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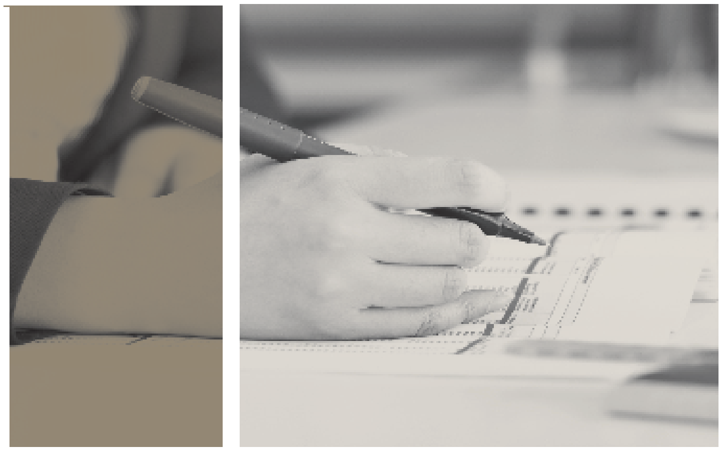

RECENT CASES ON CHANGES FROM ERRONEOUS ACCOUNTING METHODS—DO THEY APPLY TO CHANGES IN BASIS OF COMPUTING RESERVES?

By Peter H. Winslow and Brion D. Graber

A special rule applies when a life insurance company changes its basis of computing reserves. Section 807(f) of the Internal Revenue Code imposes a "10-year spread" under which the difference between the tax reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change is reflected ratably over 10 years. In general, the 10-year spread rule of section 807(f) is applicable only when there otherwise would be a change in method of accounting under general tax law principles.[1] Although the same type of events will trigger the 10-year spread rule and a change in method of accounting, there are four important differences in their consequences.

First, Internal Revenue Service ("IRS") consent is not a prerequisite for recognizing a change in basis of computing reserves for tax purposes as it is for a change in method of accounting.[2] Second, a change in method of accounting is fully implemented in the year of change, with the opening and closing items for that year computed under the new method. Under the 10-year spread rule, only reserves for contracts issued in the year of change are determined under the new method; contracts issued in prior years remain on the old method until the succeeding year, when the opening and closing balances are computed using the new method. Third, a taxpayer changing its method of accounting from an erroneous method is not permitted to go back and correct the tax return for the first year in which the erroneous method was adopted unless the IRS agrees to the change.[3] Under the 10-year spread rule, a taxpayer changing from an erroneous method of computing reserves is permitted, but apparently not required, to make the correction in the earliest year open under the statute of limitations.[4] Finally, when a change in method of accounting is made, a taxpayer generally must reflect the difference between the old and new method's opening balances in taxable income all at once as a "481 adjustment,"[5] although the IRS may provide for a spread of a net positive 481 adjustment as a condition of granting its consent to the change.[6] Under the 10-year spread, the difference between opening reserves under the old and new methods for the taxable year succeeding the year of change is spread ratably over 10 years.

The application of section 807(f) to tax reserve changes is discussed at length in an article in the February 2010 *Taxing Times*.[7] Since that article, two court cases have come out dealing wth change-in-method-of-accounting issues. In both cases, the taxpayers had been on an erroneous method and either the IRS or the taxpayer sought a change to a correct method. We thought it might be interesting to review the courts' conclusions in these cases to examine whether or how they may apply to changes in basis of computing reserves to correct errors.

BOSAMIA[8] —DECIDED OCT. 24, 2011

The taxpayers in this case were the sole shareholders of two Subchapter S corporations, India Music and HRI. Over the course of seven years, India Music purchased inventory from HRI on account, but never made any payments to HRI. India Music accounted for these purchases using the accrual method of accounting, with the result that it claimed deductions when the purchases were made, not when it made payments to HRI. HRI accounted for these same transactions using the cash method of accounting, with the result that it reported no income from these transactions because it received no payments from India Music.

The IRS disallowed India Music's deductions from the related-party transactions with HRI for the 2004 tax year. The IRS relied on section 267(a)(2), which prohibits one party from claiming a deduction as a result of a transaction with a related party until the related party recognizes the income from the transaction. The IRS treated this deduction denial as a change in India Music's method of accounting under section 481. To prevent India Music from having an omission of income as a result of this change, the IRS made a 481 adjustment to India Music's 2004 tax year that increased its income in that year by the amount of the deductions claimed by India Music in prior years relating to the related-party transactions with HRI.

At the time the IRS made the change to India Music's 2004 tax year, the first five years in which the related-party transactions had occurred were closed because the statute of limitations had run. Notwithstanding that fact, the taxpayers agreed that if the section 267(a)(2) disallowance was a change in method of accounting subject to section 481, the IRS's adjustment for 2004 to prevent an omission of income was proper. The taxpayers argued, however, that it was improper for the IRS to make them include any amount in income associated with the related-party transactions for the five closed years because the disallowance for 2004 under section 267(a)(2) was not a change in method of accounting. Instead, they argued, it was an audit adjustment to correct erroneous deductions for that tax year. The resolution to this dispute depended on whether the disallowance effected a change in India Music's timing treatment of a material item.

The Fifth Circuit agreed with the IRS's position, concluding that Congress plainly intended a disallowance under section 267(a)(2) to effectuate a change in a taxpayer's method of accounting. The Court noted that section 267(a)(2) provides for a matching of income and deductions by preventing the use of differing methods of accounting by related parties. Under applicable authorities, for the section 267(a)(2) disallowance to constitute a change in a method of accounting, it must involve a change in the treatment of a material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. The Court found that the IRS had effectively made precisely this type of change with respect to India Music's accounting for its inventory purchases from HRI by requiring India Music to wait to deduct the cost of those purchases until HRI recognized income from the transactions.

As a general matter, the Court's decision is not particularly remarkable. The specific issue addressed by the Court was one of first impression, but the holding is consistent with well-established judicial and administrative authorities. Nevertheless, the case is instructive in at least two respects in the context of changes in basis of computing reserves to correct errors. First, implicit in *Bosamia* is that India Music had adopted an erroneous method of accounting with respect to its purchases from HRI by treating that item in the same way on two or more consecutively filed returns.[9] In fact, India Music had treated the purchases in the same way on its tax returns for seven consecutive years. The adoption of this erroneous method of accounting ultimately necessitated the 481 adjustment when the IRS corrected India Music's method of accounting in the 2004 tax year. Similarly, an insurance company that uses an erroneous basis to compute its reserves is subject to 807(f), and its 10-year spread rule, if the erroneous basis is consistently applied from year to year.[10] As in *Bosamia*, it does not matter that the effect of the 10-year spread required by section 807(f) is to reverse erroneous deductions claimed in prior closed years. It also does not matter that the change is from a clearly erroneous method. When a tax reserve method has been consistently applied, a change from that method is subject to section 807(f) whether or not the prior method was correct. It is not merely a "correction of an error" for which the 10-year spread has no application. In this respect, *Bosamia* is consistent with the IRS's stated position that changes in reserve computations arising from inadvertent errors such as pure mathematical mistakes or computer programming defects "are limited to nonrecurring errors that affect the determination of the amount of a taxpayer's reserves only for a particular taxable year."[11]

Secondly, the taxpayers in *Bosamia,* were required to make the 481 adjustment in a single year, resulting in an increase in their income in that year equal to the full amount of the adjustment. If the case had instead involved a correction in the basis of computing reserves that required an increase in an insurance company's income, the increase relating to contracts issued prior to the year of change would have been spread over 10 years, beginning with the year following the year of change. This outcome under section 807(f) generally would be preferable to the one the *Bosamia* taxpayers experienced. If the required adjustment involved decreasing the taxpayer's income, however, recognizing the entire decrease in a single year as

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required for a 481 adjustment might generally be preferable to being required to spread the decrease over 10 years under section 807(f).

CAPITAL ONE[12]—DECIDED OCT. 21, 2011

This case also involved a change from an erroneous method of accounting, although here the change was initiated by the taxpayer. The taxpayer, Capital One, earned a portion of its income from a variety of fees that it charged in connection with its credit card and other consumer-lending products. Capital One had historically reported the income from fees, including late fees charged to customers who did not pay on time, at the time that it charged the fees to its customers. Tax legislation enacted in 1997, however, extended original issue discount ("OID") treatment to certain credit card revenues. OID is included in income as interest over a debt instrument's duration, rather than entirely at the time it is issued or redeemed. The IRS issued a Revenue Procedure clarifying that taxpayers could obtain "automatic consent" to change accounting methods if they were affected by this new legislation and properly filed with the IRS a Form 3115, Application for Change in Accounting Method.[13]

Capital One filed a Form 3115 with its 1998 return indicating it proposed to account for various items as OID, but did not specifically mention late fees on the form. Capital One also reported income from the items identified on the Form 3115 on its tax returns for 1998 and 1999 as OID. Income from late fees, however, was reported as it had always been reported—as income when charged to customers. Subsequently, in connection with a lawsuit in the Tax Court involving a separate issue, Capital One sought to treat its income from late fees as OID for 1998 and 1999.

The Tax Court held that Capital One could not change how it accounted for late fees in 1998 and 1999. The Fourth Circuit affirmed the Tax Court's decision. The Fourth Circuit held that the change sought by Capital One could not be made without the consent of the Secretary, which was not granted. Such consent must be secured prior to calculating taxable income. To allow changes in methods of accounting without such consent would "roil the administration of the tax laws."

Capital One advanced several arguments in support of its position, none of which the Fourth Circuit found convincing. Capital One argued it was not subject to the consent requirement because it was correcting the use of an improper method, *i.e.,* merely correcting an error. The Court rejected that argument, citing multiple authorities concluding that consent is still required when changing from an improper to a proper method. Capital One also asserted that the 1997 legislation obviated the general consent requirement because it provided for automatic consent to a change in method of accounting to comply with the new OID rules. The Court responded that even under automatic consent, there are still procedures that taxpayers must follow to receive consent, including filing Form 3115, and Capital One did not do so in this case.

Capital One argued that it in fact filed a Form 3115 and met any procedural obligations that it had. The Court rejected that argument, however, because the consent procedures require that the Form 3115 specify all classes of material items that will be treated differently under the new method of accounting. The Form 3115 Capital One filed did not identify late fees as an item, although it did identify interest and OID. Capital One contended that the late fees were not a separate item but merely a component of OID, which itself was a component of interest. In other words, Capital One argued that for accounting-method purposes, interest was a single material item and late fees were merely a component of interest that needed to be conformed to the overall accounting method. The Court stated that using such a broad definition of material item would be inconsistent with the requirement to obtain consent for each item as it would be difficult to identify any other source of revenue that would qualify as an item, yet alone a material item, if the late fees did not. Late fees are Capital One's single largest fee-based source of revenue, are earned each year, are separately identified on Capital One's income statements, and are earned on a different basis than other fees.

The Court identified one additional reason for ruling against Capital One, which it referred to as "fatal" to Capital One's claim. Even if Capital One had received consent to treat the late fee income as OID, Capital One did not so treat it on the 1998 and 1999 returns it filed, but instead continued to report it as income when charged to customers. As noted above, it is well-established that a taxpayer elects an erroneous method of accounting by consistently treating a material item in two or more consecutively filed tax returns. In this case, Capital One treated the late fees as income when they were charged to customers on the tax returns it filed for 1998 and 1999. Thus, even if Capital One had consent to treat the late fees as OID on its 1998 and 1999 returns, it did not do so, instead choosing to use an erroneous method, thereby nullifying any consent it argued it had received. Capital One's final argument was that its attempt to change how it accounted for late fees after it changed how it accounted for other fees was a mere error correction to account for all of the fees consistently. The Court dismissed this argument as well outside the error correction exception, which is limited to mathematical or posting errors.

As with *Bosamia, Capital One* allows for a couple of insights into changes in basis of computing reserves. In *Capital One*, the taxpayer attempted to make a change without IRS consent to correct an erroneous method of accounting in the earliest open year in which the erroneous method was used. The change was not allowed, however, because consent is required to make any method-of-accounting change, including changing from an erroneous method,[14] and method-of-accounting changes may not be made retroactively unless the IRS agrees to the change.[15] An insurance company desiring to correct an error in its basis for computing reserves has it easier for a couple of reasons. First, the company is not required to get IRS consent to the change, which means the company does not need to file a Form 3115 and does not need to concern itself with the possibility that the IRS may withhold its consent to the proposed change. Second, the company may make the change in the current year or, if it chooses (or the IRS so requires), go back and amend its earliest open year containing the error.[16]

The other insight is the Court's conclusion that late fees constitute a separate "material item" for accounting method purposes. In holding that the late fees constituted a material item that was distinct from interest and OID, the Court noted that the late fees were earned each year, were separately reported on Capital One's income statements, were earned on a different basis than Capital One's other fees, and were the largest source of fee revenue for Capital One. Therefore, late fees could have their own accounting method whether or not it was erroneous.

Application of section 807(f) also requires that there be a change to a material item in the tax return computation. It is clear that corrections to interest rate and mortality assumptions are separate material items, but other assumptions likely are as well. For example, changes in the assumptions as to when premiums are paid (*e.g.,* changing from the assumption that they are received annually in advance to the assumption that they are received according to the contract's premium mode), as to when claims are paid (*e.g.,* changing from the assumption that death benefits are paid at the end of the policy year in which death occurs to the assumption that they are paid in the middle of the policy year in which death occurs), and as to the age or sex of the insured (*e.g.,* changing from an assumed age or sex when the insured's exact age or sex are unclear to using the exact age or sex once precise information becomes available) all present similar considerations and may impact the proper time for the taking of a deduction by affecting the computation of reserves. The IRS is likely to contend that these changes are subject to section 807(f) even when they are correcting prior erroneous treatment.

CONCLUSION

As the preceding discussion makes clear, holdings in change-in-method-of-accounting cases can have significance in section 807(f) situations, but how the principles are implemented can be very different. In some cases, those differences may be beneficial to an insurance company faced with a change under section 807(f), such as the ability to make the change without IRS consent, and in other cases they may be adverse, such as the requirement to spread the effect of a change that reduces income over 10 years. ◀

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*

Brion D. Graber is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *bgraber@scribnerhall.com.*

END NOTES

1 *See* Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life & Accident Insurance Co. v. United States*, 71A A.F.T.R.2d 93-3319 (M.D. Tenn. 1989).

2 *See* I.R.C. § 446(e) (stating that consent generally is required to make a change of accounting method). Consent is required under section 446(e) even if the taxpayer wants to change from an erroneous method or one that does not clearly reflect income. *E.g., Witte v. Commissioner*, 513 F.2d 391 (D.C. Cir. 1975).

3 *Diebold v. United States,* 16 Cl. Ct. 193 (1989), *aff'd,* 891 F.2d 1579 (Fed. Cir. 1989); Rev. Rul. 90-38, 1990-1 C.B. 57. An erroneous method of accounting is adopted by consistently treating an item on two consecutive tax returns. *See, e.g.*, Rev. Rul. 90-38.

4 Rev. Rul. 94-74. If the IRS is making the change, it may require that the change be made in the earliest open year.

5 I.R.C. § 481; *Security Benefit Life Insurance Co. v. United States*, 517 F. Supp. 740 (D. Kan. 1980), *aff'd*, 726 F.2d 1491 (10th Cir. 1984).

6 *See* Rev. Proc. 2002-19, 2002-1 C.B. 696 (providing a four-year adjustment period for a net positive adjustment and a one-year period for a net negative adjustment when the taxpayer has properly requested IRS consent to the change in accounting method).

7 Peter H. Winslow & Lori J. Jones, *Change in Basis of Computing Reserves—Is It or Isn't It?* Taxing Times, Feb. 2010, at 9.

8 *Bosamia v. Commissioner*, 661 F.3d 250 (5th Cir. 2011).

9 *See, e.g.*, Rev. Rul. 90-38, 1990-1 C.B. 57.

10 *See* Rev. Rul. 94-74, 1994-2 C.B. 157; Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error* (Jan. 6, 1997).

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END NOTES CONT.

[11] Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error.*

[12] *Capital One Financial Corp. v. Commissioner*, 659 F.3d 316 (4th Cir. 2011).

[13] Form 3115 is the form that taxpayers requesting a change in method of accounting must file with the IRS to obtain consent to the change. It provides information about the taxpayer and the proposed change. The form is required whether the change is requested pursuant to an automatic consent procedure or an advance consent procedure. Even when the form is properly filed, the IRS may request that the taxpayer provide additional information and may decide not to give its consent.

[14] Section 446(e); Treas. Reg. § 1.446-1(e).

[15] *Diebold v. United States*, 16 Cl. Ct. 193 (1989), *aff'd*, 891 F.2d 1579 (Fed. Cir. 1989); Rev. Rul. 90-38, 1990-1 C.B. 57.

[16] Rev. Rul. 94-74, 1994-2 C.B. 157; Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error* (Jan. 6, 1997).