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Change in Accounting Methods and the Mitigation Sections

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CHANGE IN ACCOUNTING METHODS AND THE MITIGATION SECTIONS*

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Section 481

Prior to 1954, there was no statute comparable to section 481 of the Internal Revenue Code of 1954. The rule established by the decided cases under the 1939 Code was that if the Commissioner required a change in accounting method by asserting a deficiency, he could not include in the year of change income which should have been reported in other years, but that if the taxpayer voluntarily sought permission to change his accounting method, the Commissioner had authority to insist upon appropriate adjustments necessary to prevent income from escaping taxation because of the change.[1] Congress apparently felt that the adjustments should be made in the year of change in accounting method without regard to whether the change was requested by the taxpayer or required by the Commissioner and adopted section 481 as part of the Internal Revenue Code of 1954.

Section 481 provides that in computing the taxpayer's taxable income for any year if the computation is under a method of accounting different from that used in the prior year, then there shall be taken into account those adjustments which are necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except that there shall be no adjustment in respect of years not covered by the 1954 Code unless the taxpayer initiated the change. The exception relating to changes initiated by the taxpayer was added in 1958 and will be discussed later. For now, consideration will be given to what is a method of accounting for purposes of determining when the Section is applicable.

Regulation 1.481-1(a)(1) provides that a change of method of accounting to which section 481 applies includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. It also refers to section 446 and the regulations thereunder for rules relating to changes in method of accounting.

Regulation §1.446-1(a) provides similarly that "method of accounting" includes not only the overall method but also the treatment of any item. As examples of the overall method it lists the cash receipts and disbursement method, the accrual method, combinations of such meth-

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1 See cases cited in M. A. Lindner, 62-2 U.S. Tax Cas. ¶9694, (10th Cir. 1962).

ods and combinations of such methods with various methods for treating special items. The methods of accounting for special items include the accounting treatment for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. In setting forth the examples of changes in material items requiring consent, the regulation also includes a change involving the method or basis used in valuing inventories and a change from the cash or accrual method to the long-term contract method, or vice versa.[2]

It is clear from the Regulations that it is the Commissioner's opinion that "method of accounting" includes more than the overall method (such as cash or accrual) and that the treatment of any significant item or account will also come within the definition. In this opinion, he is supported by the courts. The treatment of items as methods of accounting by the courts includes a change in depreciation from straight line to 150% declining balance,[3] a change in reporting income from freight revenues attributable to barges in transit,[4] the establishment of a reserve for sales refunds,[5] the deferral of an accrual of income on a contract,[6] vacation pay,[7] property taxes,[8] insurance premiums[9] and others.

In regard to the question of what is a "material" item, it appears clear that the test used by the Commissioner is not the same test used by Certified Public Accountants in certifying financial statements. In a recent case,[10] the Tax Court held that vacation pay of approximately $25,000 was material and stated that the relationship of the amount in issue to the total vacation pay was more significant than the relationship to total payroll, gross sales or taxable income. It would appear that if the amount is worth arguing over, it is probably "material."

In attempting to resist adjustments by the Commissioner, several taxpayers in recent years have taken the position that the correction of an error is not a change in the method of accounting. The theory is that the change in treatment of an item to bring it within the overall method of accounting used is not a change in the method, but rather the correction of an error in applying it.

This theory of correction of error received acceptance by the Tax Court in three cases involving the 1939 Code. The first case was *O. Liquidating Corp.*[11] and involved an accrual basis taxpayer who had

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[2] Treas. Reg. §1.446-1(e) (2) (ii).
[3] M. Pauline Casey, 38 T.C. 357 (1962).
[4] Hay Co., 62-1 U.S. Tax Cas. ¶9273 (N.D. Ill. 1962).
[5] Erica Giepen, 16 CCH Tax Ct. Mem. 20 (1957).
[6] Advertisers Exchange, Inc., 57-1 U.S. Tax Cas. ¶9414 (2nd Cir. 1957).
[7] American Can Co., 63-2 U.S. Tax Cas. ¶9514 (2nd Cir. 1963); I. Lewis Corporation, 22 CCH Tax Ct. Mem. 35 (1963).
[8] American Can Co., *supra* note 7.
[9] The O. Liquidating Corp., 61-2 U.S. Tax Cas. ¶9508 (3rd Cir. 1961).
[10] Dorr-Oliver, Inc., 40 T.C. No. 9 (Apr. 16, 1963).
[11] O. Liquidating Corp., 19 CCH Tax Ct. Mem. 154 (1960).

for several years recorded insurance premium expense at gross premiums paid less dividends declared and received in the subsequent year. In 1953 the taxpayer changed its treatment of the premiums and deducted the gross premiums, without reduction. The Tax Court held for the taxpayer on the question of whether there was a change in the method of accounting. However, the court required that the dividend actually received in 1953 be deducted, volunteering that under the mitigation sections the taxpayer could obtain the reduction in 1952.

The second case decided by the Tax Court on the correction of error theory was *American Can Co.*[12] There the company, an accrual basis taxpayer, had changed its accounting for local taxes and vacation pay from cash to accrual in order to bring it into line with the general accrual method. The Tax Court stated that the correction of the erroneous treatment of these two items did not involve a change in accounting systems and held for the taxpayer.

The most recent case holding for the taxpayer on this theory is *The Marquardt Corp.*[13] There the taxpayer from 1949 through 1953 had included all of its fees on certain contracts in income even though 10% of the fees were not payable until the contracts were completed and accepted. In 1952 and 1953 a reserve for the 10% was set up and deducted. The Commissioner disallowed the deduction, taking the position that the taxpayer had changed its method of accounting without permission. The taxpayer argued that it was not changing its method; it was merely applying it correctly for the first time. The Tax Court held for the taxpayer, following its decision in the *American Can* case.

On appeal, the decisions in the *O. Liquidating Corp.* and *American Can Co.* cases were reversed.[14] The courts of appeals agreed that the taxpayers' prior reporting of the items in question had not been correct under the method of accounting used, but took the position that since material items were involved the corrections could not be made without the Commissioner's consent.

The Tax Court also has rejected the correction of error theory in several cases decided under the 1954 Cole. In *I. Lewis Corporation,*[15] the taxpayer, on the accrual basis, had deducted vacation pay when paid. In 1954 it deducted the amount paid plus an accrual. The Tax Court held that the change could not be made without prior approval of the Commissioner and distinguished the *American Can Co.* case on two grounds. First, the 1954 Code allows hybrid systems of accounting while the 1939 Code did not; and second, in the *American Can Co.* case the parties had stipulated to disallow the amount actually paid in the year of the change.

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[12] American Can Co., 37 T.C. 198 (1961).
[13] The Marquardt Corp., 39 T.C. No. 42 (Nov. 27, 1962).
[14] American Can Co., *supra* note 7; O. Liquidating Corp., *supra* note 9.
[15] I. Lewis Corporation, *supra* note 7.

A similar result was reached by the Tax Court in *Dorr-Oliver, Inc.*[16] The case involved vacation pay and again the *American Can Co.* case was distinguished on the ground that it was decided under the 1939 Code where hybrid accounting systems were not allowed. In *Wright Contracting Co.*,[17] a Tax Court case affirmed by the Fifth Circuit, the issue of the correctness of the taxpayer's prior treatment was not directly decided. However, the court of appeals cited with approval the language used by the Court of Appeals for the Third Circuit in the *O. Liquidating Co.* case to the effect that the fact that the method previously used by the taxpayer was not correct was not dispositive of the question of whether a change could be made without the Commissioner's prior approval.

In view of the holdings of the courts of appeals in the "correction of error" cases and the recent cases in the Tax Court involving the 1954 Code, the correction of errors theory appears to be of doubtful validity where the change of treatment of a material item is involved. The *Marquardt Co.* case is the only recent case recognizing the theory which has not been reversed and it has been appealed to the ninth circuit by the Commissioner. There is dictum in the Tax Court case of *T. I. Welch*[18] to the effect that the attempt of a revenue agent to take remedial action in regard to the notes payable account was not a change in method of accounting but was merely an attempt to correct an improper accounting treatment. However, the case was decided against the taxpayer on another ground and so is of little or no value as precedent.

In spite of the state of the law at this time, there is the possibility that the correction of error theory will be recognized in the proper case. It is therefore recommended that until additional cases have been decided, taxpayers give consideration to the correction of error theory where it is in their best interests.

As was pointed out previously, section 481 provides for adjustments to prevent amounts from being duplicated or omitted if there is a change in the method of accounting, except that there shall not be taken into account any adjustment in respect of a year not covered by the 1954 Code unless the change of method was initiated by the taxpayer. As originally enacted, adjustments in respect of years not covered by the 1954 Code could not be made regardless of who initiated the change. However, because of the large number of taxpayers who changed or attempted to change their method in 1954, the section was retroactively amended in 1958 to add the clause which prohibits adjustments in respect of pre-1954 years only if the Commissioner initiates the change. If the taxpayer initiates the change, adjustments may be

[16] Dorr-Oliver, Inc., *supra* note 10.
[17] Wright Contracting Co., 36 T.C. 620 (1961), *aff'd*, 63-1 U.S. Tax Cas. ¶9416 (5th Cir. 1963).
[18] T. I. Welch, 22 CCH Tax Ct. Mem. 151 (1963).

made without regard to the years to which they are attributable; if the Commissioner initiates the change, no adjustment may be made in respect of years not covered by the 1954 Code.

Assuming a change is initiated by the Commissioner, several computations must be made to determine the adjustments which are permitted and those which are not. The first step is to compute the income for the year of change on the new basis. The second step is to determine the adjustment necessary to prevent duplication or omission of income. The third step is to determine the adjustment attributable to pre-1954 years and reduce the adjustment determined in Step 2 by this amount.

A simple illustration may explain this. Assume a taxpayer has used an erroneous method of valuing inventories for many years, that the Commissioner requires a change to reflect correct valuations and that the inventory values over the years are as follows:

Date of Inventory	*Erroneous Value*	*Correct Value*
December 31, 1953	$120,000	$170,000
December 31, 1956	160,000	220,000
December 31, 1957	200,000	320,000

The taxable income for 1957 would first be determined by using the correct opening and closing inventories of $220,000 and $320,000 respectively. Then, in order to prevent the omission of income, the amount of $60,000 would be added. The $60,000 is the difference between the correct closing inventory at December 31, 1956 ($220,000) and the erroneous inventory as of that date ($160,000). The portion of the $60,000 adjustment attributable to pre-1954 years would be $50,000, the difference between the correct and erroneous inventory at December 31, 1953 ($170,000-$120,000). The $60,000 would be reduced by the $50,000 and the net adjustment to the 1957 income (computed under the new method) would be the addition of $10,000. Assuming the above figures but assuming that the taxpayer had initiated the change, the addition to the 1957 income would be the entire $60,000, without reduction.

It should be pointed out that under section 481, the adjustments are made whether the prior years are open or closed. The statute of limitations has no effect whatever if there is a change of accounting method to which section 481 applies.

Where adjustments are required, relief provisions are available to the taxpayer in the form of special tax computations for the year of change and an optional 10-year spread forward of that portion of the adjustment which represents pre-1954 income. These provisions are explained in detail in the Code and in the regulations and will not be discussed here.

Although the determination of who initiates the change in the method of accounting is very important, neither the Code nor the regulations lend a great deal of help. The regulations[19] provide that a change initiated by the taxpayer includes not only a change which he initiates with the consent of the Commissioner but also a change made without advance approval of the Commissioner. Therefore, any change in treatment of a material item by a taxpayer will subject him to adjustment in respect of all past years, including pre-1954 years.

In the area of changes arising out of the examination of tax returns, the Committee Reports[20] state that a change in the taxpayer's method of accounting "required by a revenue agent *upon examination* of the taxpayer's return" will not be considered as initiated by the taxpayer. However, the Regulations[21] have changed the wording somewhat and provide that a change in method "required as the *result of* an examination of taxpayer's income tax return" will not be considered as initiated by the taxpayer. The difference in the language may be significant in that the Commissioner's apparent interpretation of the regulation is that revenue agents cannot require changes and it is only where a notice of deficiency is filed as a result of the examination that the Commissioner initiates the change.

The cases decided to date on the question of who initiated the change are confusing and to a degree irreconcilable. In *M. A. Lindner,*[22] which was decided by a district court in Utah and affirmed by the Court of Appeals for the Tenth Circuit, a partnership had been on a cash basis prior to 1955. In August and September 1954 a revenue agent advised the taxpayers that income could clearly be reflected only on an accrual basis and in accordance with his statements the taxpayers changed to the accrual method as of Janury 1, 1955. The trial court found that the change was made as a direct result of and in response to the statements and representations of the agent and that the agent informed the taxpayers in substance and effect that the law required them to change. The court also found that the taxpayers in fact believed therefrom that they were required to make the change, that the statements and purported requirements communicated by the agent to the taxpayers were intended and calculated to induce said change and that had the necessity for said change not been stated to the taxpayers by the agent, no change would have been made. The district court found for the taxpayers and held that no adjustment was permissible as to pre-1954 years.

The Court of Appeals for the Tenth Circuit affirmed the district

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19 Treas. Reg. §1.481-1(c)(5).
20 H.R. Rep. No. 775, 85th Cong. (1958).
21 Treas. Reg. §1.481-1(c)(5).
22 M. A. Lindner. *supra* note 1.

court and stated that although the change was not required as a matter of law, it plainly was initiated by the revenue agent and not by the taxpayer. The court stated that the Commissioner could not change the phrase "intiated by the taxpayer" to "not required by a deficiency assessment."

A contrary decision on a similar set of facts was reached by the Tax Court in the *Irving Falk*[23] case. There the taxpayer partnership had been on a cash basis prior to 1954. In September of that year a revenue agent examined the 1952 and 1953 returns and told the taxpayer's accountant and one of the partners that an inventory should be taken in 1954. The agent also told them that the proper accounting method was an accrual basis and that the partnership should be put on that basis in 1954. The accountant asked the revenue agent to apply the accrual method to 1952 but the revenue agent refused to do so because of the adjustments which he would have had to make. The accountant discussed the change to the accrual method with the taxpayer's attorneys and filed the 1954 return on the accrual basis with a notation on the return to the effect that the accrual method was used in accordance with the instructions of the revenue agent.

The court in its decision stated that from the testimony it had drawn the inference that the agent "told" the accountant and one of the partners to take an inventory and that a proper method of keeping the taxpayer's books and reporting its income was an accrual basis. The court went on to state that it did not, however, infer from the testimony that the agent "instructed" or "required" that the return for 1954 be filed on an accrual basis. The court also stated that although the accountant might not have advised the partnership to change its method had it not been for the agent, nevertheless, the court was not of the opinion that the accountant felt required to make the change because of the agent's statements, since if he had he would not have contacted the taxpayer's attorney. The court found that the change had been initiated by the taxpayer and distinguished the *Lindner* case on the grounds that there the agent had "instructed" the taxpayers to change their accounting method and the taxpayers had made the change only because they were required by the agent so to do.

It is extremely difficult to accept the court's explanation of its decision. Apparently, although a taxpayer who is "instructed" to change his method by a revenue agent may do so without initiating a change, a taxpayer who is "told" to change his method by the revenue agent will be initiating the change if he does so.

Another case holding under a similar set of facts that the change was initiated by the taxpayer is *T. I. Welch,* a Tax Court memorandum

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[23] Irving Falk, 37 T.C. 1078 (1962), on appeal by the taxpayer to the Fifth Circuit.

decision.[24] In that case a succession of three revenue agents contacted the taxpayer. The first agent advised the taxpayer that its returns for 1957 and subsequent years should include full inventories. He prepared a statement of inventories for 1957, delivered it to the taxpayer, and "directed" that it be given to its accountant for the preparation of its 1957 return. The company reported its income on the accrual basis for the years 1957 through 1959.

The court in its decision stated that previously, in the *Falk* case, it had held that a distinction must be made between a situation where a revenue agent merely "suggests" a change in method and a situation where the revenue agent "instructs" that such change be made. It stated that in the instant case the advice amounted to nothing more than a suggestion and that it could not conclude that the agent pressured the petitioner to change under threat of finding other deficiencies. As in the *Falk* case, the court distinguished the *Lindner* case on the ground that there the court found that the change would not have been made except in response to the agent's demands.

Again, it is difficult to accept the court's rationale for its decision. Although the court in its decision stated that the agent had "directed" that the 1957 inventory be given to the accountant for preparation of the taxpayer's 1957 return, nevertheless, this was nothing more than a suggestion and was not an instruction.

In view of the *Falk* and *Welch* cases, it would appear that the only way a taxpayer can be sure that he is not initiating a change is to wait until a notice of deficiency has been filed before changing his method of handling a particular item. Certainly, to make a change in the treatment of any item on the oral representation of a revenue agent would be to invite trouble.

One other case has been decided recently on the question of who initiated the change in accounting method. That case is *Fred P. Pursell*[25] and it involvled a change made by the taxpayer to comply with court decisions and regulations issued by the Commissioner. The court held that under these circumstances the change was initiated by the taxpayer.

Sections 1311-1315

Sections 1311-1315, the so-called mitigation sections of the Internal Revenue Code, provide for the correction of certain errors under circumstances defined in section 1312 when the statute of limitations or a similar provision of law would otherwise prevent the correction. The circumstances in section 1312 include (1) the double inclusion of an item of income, (2) the double allowance of a deduction, (3) the double exclusion of an item of gross income included in income,

[24] T. I. Welch, *supra* note 18.
[25] Fred P. Pursell, 38 T. C. 263 (1962).

(4) the double exclusion of an item of gross income not included in income, and (5) the double disallowance of a deduction. There are several other circumstances of adjustment but the five referred to are of primary interest for purposes of this discussion.

In addition to the requirement that one of these circumstances exist, there must also be a "determination" as that term is defined in section 1313. Included within the definition are a court decision, a closing agreement, the denial of a claim for refund and an agreement entered into for the purpose of coming within the mitigation sections.

A further prerequisite to reopening a year to correct an error is that in the case of the circumstances referred to previously as (1), (2) and (3), an inconsistent position must be maintained, and in the case of the circumstances referred to as (4) and (5), the correction must not be barred at the time of the erroneous action. An inconsistent position is maintained when a position maintained with respect to the taxable year of the determination, and which is adopted in the determination, is inconsistent with the erroneous treatment in the taxable year of the error.[26] For example. a taxpayer maintains an inconsistent position if he deducts an item in 1950 and then claims and successfully litigates the same deduction in another year after the year 1950 is closed.

A correction is not barred at the time of the erroneous action if, in the case of the double exclusion of an item of gross income, the assessment of a deficiency against the taxpayer for the taxable year in which the item is includible was not barred at the time the Commissioner first maintained in a notice of deficiency or before the Tax Court that the item should have been included in the year to which the determination relates. An example of this is an accrual basis taxpayer who performs services in 1949 for which he receives payment in 1949 and 1950. He does not include in either return the payments which he received and in 1952 the Commissioner sends a notice of deficiency to the taxpayer with respect to the year 1949. The taxpayer contests the deficiency and in 1955, after the period of limitations has run as to 1950, the Tax Court sustains the taxpayer's position. The Commissioner may assess a deficiency for 1950 since a deficiency assessment for that year was not barred when he sent the notice of deficiency with respect to 1949.

A correction is not barred at the time of the erroneous action if in the case of the double disallowance of a deduction or credit, a credit or refund to the taxpayer was not barred by any rule of law when the taxpayer first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit for

[26] Treas. Reg. §1.311(b)-1(a).

the taxable year to which the determination relates. An example of this is an accrual basis taxpayer who deducts in his 1951 return an item of expense which he paid in such year. At the time the taxpayer files his return for 1951 the statute of limitations for 1950 has not expired. Subsequently, the Commissioner asserts a deficiency for 1951 based on the position that the liability for such expense should have been accrued for the year 1950. In 1955, after the period of limitations for 1950 has expired, the Tax Court disallows the deduction for the year 1951. The taxpayer is entitled to an adjustment for the taxable year 1950 since the statute of limitations for that year had not expired at the time the taxpayer filed his return for 1951.

This is in general, a very broad summary of the mitigation sections. However, for purposes of this discussion, the most significant question relating to such sections is whether they have any application where a change of accounting method is involved.

It would appear that they do not, since under section 481 the necessary adjustments to correct for prior years omissions or duplications are made without regard to the statute of limitations. All of the adjustments are made in the year of change and there is no need to go back to a closed year and make any adjustment.

The mitigation sections should not apply regardless of who initiates the change of method of accounting. However, as a practical matter, there may be a difference if the change is initiated by the taxpayer instead of being initiated by the Commissioner. Where the change is initiated by the taxpayer, it is clear that all necessary adjustments can be made once. However, where the Commissioner initiates the change, since he cannot make adjustments relating to pre-1954 years, he may take the position that the mitigation sections apply as to such pre-1954 adjustments. He should not be supported by the courts in this position but it is likely he will try to maintain it.

In conclusion, it would appear that if there is a change in the method of accounting, be it a change in the over-all method or a change in the treatment of a material item, the mitigation sections should not be applicable, whether the taxpayer or the Commissioner attempt to apply them.