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

OFFICE OF
CHIEF COUNSEL

December 6, 2001

Number: **200209025**
Release Date: 3/1/2002
CC:FIP:B01/TL-N-2066-01
UILC: 481.00-00; 1502.13-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

FROM: LON B. SMITH
ASSOCIATE CHIEF COUNSEL
(FINANCIAL INSTITUTIONS AND PRODUCTS) CC:FIP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated August 2, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =

Subsidiary 1 =

Subsidiary 2 =

Year 1 =

Month 1 =

Year 2 =

ISSUE

Whether the § 481 adjustment for a consolidated return member changing its method of accounting needs to take into account the corresponding adjustments that might be required of another member's method of accounting for intercompany transactions?

CONCLUSION

No, the § 481 adjustment for the member changing its method does not take into account adjustments of another member's method that might be necessitated by the consolidated return rules.

FACTS

In all relevant years, Parent filed consolidated returns with its wholly owned subsidiaries, Subsidiary 1 and Subsidiary 2.

In the ordinary course of its business, Subsidiary 1 contracted with third-parties to deliver certain commodity products. Subsidiary 1 then entered into commodity-based derivative contracts with Subsidiary 2 (acting as a hedge center for the consolidated group), which fixed Subsidiary 1's costs of delivering the commodities to third parties.[1] Finally, Subsidiary 2 fixed the intercompany risks it assumed by entering into commodity-based derivative contracts with third-parties.

In Year 1, Subsidiary 2, a dealer, filed a Form 3115, Application for Change in Accounting Method, requesting permission to change its method of accounting to the mark-to-market method under § 475(a)(2) beginning with its taxable calendar year ending Year 1. However, Subsidiary 1, not having requested a change in its method of accounting, continued to use the realization method. In Month 1, the Service granted Subsidiary 2's request to use the mark-to-market method of accounting for its taxable calendar year ending Year 1.

In Year 2, Parent filed a Form 1120X for the Year 1 taxable year reflecting Subsidiary 2's accounting method change. Subsidiary 2 calculated its § 481 adjustment taking into account only the effect of the method change on its positions. Subsidiary 2 did not include in the calculation any effect that the method change might have on other members' treatment of intercompany transactions. However, in filing the amended return for its taxable calendar year ending Year 1, Parent not only recalculated Subsidiary 2's income using mark-to-market accounting, it also marked-to-market Subsidiary 1's intercompany positions under the matching rules for intercompany obligations under § 1.1502-13(g).

Exam has suggested that because Subsidiary 1's intercompany positions were reported on a mark-to-market basis as a direct result of Subsidiary 2's accounting method change, Subsidiary 2 should have taken Subsidiary 1's intercompany positions into account in determining the amount of Subsidiary 2's § 481(a) adjustment.

LAW AND ANALYSIS

---

[1] Parent did not make a separate-entity election under § 1.1221-2(d)(2) of the Income Tax Regulations.

Each member of a consolidated group has its own method of accounting and §§ 446(e) and 481(a) are applied on a member-by-member basis. See § 1.1502-17. When a taxpayer changes its method of accounting, i.e., computes its taxable income for a taxable year under a method of accounting different from the method used in the immediately preceding taxable year, § 481(a) requires the taxpayer to take into account adjustments determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

Subsidiary 2 changed its accounting method from the realization method to the mark-to-market method. Therefore, Subsidiary 2 was subject to § 481. The § 481 adjustment is equal to the change in value that occurred prior to the year of change because that is the amount necessary to prevent duplications or omissions arising solely from Subsidiary 2's change in accounting method.

Subsidiary 1 did not change its method of accounting and, therefore, is not subject to § 481. Moreover, Subsidiary 1 did not have duplications or omissions as a result of Subsidiary 2's change in accounting method. If § 1.1502-13 did not apply, Subsidiary 1 would have continued to report gains or losses from the intercompany transactions when they closed. The transactions open at the beginning of Year 1 would be reported under the realization method. In the instant case, § 1.1502-13 also results in no duplication or omission of gains or losses. All of Subsidiary 2's transactions and Subsidiary 1's intercompany transactions outstanding at the end of Year 1 are marked-to-market, and the gain reported is equal to the cumulative change in value since the transactions were entered.

Thus, Subsidiary 2 is not required to take into account any corresponding impact of its method change on Subsidiary 1 in determining its § 481 adjustment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any questions.

PATRICK E. WHITE
Assistant to the Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)