by § 446(e).

[redacted] A did not accrue or report costs identified as on its returns for the years at issue. A asserts that the manner of accrual for actually performed and the tax deductions claimed, were also accounting mistakes or errors which it is now attempting to correct.

B did not keep a separate set of financial accounts for A; it maintained accounting information regarding A as part of its own corporate accounting system, keeping the information in certain subaccounts. Under the system used to account for expenditures arising from the activities, cost and expense items were accrued on B's financial books and records either when the activities giving rise to them were actually performed, or upon the occurrence of events which were closely related in time to actual performance. For example, A's development costs were generally entered into the accounting system at the time that work, goods or other services were paid for by the operator. [redacted]

In terms of tax accounting, during the years at issue, and through Date 3, A did not report any deductions on its partnership returns that can be separately identified as or as costs for the .

[redacted]

[redacted]

[redacted]

A's primary argument in this case has been that its claim for deductions based on the future estimated costs it will incur for represent the correction of an error in the application of an overall accrual method of accounting which it otherwise had applied consistently and correctly; and, thus, that its claims do not represent an accounting change within the meaning of § 446. Thus, A's position apparently is that it adopted a general accrual method of accounting that included a system of accounting for costs like , and that it made a mistake in applying its chosen method of accounting. Also, apparently, under this argument, A does not consider activity, by itself, a material item for which a method of accounting must be selected.

Thus, although A takes the position that is not a material item, it seeks to change the treatment afforded this item to one which is different from the way it has treated the other developmental costs it incurred during the relevant time period.

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. Although 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. 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. See Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 510 (1989); Peoples Bank & Trust Co. v. Commissioner, 50 T.C. 750 (1968), aff'd, 415 F.2d 1341 (7th Cir. 1969).

Section 446(e) and the regulations promulgated thereunder, provide that a taxpayer must first request and receive the consent of the Commissioner before computing its taxable income upon a different method of accounting. §446(e); Treas. Reg. §§ 1.446-1(e)(2)(i) and (e)(3). Once having elected a method of accounting for a material item, a taxpayer cannot change its method of accounting for that item without

first securing the consent of the Commissioner. Pacific National Co. v. Welch, 304 U.S. 191 (1938).

ANALYSIS:

1. Establishment of a Method of Accounting

A method of accounting is a set of rules consistently applied by a taxpayer under which the taxpayer determines when and how to record items of income and expense on its books, how to prepare its financial statements, and how to determine its taxable income. As the regulations state: 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. Although 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. Treas. Reg. §1.446-1(e)(2)(ii)(a).

Our view is the A established a method of accounting for its costs by never previously deducting its estimated future costs, and its effort to deduct such costs now, many years after its were first placed in service, is a change in method of accounting. A's allegation of error in its chosen method of accounting for costs is specious to the extent that we can establish an accounting practice of currently deducting as performed. Thus, on one hand A is attempting to change its method of accounting for costs from deducting them as the activities are performed to currently deducting its future estimated costs. In addition, A asserts that capitalization of the costs is the appropriate tax treatment.

That is, we understand that A asserts as one of its arguments that its future estimated costs may be properly capitalized to basis in the years of disturbance of the land. It is axiomatic that a change from expense to capitalization treatment constitutes a timing change and hence a change in treatment of a material item, which is a change in method of accounting requiring the Commissioner's advance consent.

For example, in Diebold, Inc. v. United States, 16 Cl. Ct. 193 (1989), aff'd, 891 F.2d 1579 (Fed. Cir. 1989), the taxpayer initially treated its spare modules as inventory, a method permitting the costs of acquiring inventory to be deducted in a single year, and it sought to change to recover the costs of the modules ratably over their useful lives. According to the court, it did not seek to account for the replacement modules in the same manner that it accounted for other similar items or to correct the omission of an item from a method of accounting that it otherwise consistently applied to a single category of related items. "...[T]here is no question that a change from treating the replacement modules as nondepreciable inventory, where there is no deduction until the modules are removed from service, to treating them as capital assets, where there is a depreciation deduction in each year of useful life, raises the question of the taxable year in which income is reduced by the cost or a portion of the cost of manufacturing the replacement modules, that is a question of timing." 891 F.2d at 1583. "...[S]hifting from inventory to depreciation clearly involves the proper time for the taking of a deduction...the threshold requirements for the application of the consent rule have been satisfied." 16 Cl. Ct. at 199. See also Southern Pacific Transp. Co. v. Commissioner, 75 T.C. 497,680-83 (1980) (change in depreciating certain assets affected time of deduction and was change in method of accounting); Hooker Industries, Inc. v.

Commissioner, 44 TCM 258 (1982) (court rejected taxpayer's argument that a change from expensing supplies in the year used to expensing them in the year purchased was a correction of an error in its usual method of accounting. Taxpayer did not believe that it was expensing supplies and suddenly discover that it had been mistakenly inventorying them.)

These cases establish that changes within inventory or depreciation techniques, as well as a change from inventory to depreciation, or a change from deduction to capitalization, all involve the timing of deductions.

2. Material Items

Treas. Reg. §1.446-1(e)(2)(ii)(a) specifically 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. Therefore, an attempt to either amortize or deduct estimated future DR&R costs, when this has not previously been A's accounting treatment, constitutes a change in the treatment of a material item, since it involves the proper time for the taking of a deduction.

Methods of accounting exist with respect to every item of income or expense. See generally Gertzman, Federal Tax Accounting at 9-48 (1993,2d ed). By definition, 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, and the accounting treatment of such material item is considered a method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(a).

What constitutes a change in the accounting treatment to a material item revolves around the determination of whether the item itself is basically the same as an item previously accounted for in a particular manner and thus the proposed or present method of accounting may not differ from the prior treatment. For example, in Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320 , each warrant issued by the petitioner in relation to the sales of its products was not a new item. That is, all warrants should have been reported under the same method of accounting. Id. At 95-96. Conversely, a new item may receive a different accounting treatment.

The principle that a taxpayer may change accounting methods when the treatment of a new item is involved is demonstrated by Morris-Poston Coal Co. v. Commissioner, 42 F.2d 620 (6th Cir. 1930) where an accrual method taxpayer discontinued its coal mining and coal selling business and started a cash method business of leasing its property. The Commissioner argued that the taxpayer must recognize its rental income on an accrual method and could not change to the cash method without consent. The Sixth Circuit reversed the Board of Tax Appeals and held that the taxpayer was not required to report its rental income by the accounting method formerly used for revenue from coal mining. ("The Commissioner rests his action largely upon his conclusion that this taxpayer, during the year, changed its method of accounting. We think the facts do not support this conclusion....Then a new kind of business was beginning and a new kind of income was in contemplation. This kind of income had never been handled by the method of bookkeeping in former use, because such type of income had never existed....The new rental involved a different set of conditions...." Id. At 621-22).

in general is a material item, and each individual cost is also a material item. Yet, all costs are similar and require the same accounting treatment. A taxpayer's reporting of a new and different item of income or expense for the first time does not necessarily involve a change of accounting method merely because the item is reported on a different basis than that used with respect to existing items. If the items are dissimilar, they may receive different accounting treatment, which does not constitute an improper change in method of accounting. This principle is demonstrated by Federated Dept. Stores, Inc. v. Commissioner, 51 T.C. 500 (1968), nonacq. 1971-2 C. B. 4, aff'd, 426 F.2d 417 (6th Cir. 1970). The Tax Court held that for a change of accounting to have occurred the material item must be basically the same as an item accounted for previously in a different manner. Unless the transactions are basically the same, the accounting treatment would not be a change of accounting but only a new accounting method for a different transaction. In Federated, taxpayer's sale of its receivables was found to be a new transaction not subject to the prior method of accounting for transactions which were in substance loans secured by its receivables. See generally Gertzman, supra at 9-48 to 9-49.

Thus, in your case our argument, of course, is that items are the same items. They are each individual material items because they individually involve the proper time to take a deduction. A material item is ANY ITEM which involves the proper time for taking a deduction. Treas. Reg. §1.446-1(e)(2)(ii)(a).

3. Failure to Claim

Clearly, of course, it is Service position that a method of accounting is established if it is used on a return. A taxpayer adopts a method of accounting when he uses it on a first filed return (if the method is proper) or on two consecutive returns (if the method is improper). Rev. Proc. 97-27, §2.01, 1997-1 C.B. 680. A method of accounting is not adopted in most instances without consistent treatment, but a method of accounting may exist without a pattern of consistent treatment. Id. In this case, even if no activities had yet occurred which could have been accrued upon actual performance, (thus creating a pattern of consistent treatment), our position would be that A's chosen method of accounting for was accrual upon performance. This selection of a method of accounting is based upon A's failure to accrue future estimated at the time that its facilities were placed in service. That is, A established a method of accounting by not currently deducting its future estimated costs upon filing its first tax return. In addition, of course, to the extent that we can establish that costs were deducted upon performance, we will be able to buttress our position that A had established a method of accounting for costs.[1]

[redacted] See Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320 at 97 ("Moreover, we think that when respondent does not seek to hold a taxpayer to a previously adopted method of accounting but rather seeks to impose another method in place of the one utilized by the taxpayer, the consent of respondent under section 446(e) is generally not required."). We mention this case merely to alert you to the pitfalls of not holding a taxpayer to its chosen method of accounting.

4. Financial Accounting Methods

[redacted] Yet as you note, a method adopted for financial accounting purposes is not necessarily that adopted for tax purposes. It is well established that financial and tax accounting treatment may often diverge. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-44 (1979); Challenge Publications, Inc. v. Commissioner, 845 F.2d 1541, 1546 (9th Cir. 1988). Thus, our primary focus must be on the tax accounting treatment.

[redacted]

[redacted]

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[1]Of course, it is our position that it is methodologically impermissible to currently deduct expenses projected so many years into the future that the cost estimate is largely conjectural. See Burnham Corp. v. Commissioner, 90 T.C. 953 (1988), aff'd, 878 F.2d 86 (2d Cir. 1989). (The all events test prohibits deductions for liabilities that in fact exist but the amounts of which are based upon unrealistic estimates of future expenses. 90 T.C. at 958; furthermore, no statutory authority or case law exists that would require accrual basis taxpayers to discount current deductions for long term liabilities. 90 T.C. at 960.) A seeks current deductions "for the minimum " costs to be incurred at some future time. In our view, such a methodology is merely a variation of present value (discounting a future amount to obtain today's value) and is suspect.

[redacted]

[redacted]. For example, we mention the following three cases as illustrative of the types of case which must be relied upon:

Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993) (Petitioner's reclassification of a portion of working gas (inventory) to capital asset accounts was a change in accounting method because, under Treas. Reg. §§1.446-1(e)(2)(ii)(a) and (c), the reclassification changed a material item that was used in the identification of inventory. The reclassification is material, not only because of the large dollar amount involved but also because it was a change that affected the timing of income.);

Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3d Cir. 1961), cert. denied, 375 U.S. 993 (1964) (Accrual basis taxpayer had consistently but erroneously reduced its insurance expense of each year by an amount representing dividends to be paid by the insurance company in the following year. There is a change in the treatment of a material item when a taxpayer shifts from deducting dividends when paid to deducting them in the year they are declared. "It is not dispositive that taxpayer's former consistent method of reporting the insurance dividends in the instant case was not correct under the accrual accounting system since it could not be changed without the Commissioner's consent." Id. at 231.);

Knight-Ridder Newspapers v. United States, 743 F.2d 781, 798-99 (11th Cir. 1984) (The essential characteristic of a material item is that it determines the timing of income or deductions. In this case the rebate reserve was an item which affected the timing of a deduction. Thus, the rebate reserve was a material item and a method of accounting.)

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