INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 3, 1999
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Index (UIL) No.: 446.04-1
CASE MIS No.: TAM-122570-97

Number: **199928001**
Release Date: 7/16/1999

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

x =

y =

Year 1 =

Year 2 =

Year 3 =

Year 5 =

Year 7 =

Year 8 =

Year 9 =

Trial Court =

Appeals Court =

ISSUE(S):

Whether the Service may change Taxpayer's method of depreciating certain property in Year 8 and impose an adjustment under § 481(a) of the Code where the Service previously made the change in Year 1 and the statute of limitations bars assessment of income tax deficiencies for the intervening taxable years.

CONCLUSION:

The Service may not change Taxpayer's method of depreciating the property again in Year 8. Taxpayer's method of depreciating the property was changed for the intervening taxable years when the Service-initiated change in Year 1 became final. Taxpayer may claim depreciation deductions in Year 8 and the remainder of the property's cost recovery period, but not in excess of the property's adjusted basis under § 1011 as of the beginning of Year 8. Under §§ 1011(a) and 1016(a)(2), the property's adjusted basis is equal to its cost reduced by the greater of any depreciation allowed or allowable during the taxable years preceding Year 8.

FACTS:

Taxpayer placed certain property into service in Year 1 and began depreciating the property as tangible personal property with a x year recovery period under the Accelerated Cost Recovery System (ACRS) of former § 168 of the Code. The Service examined Taxpayer's federal income tax returns for Year 1 and Year 2. The Service determined that the property at issue was properly classified as real property with a y year recovery period under ACRS. Accordingly, the Service changed Taxpayer's method of depreciating the property for Year 1 and Year 2 and made appropriate adjustments to taxable income and the basis of the property for those years.

Taxpayer disagreed with the Service's determination and, after exhausting its administrative remedies, litigated the issue. The Trial Court held that the property at issue was properly classified as real property with a y year recovery period under ACRS. Taxpayer appealed the Trial Court's decision. The Appeals Court affirmed the Trial Court's decision.

While the issue regarding the proper ACRS classification was working its way through the administrative and judicial processes, Taxpayer continued to take depreciation deductions for the property based on a x year cost recovery period in computing its taxable income. The Service did not examine Taxpayer's returns for Year 3 through Year 7 (the intervening taxable years). Section 6501 now bars assessment of income tax deficiencies for the intervening taxable years.

The Service is currently examining Taxpayer's federal income tax returns for Year 8 and Year 9. In those returns, Taxpayer did not take depreciation deductions for the property at issue because Taxpayer had fully recovered the cost of the property as of the end of Year 5 when the x year recovery period expired. The examining agent proposes to change Taxpayer's method of depreciating the property to the y year cost recovery method again in Year 8. The examining agent would require Taxpayer to compute its depreciation deduction for Year 8 and the remainder of the y year recovery period as if Taxpayer had computed its depreciation deduction for all preceding taxable years on the basis of a y year cost recovery method. To prevent duplication of the excess deductions that were taken, and omission of deductions that should have been taken, in the intervening years, the examining agent would require Taxpayer to take into account a § 481(a) adjustment.

LAW AND ANALYSIS:

Section 446(b) provides that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Commissioner, does clearly reflect income.

Section 1.446-1(e)(2)(ii)(*a*) of the Income Tax Regulations 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 is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 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 adjustments of any item of income or deduction which does not involve the proper time for the inclusion of the item or the taking of a deduction.

Section 481 states:

(a) General Rule - In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change"),

(1) *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

(2) 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....(emphasis added).

Section 1016(a)(2) provides that the basis of property is reduced by the amount of depreciation allowed (resulting in a reduction for any taxable year of the taxpayer's taxes), or allowable, whichever is greater.

The examining agent argues that Taxpayer used the x year cost recovery method for the intervening taxable years because Taxpayer's method of accounting for those years is determined by reference to the returns for those years. The examining agent further argues, on the basis of the literal language in § 481(a)(1), that since he computed Taxpayer's taxable income for Year 8 using the y year cost recovery method, which is a method of accounting different from the method used in the preceding taxable year, his adjustments to Taxpayer's return for Year 8 constitute a change in method of accounting under § 446(e) requiring an adjustment under § 481.

Taxpayer agrees that a change from one ACRS cost recovery method to another is a change in method of accounting under § 446(e) to which § 481(a) applies. Indeed, Taxpayer acknowledges that if the Service had proposed the change from the x year cost recovery method to the y year cost recovery method for the first time in Year 8, a full § 481(a) adjustment would be necessary and appropriate.

Under the facts of this case, however, Taxpayer argues that the examining agent's adjustments in Year 8 do not constitute a change in method of accounting. Taxpayer argues that the Service changed Taxpayer to the y year cost recovery method in Year 1 and both the Trial Court and the Appeals Court approved that change. The Service must change Taxpayer from one accounting method to another to invoke § 481. Here, Taxpayer argues, the Service is simply requiring Taxpayer to conform its Year 8 return to the y year cost recovery method imposed by the Service and approved by the Trial Court and the Appeals Court for Year 1 and Year 2.

Taxpayer further argues that there will be no omission or duplication of deductions in the future. Taxpayer contends that the basis of the property at the beginning of Year 8 is its cost reduced by the amount of depreciation allowed in taxable years preceding Year 8. Taxpayer will claim depreciation deductions for Year 8 and the remainder of the y year recovery period using the y year cost recovery method until its remaining basis is fully recovered.

We agree with Taxpayer that the examining agent's adjustments in Year 8 do not constitute a change in method of accounting. We believe that the better interpretation of §§ 446 and 481 is that the Taxpayer's method of depreciating the property was changed to the y year cost recovery method when the Service-initiated change in Year 1 became final. Taxpayer's returns for the intervening taxable years are deemed to be on the y year cost recovery method even though the amount of taxable income reported in those returns was computed as if the property were tangible personal property with a x year recovery period.[1] Since Taxpayer is deemed to have used the y year cost recovery method for the intervening taxable years, the computation of taxable income in Year 8 is not under a different method of accounting and § 481(a), by its terms, does not apply.

The examining agent's interpretation of §§ 446 and 481 compels the conclusion that Taxpayer's method of depreciating the property was changed from the y year cost recovery method back to the x year cost recovery method in Year 3. We believe that the better interpretation of §§ 446 and 481 is that Taxpayer's method of depreciating the property was not changed back to the x year cost recovery method in Year 3 where Taxpayer consistently computed depreciation for the property on its returns for the Year 1 through Year 5 taxable years as if the property were tangible personal property with a x year recovery period.

The examining agent's interpretation of §§ 446 and 481 also results in an omission of depreciation deductions. Section 481(a) permits only those adjustments that are "determined to be necessary *solely by reason of the change"* (emphasis added). Assuming arguendo that the examining agent is permitted to change Taxpayer to the y year cost recovery method again in Year 8, application of § 481(a) would be based solely on the change from the x year cost recovery method to the y year cost recovery method. The § 481(a) adjustment would not prevent the omission of depreciation deductions that arises as a result of the change from the y year cost recovery method back to the x year cost recovery method in Year 3. This omission of depreciation deductions results because Taxpayer's method of accounting is deemed changed in Year 3, but Taxpayer did not take into account the § 481(a) adjustment required as a result of the change.

We do not believe that it is appropriate to impute a change in Taxpayer's method of accounting back to its former method in the earliest closed taxable year based on the failure of the parties to keep the statute open. The Service and Taxpayer both had the ability to keep the intervening taxable years open until the Service-initiated change was finalized to ensure that the change was reflected in those years. If one of the parties failed to keep the statute open for a taxable year in which the adjustment resulting from

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[1]We agree with the examining agent that generally a taxpayer's method of accounting for a taxable year is determined by reference to the manner in which it computed taxable income on its return for that year. *See, e.g., Aluminum Castings Co. v. Routzahn,* 282 U.S. 92, 99 (1930); *Stephen's Marine, Inc. v. Commissioner,* 430 F.2d 679, 687 (9th Cir. 1970); *Hamilton Indus., Inc. v. Commissioner,* 97 T.C. 120, 142-147 (1991); *Peninsula Steel Prod. & Equipment Co. v. Commissioner*, 78 T.C. 1029, 1040-1042 (1982). These cases, however, did not involve a Service-initiated accounting method change for a prior taxable year that became final after the return was filed.

the Service-initiated change would have been favorable to such party, the party should not be able to retain the benefit of the adjustment through a second § 481(a) adjustment.

We disagree with Taxpayer's assertion, however, that the basis of the property at the beginning of Year 8 is its cost reduced by the amount of depreciation allowed in taxable years preceding Year 8. Taxpayer may claim depreciation deductions in Year 8 and the remainder of the y year recovery period, but not in excess of the property's adjusted basis under § 1011 as of the beginning of Year 8. Under §§ 1011(a) and 1016(a)(2), the property's adjusted basis is equal to its cost reduced by the greater of any depreciation allowed or allowable during the taxable years preceding Year 8. The depreciation allowable is determined based on the property's classification as y year real property under ACRS.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.