INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Heather Maloy
Associate Chief Counsel CC:IT&A

SUBJECT: Change in Accounting Method

This Field Service Advice responds to your memorandum dated May 18, 2000. 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.

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LEGEND:

A =
Year 1 =
Year 2 = ____
Year 3 =
Year 4 =
Year 5 = ____
Year 6 =
$X = ________

ISSUE:

Under the facts of this case, because A impermissibly changed its method of accounting, should the Service deny A's use of the correct method of accounting and return it to its prior erroneous method.

CONCLUSION:

We recommend against returning A to its prior method of accounting.

FACTS:

A is a dealer in the business of selling time-shares. Units are sold on installment sales contracts, and for tax purposes, income is included as the installment contracts are paid. For the taxable years from Year 1 to Year 2, A did not deduct direct selling expenses or marketing costs as they were incurred, but rather capitalized them into cost of goods sold. The direct selling expenses included salaries, payroll taxes, sales commissions, referral fees, supplies, and travel and entertainment. The expenses were thus deducted ratably over succeeding years with the income from the installment sales contract.

For taxable Year 2, A filed an amended return reducing taxable income by $ X. The stated reason was to account for a net overstatement of income by erroneously capitalizing direct marketing costs. A's adjustment as reflected on its amended return put into Year 2 all the prior selling expenses that had been capitalized but not yet deducted. The amended return generated a NOL which was carried forward for two years. The return did not give notice that this was anything other than the correction of an error; the amended return did not state that it was changing the method of accounting for marketing costs, and it did not disclose that the adjustment in effect included a section 481 adjustment for prior year's amounts.

A used one accounting firm to prepare its tax returns for Years 1 through 2, and then engaged the services of another firm, based on their expertise in the timeshare industry, to prepare the certified audit for Year 3. During this audit the firm determined that A's method of computing gross profit on installment sales was incorrect, and subsequently the amended return at issue in this case was submitted.

A's first position is that the amended return is the correction of an error rather than a change in accounting method. Alternatively, A argues that because the capitalization of the direct marketing/selling costs is an erroneous method of accounting, the Service should allow the change in method of accounting based on the District Director's discretion pursuant to Rev. Proc. 97-27, 1997-1 C.B. 680.

The statute of limitations has expired for Year 2 and Years 3-6 are under audit. The agent proposes to reinstate the prior accounting method and to make a section 481 adjustment, which would recapture A's Year 2 section 481 adjustment made pursuant to the amended return and for which the statute of limitations has expired. The reversion to A's original accounting method is proposed not because the present accounting method does not clearly reflect income, but because A failed to obtain the required consent for a change in method of accounting.

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.

Because advance consent is required, changes in methods of accounting may only be made prospectively. "[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). Seeking to change a method of accounting by filing an amended return is impermissible. Diebold 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.

ANALYSIS:

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 represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)-(2)(ii)(a). In addition, Treas. Reg. § 1.446-1(e)(2)(i) indicates that the consistent, but erroneous, treatment of material items constitutes a method of accounting. Rev. Rul. 90-38, 1990-1 C.B. 57. Accordingly, in this case A had adopted capitalizing selling expenses as a method of accounting.

A argues that its amended return corrects an error in its method of accounting but does not change a method of accounting. A would be allowed, without securing the Commissioner's approval, to correct mathematical or posting errors in the figures generated by its original capitalization accounting of selling expenses. But A changed from capitalization to deduction of selling expenses–a change involving the timing of deductions. By definition, this required consent. If the amended return corrected items which did not involve deduction timing, consent would not be required. Diebold, 16 Cl. Ct. at 200.

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, and 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, supra. 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.

Without question A has retroactively changed its method of accounting without permission. The agent concedes that A's new method of accounting (deducting selling/marketing expenses) would have been a permissible method if originally adopted. Since the sale of timeshares in the ordinary course of a taxpayer's trade or business would be a dealer disposition, current deduction of the sales expenses would be consistent with the treatment accorded dispositions by dealers when the installment method was available to them. Section 453(l). But A elected and consistently used an erroneous method of accounting–capitalizing selling expenses.

Even though there may be sufficient grounds to argue in this case that the Commissioner was not on notice that the amended return changed a method of accounting and hence, any purported acceptance of the amended return by the Commissioner cannot be construed as consent to the change in method of accounting, see, e.g., Daktronics, Inc. v. Commissioner, T.C. Memo.

1991-60, we believe that absent some tax avoidance scheme on the part of A, we should not require A to return to an incorrect method of accounting.

A apparently switched accounting firms, and the new firm determined that it was incorrect for A to capitalize selling costs; the new firm prepared the amended return with the change to deduction from capitalization and included a section 481 adjustment to account for the past years of capitalizing the costs. There apparently is no evidence that A was purposefully deferring deductions in order to take advantage of expiring NOL's. The NOL generated by the Year 2 amended return was carried forward for two of the next four years, and as of the end of Year 6, A had an unused loss balance. The agent believes that the first accountants were merely being conservative, and capitalized the selling expenses because they thought that it was the correct treatment.

Prior consent for a change in method of accounting is required to permit the Commissioner to review the proposed change in method in order to make certain that the change will be to a correct method, that no tax abuse will result from the change, and that the change will be made with appropriate adjustments to ensure that no items of income escape taxation and that no items of expense are deducted twice. The requirement also enables the Commissioner to review changes for the protection of the public treasury, to assure taxpayer compliance with the requirement that the method used clearly reflects income, and otherwise to monitor taxpayer conduct. The requirement generally applies even though there may be legitimate reasons for the change and despite the fact that it might be an abuse of discretion for the Commissioner to refuse to permit the change. S. Gertzman, Federal Tax Accounting ¶8.03 (2d ed. 1993).

Where the request for change is from an improper to a proper method, the Commissioner's discretion is limited. The courts have made it clear that the denial of a request to change from an incorrect to a correct method would constitute an abuse of discretion. Id. at ¶ 8.07[2]. See Wright Contracting Co.v. Commissioner, 36 T.C. 620 (1961), acq. 1966-2 C.B. 7, aff'd, 316 F.2d 249 (5th Cir. 1963), cert.denied, 375 U.S. 879 (1963) (court indicated that it would amount to an abuse of discretion for the Commissioner to refuse a request for change from an improper to a proper method); Elsie SoRelle v. Commissioner, 22 T.C. 459 (1954), acq. 1955-1 C.B. 6, and Douthit v. United States, 299 F. Supp. 397 (W.D. Tenn. 1969), rev'd on other grounds, 432 F.2d 83 (6th Cir. 1970) (in each case, in the context of other questions, courts made it clear that the Commissioner could not compel a taxpayer to remain on an improper method of accounting). Some courts have even held that the Commissioner's prior consent to a change from an incorrect method is not necessary. Gertzman at ¶ 8.07[2].

The Service would be technically correct to assert that A's change in method of accounting without permission allows the Service to place it back on its prior capitalization method of accounting, although as noted, supra, if litigated, an issue would arise about the Commissioner's discretion to compel the continued use of an erroneous method of accounting. A could also argue that the proposed change back to capitalization is not proper because the present method of accounting clearly reflects income and is the proper method.

Accordingly, we do not believe that sound and reasonable tax administration supports returning A to its previous method of accounting solely because the change was made without permission. Our view would be different if tax avoidance was involved. Not changing A back to its previous accounting method is consistent with the considerations set forth in Rev. Proc. 97-27, supra, (general procedures for obtaining Commissioner's consent for a change in method of accounting) for the Service's discretion to not approve an application for a change in method of accounting. Changes are not approved which would not be in the best interest of sound tax administration and where the change would clearly and directly frustrate compliance efforts of the Service in administering the tax laws. Id. at section 8.01. We believe that imposing an incorrect accounting method is inconsistent with sound tax administration.

Therefore, even though there may be sufficient facts to support an argument that the Commissioner did not consent to the change in method of accounting as reflected in the amended return, we do not recommend returning A to its prior incorrect method of accounting. Rather, we recommend allowing the change in method of accounting pursuant to the District Director's discretion as set forth in Rev. Proc. 97-27, supra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Our response is based on the assumption that tax avoidance was not a factor in A's change in method of accounting. Our opinion would be different if this was not true.

[redacted]

There is case law defining the limited discretion of the Commissioner to deny a change in method of accounting from an improper method to a proper method. Similarly, in this context we believe that the Commissioner's discretion would also be limited for reversing a change from an incorrect to an correct method without a reason other than the change was made without permission.

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