Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Change in Method of Accounting and Section 481(a) Adjustment

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

B =

C =

Date1 =

Date2 =

Year1 =

Year2 =

Year3 =

a% =

b% =

c% =

d =

e =

$f =

$g =

ISSUES

1. Does a change in the treatment of participation agreement gains from deferral under § 1.446-4 of the Income Tax Regulations to recognition in the year of realization constitute a change in method of accounting under § 446 of the Internal Revenue Code?

2. If there is a change in method of accounting, does the adjustment under §481(a) (§ 481(a) adjustment) include the gains from certain participation agreements from Year2, a closed year?

CONCLUSIONS

1. The change in the treatment of participation agreement gains to recognition in the year of realization constitutes a change in method of accounting under § 446.

2. The § 481(a) adjustment includes gains from certain participation agreements from Year2.

FACTS

Taxpayer is an investment advisor who provides investment services to its related hedge fund entities through management agreements. Taxpayer is compensated for its services through management fees equal to a% of the net assets of a particular fund and incentive fees equal to approximately b% to c% of the net appreciation of each fund's shares for the given year. Under the management agreements, Taxpayer may defer its incentive fees. The default deferral period is d years. If the incentive fees are deferred, they are deemed reinvested in the applicable offshore feeder fund; therefore, they either increase or decrease in value depending on the performance of the applicable fund's assets. Taxpayer's funds invest in corporate or other types of debt, equities and real estate. In the Year1, Year2, and Year3, Taxpayer deferred its incentive fees.

In Date1, B, one of Taxpayer's consolidated investments funds entered into credit default swaps with C, an investment bank. Through the credit default swaps, B purchased protection against the lack of future cash flows from e subprime mortgage backed securities. On Date2, Taxpayer entered into a Participation Agreement with B (Participation CDS), whereby Taxpayer received a participation interest in the credit default swap transactions between B and C. Taxpayer claims that it entered into the Participation CDS to hedge its price risk with respect to its deferred incentives fees.

In Year2, Taxpayer realized gains of $f from the Participation CDS. In Year3, Taxpayer realized gains of $g from the Participation CDS. Taxpayer did not recognize any gains from the Participation CDS on its Year2 and Year3 tax returns. Instead, Taxpayer contends that the recognition of the gains from the Participation CDS is deferred until the gains or losses from its incentive fees are recognized under §1.446-4 relating to hedging transactions.

The Service is currently auditing Taxpayer's treatment of its Participation CDS. The Service may conclude, for multiple potential reasons, that the Participation CDS gains are not properly deferred pursuant to section§1.446-4. The Service expects that it may propose that Taxpayer must recognize the gains arising from the Participation CDS upon realization. Taxpayer's statute of limitations for Year2 taxable year is closed. The Service is proposing to make a § 481(a) adjustment to prevent the taxpayer from omitting income related to Year2.

LAW AND ANALYSIS

Issue 1

Section 446(a) provides that taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income keeping his books.

Section 1.446-1(e)(2)(ii)(a) provides that a change in 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 includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the taxable year in which taxable income is reported. See section 2.01(1) of Rev. Proc. 97-27, 1997-1 C.B. 680; section 2.01(1) of Rev. Proc. 2011-14, 2011-1 C.B. 330; Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969). An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting.

General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C.Memo. 2003-95.

Where the correction of an error results in a change in accounting method, the requirements of § 446(e) are applicable. Huffman v. Commissioner, 126 T.C. 322, 354 (2006), aff'd 518 F.2d 357, 364-8 (6th Cir. 2008); First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987); Diebold, Inc. v. United States, 16 Cl. Ct. 193, 203-205 (1989), 891 F.2d 1579 (Fed. Cir. 1989), cert. denied 498 U.S. 823 (1990).

Although a method of accounting may exist under the definition in § 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See § 1.446-1(e)(2)(ii)(a). 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 (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

Section 1.446-4(a) provides generally that a hedging transaction as defined under § 1221 must be accounted for under the rules in §1.446-4. Section 1.446-4(b) provides that the method of accounting for a hedging transaction must clearly reflect income, which is achieved by reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged.

The change in treatment from deferring the recognition of the gains from the Participation CDS until the gains or losses from the incentive fees are recognized under § 1.446-4 to recognizing the gain in the year of realization constitutes a change in method of accounting under § 446. The gain resulting from the Participation CDS is a material item because it involves the proper time for the inclusion of the gain in gross income. The alternative treatments of the gain – deferral under § 1.446-1 and recognition upon realization -- result in recognition of the same amounts of taxable income over the lifetime of Taxpayer. The only difference is the taxable year in which the income is reported. Therefore, the change in treatment of the gain from the Participation CDS at issue constitutes a change in method of accounting under § 446.

Issue 2

Section 481(a) provides that, in computing the taxpayer's taxable income for any taxable year, if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts

from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also § 1.448-1(a).

A change in method of accounting to which § 481(a) applies includes a change in treatment of a single material item. See § 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder v. United States, 743 F.2d at 798; Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. See section 2.04(1) of Rev. Proc. 2002-18.

An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See section 5.04(1) of Rev. Proc. 2002-18.

An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See section 5.04(2), (3) of Rev. Proc. 2002-18.

A § 481(a) adjustment can include amounts attributable to taxable years that are closed by the statute of limitations. Suzy's Zoo v. Commissioner, 114 T.C. 1, 12-13 (2000), aff'd 273 F.3d 875, 884 (9th Cir. 2001); Huffman v. Commissioner, 126 T.C. 322, 341-2 (2006), aff'd 518 F.2d 357, 363-4 (6th Cir. 2008); Graff Chevrolet Co. v. Campbell, 343 F.2d at 571-572; Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983); Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968); Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds 791 F.2d 906 (Fed. Cir. 1986).

Once the Commissioner has imposed a change in method of accounting, the application of § 481(a) to such change is patent and mandatory. Primo Pants Co. v. Commissioner, 78 T.C. 705, 720 (1982); Emert v. Commissioner, T.C.Memo. 1999-175; Hitachi Sales Corp. of America v. Commissioner, T.C.Memo. 1994-159, supp. T.C.Memo. 1995-84.

Because the change in treatment discussed above constitutes a change in method of accounting under § 446, the adjustment should be made in the year of change. We understand that the year of change is Year3, the earliest year under examination.

The gain realized from the Participation CDS in Year3 will be recognized in Year3 (the year of realization) under the new method of accounting imposed by the examining agents. Because such gain was not recognized previously under Taxpayer's old method of accounting, the imposition of the method change does not result in a duplication or omission of the gain, and no adjustment under § 481(a) is required.

The gains realized from the Participation CDS in Year2 will never be recognized under the new method of accounting because the realization of the gains occurred in Year2, which is prior to the imposition of the new method of accounting in Year3. Further, such gains were not recognized under the old method of accounting because the gains or losses from the related incentive fees were not recognized during the years in which the old method of accounting was used. Because the gains will not be recognized under either the old or new method of accounting, the imposition of the method change results in an omission of such gains and an adjustment under § 481(a) is required to remedy such omission. The § 481(a) adjustment is a positive amount (addition to taxable income) and is imposed in full in the year of change as required by section 5.04(3) of Rev. Proc. 2002-18.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

No opinion is expressed or implied on whether Taxpayer's Participation CDS transactions at issue were properly treated by Taxpayer as hedging transactions under §1221 and no opinion is expressed on the proper application of § 1.446-4.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-7007 if you have any further questions.

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