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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES W. CLARK
DISTRICT COUNSEL
CC:WR:PNW:SEA

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: INQUIRY CONCERNING WHETHER CERTAIN ADJUSTMENTS CONSTITUTE CHANGES IN METHOD OF ACCOUNTING

This Field Service Advice responds to your memorandum dated October 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer:
Regulatory Authority:
Year 1:
Year 2:
Year 3:
Year 4:
Acquisition Year:
Date 1:

ISSUES

1. Whether the proposed adjustments constitute changes in Taxpayer's methods of accounting.

2. Whether issuing a statutory notice of deficiency for Year 3 that does not contain adjustments under I.R.C. § 481(a) forecloses the Service from making section 481(a) adjustments in Year 4.

3. Whether Examination is permitted to issue a summons to Taxpayer requesting information from closed tax years for the purpose of determining adjustments under section 481(a).

CONCLUSIONS

1. On the facts presented, we recommend that Exam consider revoking Taxpayer's conformity election in the earliest open year under examination in accordance with Treas. Reg. § 1.166-2(d)(3)(iv)(D). Any such revocation must be handled as a cut-off method with no attendant adjustment under section 481(a) with respect to loan amounts previously charged off for book purposes. The issue of Taxpayer's proper accrual of interest income, while related, would constitute a separate item for adjustment. We conclude that the change to Taxpayer's treatment of this interest income constitutes a change in accounting method subject to an adjustment under section 481(a), if necessary. With respect to the proposed adjustments to Taxpayer's treatment of core deposits, we have determined that we are not in possession of sufficient facts concerning the proposed adjustments to opine on whether they constitute changes in Taxpayer's accounting method.

2. To the extent the proposed adjustments constitute changes in Taxpayer's methods of accounting, the related adjustments under section 481(a), if any, would have to be made in the year of change. Accordingly, if the Service changes Taxpayer's methods of accounting in Year 3, it must make related section 481(a) adjustments in that year, not in Year 4.

3. Examination may issue a summons to Taxpayer requesting information from closed tax years for the purpose of determining adjustments under section 481(a) so long as the issue of making adjustments under section 481(a) remains unresolved. A summons which is issued for a proper purpose and which seeks relevant information that the Service does not currently possess is enforceable if the Service complies with all administrative steps required by the Code.

FACTS

We rely on the facts set forth in your memorandum. We understand the facts of this case are not fully developed and that certain key facts are in dispute. If it is determined that the facts of this case differ substantially from the facts stated in your memorandum, you may wish to consider submitting a new request for advice for consideration.

Taxpayer is an accrual basis taxpayer engaged in the business of banking. Taxpayer is supervised for regulatory purposes by Regulatory Authority.

Prior to Year 1, Taxpayer wrote off its bad debts using the specific charge off method. In Year 1, Taxpayer requested and received permission to change its method of accounting for bad debts to the conformity election method provided in Treas. Reg. § 1.166-2(d)(3). Under this method, the debts of a qualifying bank are conclusively presumed to have become worthless, or worthless in part, if the charge off results from a specific order of the bank's supervisory authority or corresponds to the bank's classification of the debt, in whole or in part, as a loss asset. In order to implement the use of the conformity election method, Taxpayer established internal procedures to quality grade its loans.

Pursuant to Taxpayer's internal procedures and Regulatory Authority guidelines, Taxpayer used the following four quality grades to classify its commercial loans:

QG-4 Loans with more than average risk;

QG-5 Below average loans containing actual credit weakness of a continuing well-defined nature that jeopardizes liquidation of the debt;

QG-6 Clearly unsatisfactory loans with a high likelihood of loss;

QG-7 Uncollectible loans.[1]

Taxpayer's grading system is in conformity with the requirements of Regulatory Authority and Taxpayer has received determination letters expressly confirming its classification method. Taxpayer's internal procedures require its lending officers to

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[1] The incoming request for advice states that QG-4 loans correspond to "other loans especially mentioned," QG-5 loans correspond to "substandard loans," QG-6 loans correspond to "doubtful loans," and QG-7 loans correspond to "loss loans" under the regulatory standards of Regulatory Authority. However, the basis for this statement is unclear.

reclassify the quality grade of any loan to QG-7 prior to charging the loan off as a bad debt.[2]

According to your memorandum, the adjustments in Year 3 and Year 4 are based on the position that, in addition to charging off as loss assets loans classified as QG-7, Taxpayer has charged off all loans classified under QG-5 and QG-6. We understand that Taxpayer has claimed bad debt deductions for its QG-5 and QG-6 loans consistently since it made the conformity election in Year 1. In addition, we understand that, consistent with the position that the category QG-5 and QG-6 loans are uncollectible, Taxpayer does not accrue interest on the loans after they are charged off.[3]

Taxpayer disagrees with these determinations and argues that it is only charging off loans classified as QG-7 and certain loans that become uncollectible between the time they are graded and the end of the taxable year. For purposes of this advice, we are assuming that the facts will sustain Exam's determination that Taxpayer is accelerating its bad debt deduction on QG-5 and QG-6 loans.

The Service has determined that only QG-7 loans should be currently charged off as bad debts under the conformity election method. Consequently, Exam proposes to adjust Taxpayer's income in Year 3 and Year 4 by disallowing the bad debt deductions attributable to QG-5 and QG-6 loans.[4] In addition, Exam proposes to

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[2] It is unclear whether, under its internal procedures, Taxpayer must first classify a portion (as opposed to the entire amount) of a loan as QG-7 (loss) before charging that portion off for book purposes. We assume for purposes of our discussion that reclassification is required under Taxpayer's procedures for book purposes and that it applies to any amount of the loan that is to be charged off. Thus, if a loan is partially worthless, that portion of the loan is to be reclassified as QG-7 prior to taking a charge off for that portion.

[3] As a general matter, it may be appropriate for Taxpayer to cease accruing interest on loans charged-off as wholly worthless on its books although the OID provisions may specifically override this general rule in some situations.

[4] We understand that the adjustments concern only Taxpayer's commercial loans. We are unsure whether this is due to (1) the scope of the examination, (2) there being no question with respect to Taxpayer's application of the conformity election to other covered loans, or (3) Taxpayer having no other loans covered by the conformity election. We note, however, that the conformity election applies to any loan that is subject to a regulatory loss classification standard. See Treas. Reg. § 1.166-2(d)(3)(ii)(B)(2) which provides that the conformity election method will apply to any

increase Taxpayer’s income for Year 3 and Year 4 by the amount of interest income from the QG-5 and QG-6 loans that Taxpayer failed to accrue. Examination also proposes to make adjustments under section 481(a) on both issues for Year 1 through Year 2, inclusive. In connection with the proposed adjustments under section 481(a), Examination has issued Information Document Requests to Taxpayer for the period from Year 1 through Year 2, inclusive. Thus far, Taxpayer has refused to provide information on closed years.

In the Acquisition Year, Taxpayer acquired the deposits of another bank. Taxpayer allocated a portion of the purchase price to a core deposits intangible. Taxpayer has claimed amortization deductions since the Acquisition Year.

It is our understanding that Examination is considering whether to make adjustments to the claimed amortization amounts. The basis for such adjustments is not entirely clear; however, your memorandum indicates that Examination believes Taxpayer may have improperly inflated the amount of core deposits subject to amortization and may have amortized the core deposits at too high a rate. You have asked whether such adjustments would constitute changes to Taxpayer’s methods of accounting for purposes of adjustments under section 481(a). As with the bad debt and interest income adjustments, Examination has issued Information Document Requests to Taxpayer related to the amortization of core deposits for the period from the Acquisition Year through Year 2, inclusive. Taxpayer has refused to provide any of the requested information on closed years.

The statute of limitation on Year 3 expires on Date 1.

LAW AND ANALYSIS

Issue 1

Section 446(a) provides generally that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the taxpayer's overall method of accounting, but also the accounting treatment of any item. Treas. Reg. § 1.446-1(a)(1). Although a method of accounting may exist

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debt held by the bank that is subject to regulatory loss classification standards; see also Treas. Reg. § 1.166-2(d)(3)(ii)(B)(3) which provides that, for loans not subject to regulatory loss classification standards or loans that have been totally charged off prior to the year of change, “bad debt deductions are determined under the general rules of section 166.”

without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established without such consistent treatment. Treas. Reg. § 1.446(e)(2)(ii)(a). For these purposes, a consistent but erroneous treatment of a material item constitutes a method of accounting. See Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 512 (1989) and the cases cited therein.

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 the 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. Treas Reg. § 1.446-1(e)(2)(ii)(a). A change in method of accounting does not include the correction of a mathematical or posting error, adjustments to items of income or deduction which do not involve the proper time for the inclusion of income or the taking of deductions, an adjustment to the addition to a reserve for bad debts, an adjustment to the useful life of a depreciable asset, or a change in treatment resulting from a change in underlying facts. Treas Reg. § 1.446-1(e)(2)(ii)(b).

Section 481(a) provides that if a taxpayer's taxable income is computed under a different method of accounting from the method used in the preceding taxable year, there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in accounting method in order to prevent amounts from being duplicated or omitted. Section 481 adjustments are only implicated when there has been a change in method of accounting. Angelus Funeral Home v. Commissioner, 47 T.C. 391, 397 (1967), acq. 1969-2 C.B. xxiii, aff'd, 407 F.2d 210 (9th Cir. 1969).

Section 481(a)(2) limits adjustments to those which are determined to be necessary solely by reason of the change in accounting method in order to prevent amounts from being duplicated or omitted. Where a taxpayer’s method of accounting has been changed, a section 481(a) adjustment is mandatory if needed to prevent amounts from being duplicated or omitted.

Treas. Reg. § 1.481-1(c)(1) provides that the term “adjustments,” as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and Treas. Reg. § 1.481-1(b). In the case of an overall change in method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term “net amount of the adjustments” means the consolidation of adjustments arising with respect to balances in various accounts. In the case of a change in the treatment of a single material item, the amount of the adjustment is determined with reference only to the net dollar balances in that particular account.

<u>Bad Debt Deductions</u>

Section 166(a) provides for a deduction for any debt which becomes worthless in whole or in part within a taxable year.

Section 166(b) provides that for purposes of section 166(a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Treas. Reg. § 1.166-2 provides guidance on the appropriate evidence for establishing a debt as worthless in whole or in part.

Treas. Reg. § 1.166-2(d) provides special rules for certain financial institutions such as Taxpayer.

Treas. Reg. § 1.166-2(d)(1), provides that worthlessness is presumed to occur in the year in which the taxpayer charges off a debt in obedience to the specific order of its regulatory authority or pursuant to established policies of that regulatory authority provided the taxpayer subsequently receives a written confirmation that such an order would have been issued had the regulatory audit occurred on the date of the charge off.

Treas. Reg. § 1.166-2(d)(3)(i) provides that a qualifying bank[5] that is subject to the supervision of Federal authorities, or the supervision of state authorities maintaining substantially equivalent standards, may elect to use a method of accounting that establishes a conclusive presumption of worthlessness for debts (the conformity election). The conformity election was made available beginning in 1992.

Treas. Reg. § 1.166-2(d)(3)(ii)(A)(1) provides that under the conformity election, debts charged off, in whole or in part, for regulatory purposes during a taxable year are conclusively presumed to have become worthless, or worthless in part, during the year for tax purposes, but only if the charge-off results from a specific order or the bank's supervisory authority or corresponds to the bank's classification of the debt in whole or in part, as a loss asset.

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[5] To be eligible to make this election, a bank must meet all of the requirements of Treas. Reg. § 1.166-2(d)(3)(iii)(D). Treas. Reg. § 1.166-2(d)(3)(iii)(D) essentially provides that the bank's supervisory authority must have made an express determination that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of the supervising authority.

Treas. Reg. § 1.166-2(d)(3)(ii)(A)(2) provides that a bad debt deduction for a debt that is subject to regulatory loss classification standards is allowed for a taxable year only to the extent that the debt is conclusively presumed to have become worthless under paragraph (d)(3)(ii)(A)(1) during the year.

Treas. Reg. § 1.166-2(d)(3)(ii)(C) provides that a debt is classified as a loss asset if the bank assigns the debt to a class that corresponds to a loss asset classification under the standards set forth in the “Uniform Agreement on the Classification of Assets and Securities Held by Banks,” or on similar guidance issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, or the Farm Credit Administration; or for institutions under the supervision of the Office of Thrift Supervision, 12 CFR 563.160(b)(3).

Treas. Reg. § 1.166-2(d)(3)(iii)(A) provides that a conformity election is to be made on a bank-by-bank basis and constitutes either the adoption or a change in method of accounting.

Treas. Reg. § 1.166-2(d)(3)(iii)(B) provides that a change in method of accounting resulting from a conformity election does not require or permit an adjustment under section 481(a). Thus, the regulation provides for the adoption of the conformity election on a cut off basis.

Treas. Reg. § 1.166-2(d)(3)(iv)(D) provides that a conformity election may be revoked by the Commissioner as of the beginning of any taxable year for which a bank fails to follow the method of accounting prescribed by the regulations. In addition, the Commissioner may revoke an election as of the beginning of any taxable year for which the Commissioner determines that a bank has taken charge offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards of the bank’s supervisory authority.

Treas. Reg. § 1.166-2(d)(3)(iv)(A) provides that revocation of the conformity election constitutes a change in method of accounting.

Treas. Reg. § 1.166-2(d)(3)(iv)(B) provides that a change in method of accounting resulting from the revocation of a conformity election does not require or permit an adjustment under section 481(a). Thus, a conformity election is also revoked on a cut off basis. Under this cut-off approach, there is no change in the adjusted basis of the bank’s existing debts as a result of the change in method of accounting and the bad debt deductions in the year of change and thereafter with respect to all debts held by the bank, whether in existence at the beginning of the year of change or subsequently originated or acquired, are determined under the new method of accounting.

We understand that Exam is not questioning Taxpayer's eligibility, in Year 1, to make an election under Treas. Reg. § 1.166-2(d)(3). Rather, we understand that Exam is questioning Taxpayer's inclusion of categories QG-5 and QG-6 loans as loss assets under these provisions. Accordingly, we assume that Taxpayer was eligible to make a conformity election, and in fact made a valid conformity election, in Year 1.

Based on the facts provided, we conclude that QG-5 and QG-6 category loans do not qualify for the conclusive presumption under Treas. Reg. § 1.166-2(d)(3) as these categories do not appear to correspond to a loss asset classification under the applicable regulatory standards. See Treas. Reg. § 1.166-2(d)(3)(ii)(C). However, if Taxpayer has other information to substantiate that some or all of the QG-5 and QG-6 category loans do, in fact, correspond to a loss asset classification under the applicable guidelines of Regulatory Authority, our conclusion might be different.[6]

Treas. Reg. § 1.166-2(d)(3)(iv)(D) contemplates that the Commissioner may revoke a taxpayer's conformity election if it appears that "a bank has taken charge-offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority as defined in paragraph (d)(3)(iii)(D)." Thus, if Exam determines that Taxpayer's bad debt deductions are "substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards," Exam should consider revoking Taxpayer's conformity election.

We also recommend that Exam consider revoking Taxpayer's election if Bank is taking deductions for bad debts (with respect to loans that are subject to regulatory loss classification standards) for loans that have not been classified as loss assets and charged off for regulatory purposes in the same tax year. In this circumstance, Taxpayer is not in compliance with Treas. Reg. § 1.166-2(d)(3). In any event, we note that such debts would not be entitled to a conclusive presumption of

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[6] We have no information that would lead us to conclude that Taxpayer's classification system was administered other than as described. Therefore, we need not resolve this issue now.

worthlessness under the conformity method.[7] See Treas. Reg. § 1.166-2(d)(3)(ii)(A).

Exam's consideration of revocation is the sole remedy to a bank's intentional improper use of the conformity method. See Treas. Reg. § 1.166-2(d)(3)(iv)(D). This remedy is required by Treas. Reg. § 1.166-2(d)(3) which sets forth the procedures for adoption, use and revocation of the conformity election. In some circumstances, such as when a bank has inadvertently treated a very small number of loans as loss assets that in fact were not classified and charged off that way, it may be appropriate to consider making a correction with respect to the conformity method of accounting. However, when it appears that a bank has systematically deducted whole categories of loans that were not classified as loss assets, as in this case, that is the circumstance contemplated by Treas. Reg. § 1.166-2(d)(3)(iv)(D).

If Exam determines that Taxpayer's conformity election should be revoked, the required method change is accomplished on a cut-off basis as of the first day of the year of change (that is, there is no adjustment under section 481(a)) and Taxpayer's basis in its existing loans is unchanged. See Treas. Reg. § 1.166-2(d)(3)(iv)(B). Once Taxpayer's election is revoked, Taxpayer may make a new election under Treas. Reg. § 1.166-2(d)(3) only upon receipt of the advance consent of the Commissioner. Treas. Reg. §§ 1.166-2(d)(3)(iv)(A) and 1.166-2(d)(3)(iii)(C)(3).

Accrual of Interest Income

Taxpayer uses an accrual method of accounting, but does not accrue interest on loans that have been charged off as loss assets. Based on the position that Taxpayer is prematurely charging off QG-5 and QG-6 loans, Exam maintains that Taxpayer is improperly failing to accrue the related interest income.

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[7] If Taxpayer is taking deductions for bad debts that are not entitled to a conclusive presumption of worthlessness under the regulation, Taxpayer must establish its entitlement to a deduction for the amount of those debts under the general rules of section 166. This may result in an adjustment to the amount of Taxpayer's claimed deductions for bad debt losses in Year 3 and Year 4 but, because such items are outside of the scope of the conclusive presumption under the conformity method, it would not require a change in Taxpayer's conformity method of accounting in those years. Whether such adjustments would rise to the level of a change in accounting method and trigger a correlating adjustment under section 481(a) would depend on the nature of the specific adjustments.

As a general matter, the determination of the proper accrual of interest on nonperforming loans should be considered separately from the issue of whether Taxpayer is entitled to a bad debt deduction with respect to a debt instrument or whether Taxpayer is entitled to a conclusive presumption of correctness under the conformity method. Taxpayer's failure to accrue the interest income involves the treatment of a material item because it involves the proper timing for the inclusion of the interest in income. Hamilton Industries v. Commissioner, 97 T.C. 120, 126 (1991). Thus, a change to Taxpayer's treatment of the interest income earned on QG-5 and QG-6 loans would constitute a change in Taxpayer's method of accounting because it involves a change in the treatment of a material item. See Cordes Fin. Corp. v. Commissioner, T.C. Memo. 1997-162, aff'd, 98-2 USTC (CCH) ¶ 50,824 (10th Cir. 1998). A section 481(a) adjustment would be applicable to an adjustment of this nature.

However, whether Taxpayer is required to accrue interest on a nonperforming loan may differ depending on whether the debt to which the interest relates is subject to the original issue discount ("OID") rules of the Code. Therefore, we will discuss this issue separately in the context of OID and non-OID debt.[8]

A. Non-OID Debt

Taxpayer, as an accrual method taxpayer, is generally required to include income when all events have occurred to fix its right to receive such income and the amount of that income can be determined with reasonable accuracy. See Treas. Reg. § 1.451-1(a). Under Treas. Reg. § 1.451-1(a), Taxpayer is generally required to include interest in income as it is economically earned over the term of the debt instrument regardless of when Taxpayer actually receives it. See Treas. Reg. § 1.446-2; Rev. Rul. 83-84, 1983-1 C.B. 97.

An exception to this general rules exists, however, if the income item is uncollectible when the right to the receipt of that income becomes fixed. Jones Lumber Co. v. Commissioner, 404 F.2d 764 (6th Cir. 1968); Atlantic Coast Line R.R. Co. v. Commissioner, 31 B.T.A. 730, 749-751 (1934), acq., XIV-2 C.B. 2 (1935), aff'd, 81 F.2d 309 (4th Cir. 1936). As interest income accrues over the term

[8] For both OID and non-OID instruments, we assume that all preconditions fixing Taxpayer's right to the income at issue have occurred and that the only issue is whether Taxpayer's classification of the relevant debt as nonperforming for regulatory purposes is a sufficient basis to preclude the accrual of interest (or recognition of OID) in income by Taxpayer for federal income tax purposes. In addition, we assume that Taxpayer's classification of a loan as nonperforming is based on the applicable standards of Regulatory Authority.

of a debt instrument, the test of collectibility is applied to each accrual at the time that the right to that interest accrual otherwise becomes fixed. Rev. Rul. 80-361, 1980-2 C.B. 164. Thus, Taxpayer is required to include interest in income that accrues (or has become fixed) prior to the point in time that the interest is determined to be uncollectible.

Interest income that is properly accrued in income by Taxpayer, but which subsequently becomes uncollectible, may be charged off in accordance with applicable regulatory procedures and a bad debt deduction claimed. See Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934). Thus, as a general matter, Taxpayer is required to accrue interest on its nonperforming loans until the point in time when it can establish that the interest income is uncollectible.[9]

B. OID Debt.

Sections 1271 through 1275 of the Code provide the general statutory framework for the treatment of debt instruments that have OID. Section 1272 generally requires the current recognition of OID in income. See I.R.C. § 1272(a)(1). Although there are a number of specific exceptions to this general rule, a payment on an OID instrument is not considered contingent "merely because of the possibility of impairment by insolvency, default, or similar circumstances." Treas. Reg. § 1.1275-4(a)(3). Consequently, for OID instruments, there is no comparable exception from current accrual for OID as exists for interest on non-OID instruments held by an accrual basis taxpayer.

OID instruments often provide for stated interest. Generally, qualified stated interest (as defined in Treas. Reg. § 1.1273-1(c)) is accrued by an accrual basis taxpayer in accordance with the rules under section 451.[10] See Treas. Reg. § 1.1273-1(c)(i) and Treas. Reg. § 1.446-2(b). Otherwise, the recognition of interest on an OID instrument is controlled by the OID provisions of the Code and regulations.

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[9] As a general matter, interest that has not been accrued for regulatory purposes is outside the scope of the conformity method under Treas. Reg. § 1.166-2(d)(3). Therefore, the general rules of section 166 would apply. See Treas. Reg. § 1.166-2(d)(3)(iii)(B)(3). Moreover, because the facts of this case are different, Rev. Rul. 81-18, 1981-1 C.B. 295, is not controlling with respect to the accrual of interest by Taxpayer.

[10] One exception to this rule occurs when an election is made under Treas. Reg. § 1.1272-3 to treat all interest on a debt instrument as OID.

The rationale for the potentially disparate result in treatment with respect to qualified stated interest and OID on a single debt instrument is grounded in the difference in their nature. The OID regime treats OID as interest that is paid by the issuer to the holder and then re-lent by the holder to the issuer. Thus, OID (unlike qualified stated interest or interest on non-OID debt) is included in income regardless of when paid and this accrual of OID by a holder causes the holder's basis in the OID debt instrument to increase in an amount equivalent to the deemed extension of credit by the holder to the issuer of the instrument. See I.R.C. §§ 1272(a)(1) and 1272(d)(2); see also H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1034 (1984).

Accordingly, if Taxpayer's nonperforming loans include OID instruments, whether Taxpayer may properly cease to accrue OID must be determined under the appropriate OID rules of sections 1271 through 1275 (and the regulations thereunder). This determination must be made separately by Exam with respect to the accrual of OID even for those OID instruments as to which Exam concludes that Taxpayer properly stopped accruing qualified stated interest.

Amortization of Core Deposits

Section 167 provides for a depreciation deduction in a reasonable amount to account for the exhaustion, wear and tear, or obsolescence of property used in a trade or business or held for the production of income.

Treas. Reg. § 1.167(a)-3 provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.

Treas. Reg. § 1.167(a)-5 provides that, in the case of the acquisition of a combination of depreciable and nondepreciable property for a lump sum, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

Treas. Reg. § 1.167(e)-1 provides that, with the exception of certain changes not relevant to this case, any change in the method of computing the depreciation allowances with respect to a particular account, is a change in method of accounting and such a change will be permitted only with the consent of the Commissioner.

It is our understanding that Exam does not dispute that Taxpayer acquired amortizable core deposits when it acquired the deposits of another bank in the Acquisition Year. See Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993) (an intangible asset can be depreciated if it can be shown to have a value which diminishes over its useful life); Colorado Nat'l Bankshares, Inc. v. Commissioner, 984 F.2d 383 (10th Cir. 1993) (a bank's core deposits are amortizable); and First Chicago Corp. v. Commissioner, T.C. Memo. 1994-300 (deposits are amortizable core deposits when the deposit is shown to be insensitive to market rate fluctuations and, in valuing said core deposits, the cost savings method is the reliable measure). However, you have indicated there may be a dispute as to the value of the core deposits and as to the amortization rate. You have asked whether adjustments to the value of the core deposits or to the amortization rate would constitute changes in method of accounting for purposes of justifying related adjustments under section 481(a).

In analyzing change in method issues, it is useful to inquire whether there is a permanent difference in income through the inclusion of an item in income or the taking of a deduction by using one accounting practice rather than another. See, e.g., Primo Pants Co. v. Commissioner, 78 T.C. 705 (1982). When there is a permanent difference, the practice generally does not qualify as an accounting method for purposes of sections 446 and 481. Thus, an adjustment to correct the taxpayer's characterization of personal expenses as business expenses is not a change in method of accounting because it does not involve the proper time for taking a deduction. By contrast, if the practice does not permanently affect the taxpayer's lifetime income, but instead changes the tax year in which taxable income is reported, timing is implicated and the practice generally qualifies as a method of accounting. Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 799 (11th Cir. 1984). Characterization of an item can constitute a method of accounting if it has the effect of shifting income or deductions from one period to another. Rev. Proc. 97-27, 1997-21 I.R.B. 10, 11 Sec. 2.01(3).

Obviously, the determination of whether an adjustment constitutes a change in method of accounting depends on the nature of the adjustment and the specific facts surrounding the taxpayer's practices. In this case, we have been provided no background information on the basis of the proposed adjustment to the value of the core deposits. Thus, we cannot tell whether Exam proposes the adjustment because the valuation method used by Taxpayer was imprecise, or because Taxpayer has incorrectly identified amortizable assets. Moreover, it is unclear how Taxpayer arrived at its value for the core deposits. Under these circumstances, we do not believe we have sufficient facts to say whether Exam's proposed adjustment to the value of core deposits would constitute a change in method of accounting. Accordingly, we offer no opinion on this issue.

With respect to an adjustment to change the rate at which Taxpayer amortizes the core deposits, we note that as a general matter, a change in rate would affect the computation of the amortization deduction. Under Treas. Reg. § 1.167(e)-1, any change in the method of computing depreciation allowances is a change in method of accounting. See Standard Oil Co. (Indiana) v. Commissioner, 77 T.C. 349, 410-411 (1981), acq., 1989-2 C.B. 1. However, similarly to the valuation issue, we do not believe we are in possession of sufficient facts regarding the basis for the determination that a change in amortization rate is warranted to conclude that the adjustment in this case would constitute a change in method of accounting.

Issue 2

Section 481 prescribes rules for computing taxable income in cases where the taxable income of the taxpayer is computed under a different method of accounting from that under which the taxable income was previously computed.

Treas. Reg. § 1.481-1(a)(1) provides that, in computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is defined as the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

We agree with your conclusion that when the Service changes a taxpayer's method of accounting, subject to any express waivers of authority, any section 481(a) adjustment deemed to be necessary is mandatory in the year of change. I.R.C. § 481(a). Thus, adjustments under section 481(a) are only permissible in the year of the change. In the instant case, assuming the adjustments which constitute changes in Taxpayer's accounting methods are made in Year 3, Year 3 would be the year of the change. Accordingly, it would not be permissible for the Service to make section 481(a) adjustments in Year 4 that relate to changes in Taxpayer's methods of accounting made in Year 3.

Issue 3

Section 481 was enacted to allow, in the year a taxpayer's method of accounting changes, an adjustment of the amount that was improperly reported whether that amount relates to gross income or deductions. Section 481 is designed to prevent a distortion of taxable income and a windfall to the taxpayer stemming from a change in accounting method at a time when the statute of limitations bars the reopening of the taxpayer's returns for earlier years. Rankin v. Commissioner, 138

F.3d 1286, 1290 (9th Cir. 1998). There is no necessary conflict between section 481 and the statute of limitations because the statute of limitations is directed against stale claims. In the case of an adjustment under section 481(a), however, the Commissioner has no claim against the taxpayer for amounts which the taxpayer should have reported in prior years. Rather, the taxpayer, through use of its improper method of accounting, has impliedly promised to report the income at a later date. Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969). Thus, the claim arises in the year of the change in method when deferred income or accelerated deductions must be taken into account. See Graff Chevrolet Co. v. Commissioner, 343 F.2d 568, 572 (5th Cir. 1965).

The Service is considering whether certain changes made to Taxpayer's practices constitute changes in accounting methods within the meaning of the regulations under section 446. If so, section 481 authorizes the Service to make adjustments in the year of change to "prevent amounts from being duplicated or omitted." The Service contemplates making adjustments in Year 3 and Year 4, which remain open under the statute of limitations.

With respect to the interest issue the Service needs information from which to determine whether the change in method resulted in amounts being duplicated or omitted. With respect to the core deposits issue, the Service needs information to identify the assets subject to amortization. In addition, if it is determined that this adjustment constitutes a change in method of accounting, the Service will need information to determine whether amounts have been duplicated or omitted. It is necessary to obtain information about closed years to determine whether adjustments should be made to Year 3 and Year 4. In the context of these facts, you have asked whether the Service can properly summon information concerning Taxpayer's closed years.

We conclude it can based on the Supreme Court's holding in United States v. Powell, 379 U.S. 48 (1964). In that case, the Court clearly established that it would not inquire into the Service's decision to issue a summons pursuant to a fraud investigation of a closed taxable year. In Powell, the Court set forth four requirements needed for a valid summons: 1. the summons must be issued for a proper purpose (i.e., a legitimate exercise of the Service's investigatory authority); 2. the summons must seek information that may be relevant to the investigation; 3. the Service must not be in current possession of the summoned information; and 4. In issuing the summons, the Service must have complied with all administrative steps required by the Code. United States v. Powell, 379 U.S. 48, 54-58 (1964).

As applied to the facts of this case, the Service may properly summon information relevant to the determination of whether Taxpayer properly reported income on the returns under examination. Thus, a summons, which seeks information from closed years to determine whether interest income was reported or to identify core deposits, will clearly seek information that may be relevant to the resolution of the issues being examined in Year 3 and Year 4. In addition, although it may not be clear whether certain other adjustments constitute changes of accounting methods, so long as the issue remains unresolved, the Service may summon information that may be relevant to resolving the matter, even information from closed years. Under these circumstances, the Service's purpose for summoning the information would be proper as of the date it issues and serves the summons. See Couch v. United States, 409 U.S. 322, 329 n.9 (1973) (the court evaluates the rights and obligations of the parties on the date the summons is served).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is clear that there are major gaps in our understanding of the basic facts surrounding Taxpayer's practices in this case. In addition, the issue of the amortization of core deposits largely rests on a factual determination of the value of the core deposits which, at present, appears to be completely unsupported. We believe significant additional factual development will be necessary to sustain the proposed adjustments or, alternatively, to determine whether any adjustments are warranted.

[redacted]

[redacted] The authority on this issue is not entirely consistent or clear. We are concerned, particularly with respect to the adjustment to accrued interest income, that if the conformity election is revoked, a court could conclude that we have changed Taxpayer's overall method of accounting for bad debts. Under these circumstances, the court might also conclude that rather than being a separate accounting method, subject to an adjustment under section 481(a), Taxpayer's treatment of interest income from QG-5 and QG-6 loans is merely an offshoot of its application of the conformity election. Thus, the court could consider the change to the interest account to be part of the section 481(a) adjustment relating to the change in Taxpayer's method of accounting for bad debts. Viewed in this light, because the revocation of the conformity election is treated as a cut off method, the adjustment to interest might be foreclosed in closed years.

In addition, we acknowledge that the line between a change of accounting method and a change in underlying facts or a correction of an error is often hazy. In Gimbel Bros., Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), the court considered a taxpayer's change in method to be the correction of an error. In Gimbel, the taxpayer operated department stores. It elected to use the installment method of reporting income from installment sales. However, consistent with an existing policy of the Service, under which sales on revolving credit plans did not qualify for installment reporting, the taxpayer did not report income from sales on revolving credit plans on the installment method. After the Service changed this policy, the taxpayer attempted to correct its reporting for income from sales on revolving credit plans via timely filed refund claims.

The Service argued the taxpayer was attempting to change its accounting method for reporting sales on revolving credit plans without permission. The Service argued that the taxpayer had elected the installment method, but only for certain sales. The court disagreed, finding that after a taxpayer elected the installment method, the applicable regulations required installment reporting on all eligible sales. According to the court, the taxpayer's failure to report some of the sales in conformity with the election of the installment method amounted to an error which could be corrected in an amended return or refund claim.

More recently, in Northern States Power Co. v. United States, 151 F.3d 876 (8th Cir. 1998), the Service made an unsuccessful argument that the taxpayer's refund claim constituted an impermissible change in the taxpayer's accounting method for certain contract losses. In Northern States, the taxpayer had entered into unprofitable "take or pay" contracts. In order to mitigate losses, the taxpayer began to sell or assign to third parties various amounts of separate work units it was bound to purchase under the contracts. The taxpayer's tax department was unaware of these sales when the taxpayer's returns for 1984, 1985 and 1986 were prepared. Consequently, the amount of the contract losses was capitalized instead of being deducted in the year the separate work units were disposed of. In 1994, the taxpayer's tax department became aware of the sale of the separate work units and filed refund claims for 1985 and 1986, the two years that remained open.

The court agreed with the taxpayer that the claims for refund did not constitute a change in method of accounting within the meaning of section 446(e). The court viewed the change as a correction of a posting error. The court was persuaded by the fact that the taxpayer was seeking to treat the contract losses in the same manner that it had consistently treated similar types of losses.

We believe the facts of the instant case can be distinguished from Gimbel Bros. and Northern States because there is no evidence that Taxpayer's methods are the result of inadvertence or that the changes contemplated by Exam are being made to correct the mistaken application of an accounting method. Moreover, we note that the Service does not follow Gimbel Bros. See Rev. Rul. 90-38, 1990-1 C.B. 57, 59. Nevertheless, we bring these cases to your attention because they underline certain hazards inherent in arguing that the requirement to accrue the interest income from QG-5 and QG-6 loans is a change in method of accounting. Cases such as Gimbel Bros. and Northern States could be used to support a finding that the adjustment proposed by the Service to Taxpayer's interest income is not a change in the method of accounting, but rather is a correction to Taxpayer's improper application of an accrual method.

With respect to the core deposits issue, particularly the determination of what assets are properly included in the core deposits intangible, courts have been unreceptive to arguments made by the Service that a change in the taxpayer's characterization of an item constitutes a change in method of accounting, even when the characteriztion has the effect of implicating different tax treatment. Underhill v. Commissioner, 45 T.C. 489, 496 (1966).

In Standard Oil, 77 T.C. at 379, the taxpayer argued that it was entitled to deduct as intangible drilling and development costs (IDC) certain costs that had been capitalized when originally incurred. Prior to the years at issue, the taxpayer had elected to deduct as current expenses all IDC in accordance with section 263(c) and Treas. Reg. § 1.612-4. However, the taxpayer did not classify certain costs incurred in the first phase of the construction of its offshore platforms as IDC. Later, it determined these costs qualified as IDC and, thus, were deductible in the year in which they were incurred.

Because the change in characterization affected the timing of a deduction, the Service argued that the change in the treatment of the costs was a change in the treatment of a material item. The court disagreed. The court considered the fact that the exercise of an election to deduct IDC made mandatory the deduction of all IDC. Thus, assuming the disputed costs qualified as IDC, the taxpayer had no choice but to deduct them. Accordingly, the court viewed the change in practice as a correction of internal inconsistencies and akin to a correction of a mathematical error. Id. at 383. In reaching its conclusions, the court gave consideration to the fact that the taxpayer's right to deduct some IDC in the years in dispute was not challenged. Thus, the change proposed by the taxpayer affected the amount of the deduction, rather than the timing.

Similarly to Standard Oil, the proposed change to Taxpayer's valuation of core deposits appears to have more of an effect on the amount of the deductions to which Taxpayer may be entitled than it has on the timing of the deductions. Moreover, the Service cannot rely on Treas. Reg. § 1.446-1(e)(2)(ii)(c) (which provides specifically that a change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting). Thus, the Service's ability to impose adjustments under section 481(a) relate to the valuation of core deposits, or to the identification of core deposits may be limited.

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