INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated April 30, 1999. 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 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Tax year 1 =
Tax year 2 =

ISSUE:

When A, under the facts described, changed the classification of its aircraft from depreciable assets to inventory, was this a change in method of accounting requiring the Commissioner's advance consent.

CONCLUSION:

Based on the facts presented in the incoming request for advice, we conclude that A's change from leasing to selling aircraft is a change in underlying facts, and the concomitant reclassification of its assets, therefore, is not a change in method of accounting.

FACTS:

The following facts are based on your incoming request for advice as well as a conference call between the National Office and the field held on June 21, 1999.

For approximately eight years, B, a subsidiary of A, was in the business of leasing aircraft to major airlines. Subsequently, several of B's major clients went out of business, and on Date 1, A adopted a formal plan to permanently discontinue the aircraft leasing business product line of B. B's new line of business was selling aircraft. From the time of the decision on Date 1 to discontinue the leasing business, B began selling its leased aircraft until all of them had been sold by Date 3. Most of them were sold on Date 3. A reported the decision to permanently change the business of B from that of leasing to selling aircraft in the Date 5 annual report, and it also publicly announced the change to its shareholders and the investment community on Date 4.

During the period of time that B was primarily engaged in leasing aircraft (from Date 2 until Date 3) it never included purchase options in its lease agreements, and when leases terminated, B actively sought new lessees. When aircraft were no longer profitable to lease, the planes were sold (apparently not merely for parts, based on the sale prices).

To reflect this new business of selling aircraft, aircraft were now reported as inventory rather than as depreciable capital assets. This conversion resulted in a substantial loss on A's Date 4 consolidated return. Tax years 1 and 2 are under audit, and the Date 3 corporate return was B's final return.

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 the method of accounting does not include a change in treatment resulting from a change in underlying facts. See e.g, Example 3, Treas. Reg. §1.446-1(e)(2)(iii):

> A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its federal income

> tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

ANALYSIS:

A change in underlying facts, rather than a change in method of accounting, occurs when a taxpayer continues to apply its existing method of accounting to a change in business practices, a change in economic or legal relationships, or an otherwise altered fact situation. In Example 3, supra, the taxpayer has applied its existing method of reporting to a changed fact situation. The different tax consequences arose from a different legal obligation and economic condition, not from a change in method of reporting. See generally, Stephen F. Gertzman, Federal Tax Accounting ¶9.07 (2d ed. 1993). In this case, a change in facts occurred (now selling rather than leasing aircraft) which necessitated an accounting change. Thus, of course, the accounting change was a direct result of the change in facts of B's business operations and comes under the change in underlying facts exception to a change in method of accounting.

It is important to note, though, that the change in underlying facts exception to a change in method of accounting does not preclude the existence of a timing change. Rather, the regulations allow an exception for a change in underlying facts, notwithstanding a change in timing caused by the change in facts. See Treas. Reg. §1.446-1(e)(2)(ii)(b) and Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2, infra.

Decision is a frequently cited case for what constitutes a change in underlying facts. In that case, taxpayer changed a business policy; it changed its advertising contract terms and billing procedures. These changes resulted in a deferral of income when compared to its previous contractual terms with its customers. The court stated that the change in customer contracts and billing terms, which affected income recognition, was not a change in method of accounting. "Although the change had consequences in the annual determination of income, such consequences were not produced by the accounting system. In essence this kind of business policy change was no different from a decision to lower prices or halt production for a year." 47 T.C. at 64.

Similarly, in Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967), acq., 1969-2 C.B. 20, aff'd, 407 F.2d 210 (9th Cir. 1969), cert. denied, 396 U.S. 824 (1969), taxpayer sold funeral plans under a contract providing that the amounts would be deposited and maintained in trust for the benefit of the purchaser, and used only for specified purposes consistent with the trust relationship. Subsequently, the taxpayer changed its contract to one requiring it to pay interest to the purchaser and permitted it to use the funds as it wished. The court held that there was not a change in method of accounting, but rather a change in facts had occurred. That is, amounts received under the earlier contract did not have to be included in income until used for the intended purposes, but amounts received under the later contract were includible at the time of payment. See also Charles Schniers v. Commissioner, 69 T.C. 511 (1977) (cash basis taxpayer entered into agreements with purchaser that payment was not due until the following year and that taxpayer would have no rights, claim or action against purchaser for payment prior to the succeeding year; court held that due to the agreement, there was no change in accounting method).

In Morris-Poston Coal Co. v. Commissioner, 42 F.2d 620 (6th Cir. 1930), taxpayer discontinued its business of mining and selling coal and started the business of leasing its property. The Sixth Circuit held that taxpayer was not bound by the accounting methods formerly used with respect to its revenue from coal mining. "[T]he outstanding controlling fact is that petitioner's going business, with its established customs of sale and methods of bookkeeping, ended....It then engaged in a new business–with the same capital...but of a different character, with different prospective income...."

Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989), aff'g, 16 Ct. Cl. 193 (1989), is different from the instant case. In Diebold, taxpayer had consistently accounted for its replacement modules (used to repair ATM machines) as inventory, and then sought, by way of amended returns, to treat them as depreciable assets without requesting the Commissioner's advance consent. The court held that taxpayer's claim for refunds was based on an impermissible change in method of accounting from the accounting method regularly used by the taxpayer in computing income. Diebold had established the inventory method of accounting for the replacement modules and sought to change to a different method by treating the modules as depreciable assets rather than as inventory. Unlike the instant case, there was no factual change to its business.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

While we have concluded, based on the facts as presented to us, that there was a change in underlying facts and not an unauthorized change in method of accounting, this is a very close call on this issue, and this analysis might change if the facts are other than as presented to us.

[redacted]. Second, we might be able to argue that A never entered the business of selling planes; it simply exited the business of leasing planes by selling the assets used in its leasing business. In that event, the cases related to a change in business, such as Morris-Poston Coal, are inapplicable.

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By: ________________________

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