



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES E. KEETON, JR.  
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FROM: Deborah A. Butler  
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SUBJECT: Field Service Advice: Application of I.R.C. Section 481

This Field Service Advice responds to your memorandum dated February 2, 2000. 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

Taxpayers =  
Taxpayer =  
Profession 1 =  
Profession 2 =  
University =  
Subject =  
Credential 1 =  
Credential 2 =  
Credential 3 =  
Publications =  
Company =  
Date 1 =  
Year 1 =  
Year 2 =  
\$A =

\$B =  
\$C =  
\$D =  
\$E =

ISSUES

1. Whether funds held by a publishing services company in an account for benefit of Taxpayer, and subject to “draws” by Taxpayer, were income to Taxpayer when received by the company and credited to Taxpayer’s accounts.
2. Whether, if such funds were income to Taxpayer, the Service may change Taxpayer’s method of accounting under I.R.C. §§ 446(b) and 446(e), and adjust Taxpayer’s income accordingly under I.R.C. § 481.

CONCLUSIONS

The amounts held by the publishing services company constituted income to Taxpayer when received by the company, not when withdrawn by Taxpayer. Furthermore, the Service’s adjustment of Taxpayer’s income tax liability involved the proper timing of Taxpayer’s receipt of income, not a question of permanent inclusion in, or exclusion from, Taxpayer’s income. Accordingly, this adjustment constituted a change of Taxpayer’s method of accounting, warranting an adjustment under I.R.C. § 481.

FACTS

Taxpayer is a Profession 1 and Profession 2 of Subject at University. He holds several degrees, including a Credential 1 and a Credential 2, and is a Credential 3. He derives most of his income from writing Publications.

In Year 1, Taxpayer engaged Company to provide certain subscription services regarding Taxpayer’s publishing activities, including the handling of subscriber payments. Company received subscription payments, payable to Company, on Taxpayer’s behalf, and credited the payments to Taxpayer’s various Publications accounts. You have represented to us your understanding that the duration of these subscriptions was generally one or two years.

Company sent monthly statements to Taxpayer showing the revenues from the Publications. Company did not make routine payments to Taxpayer. Rather, Taxpayer would make periodic cash “draws” upon the accounts at intervals, and in amounts, that Taxpayer chose. Company placed no restriction upon the amounts or timing of Taxpayer’s withdrawals. Company did not issue Forms 1099 to Taxpayer.

Since beginning the Publications business in Year 1, Taxpayer has allowed the balances in his accounts with Company to accumulate. On Taxpayers' joint income tax returns, Taxpayer did not report the full amount of income that he received from the Publications business, but only the amounts that he actually withdrew from his accounts with Company. For their Year 2 taxable year, Taxpayers reported total taxable income of \$A, while failing to report income earned during that year in the amount of \$B. By the end of taxable year Year 2, Taxpayer had accumulated, and had failed to report, income totaling \$C.

On Date 1, the Service issued a notice of deficiency to Taxpayers for Year 2, asserting an increase in tax of \$D, plus a penalty under I.R.C. § 6663 in the amount of \$E. In the alternative to the section 6663 penalty, the Service asserted an accuracy-related penalty under I.R.C. § 6662. In computing Taxpayers' deficiency for Year 2, the Service imposed a change in method of accounting under I.R.C. § 446(b), plus an adjustment under I.R.C. § 481.

## LAW AND ANALYSIS

Issue 1: Whether funds held by a publishing services company in an account for benefit of Taxpayer, and subject to "draws" by Taxpayer, were income to Taxpayer when received by the company and credited to Taxpayer's accounts.

As a general proposition, an individual cash basis taxpayer is taxed upon "receipt" of an item of income. I.R.C. § 451(a). Under the cash receipts and disbursements method of accounting, a taxpayer must report income in the year that it is actually or constructively received. Treas. Reg. § 1.451-1(a).

A taxpayer constructively receives income, even though the income is not actually in the taxpayer's possession, in a taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer can draw upon it at any time. Treas. Reg. § 1.451-2(a). The latter condition is satisfied merely by the taxpayer's having been able to draw upon the income if the taxpayer had given notice of intent to withdraw. Id. The taxpayer does not constructively receive income if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Id. The test of the presence or absence of substantial limitations or restrictions is whether the taxpayer has "unfettered control" of when the income is paid, whether or not the taxpayer chooses to exercise such control. Corliss v. Bowers, 281 U.S. 376, 378 (1930); Fetzer Refrigerator Co. v. United States, 437 F.2d 577, 579 (6<sup>th</sup> Cir. 1971).

A taxpayer need not personally receive income for it to be taxable in the current year. It is sufficient that the taxpayer's agent, acting for the taxpayer, be in receipt of the income. Bratton v. Commissioner, 283 F.2d 257 (6<sup>th</sup> Cir. 1960), acq., 1964-2 C.B. 4.

In the present case, Company received income from subscribers for benefit of Taxpayer. (Although we have not seen a contract between Company and Taxpayer, it appears that Company acted as Taxpayer's agent.) Taxpayer could have drawn as much of the income as he desired, and could have withdrawn it whenever he chose, but chose not to do so. Accordingly, Taxpayer had unfettered control over the monies in the accounts that Company maintained for his benefit. Therefore, Taxpayer received income in each year that Company received the subscription money in his behalf.

Issue 2: Whether, if such funds were income to Taxpayer, the Service may change Taxpayer's method of accounting under I.R.C. §§ 446(b) and 446(e), and adjust Taxpayer's income accordingly under I.R.C. § 481.

A taxpayer must compute taxable income under the "method of accounting" by which the taxpayer keeps books and financial records. I.R.C. § 446(a). If a taxpayer does not regularly use a method of accounting, or if the method of accounting used does not clearly reflect income, the Secretary may change the taxpayer's method of accounting to one that, in the Secretary's opinion, does clearly reflect income. I.R.C. § 446(b).

The regulations define a "method of accounting" to include not only a taxpayer's overall method of accounting (such as the cash receipts and disbursements method or an accrual method), but also the taxpayer's treatment of "material items." Treas. Reg. § 1.446-1(a)(1). A material item is one involving the proper time for including an item in income or taking a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). If the treatment of an item does not affect a taxpayer's lifetime income, then that treatment constitutes a method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(b); Rev. Proc. 97-27, 1997-1 C.B. 680. In general, an accounting practice must be consistently applied from year to year to be a method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(a). Consistent, but erroneous, treatment of an item may constitute a method of accounting, also. Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6<sup>th</sup> Cir.), cert. denied, 385 U.S. 822 (1966); Rev. Rul. 90-38, 1990-1 C.B. 57. A taxpayer using an improper method of accounting must obtain the Commissioner's prior approval to change to a proper method. Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990); Treas. Reg. § 1.446-1(e)(2)(i).

A taxpayer filing either its first return or the first return in which a material item is reported may adopt any permissible method of accounting without the Commissioner's prior approval, Treas. Reg. § 1.446-1(e)(1), but may not change that method later without first obtaining the Commissioner's approval. Treas. Reg. § 1.446-1(e)(2)(i). By contrast, a taxpayer adopts an improper method of accounting when the taxpayer files its second consecutive tax return using that improper method, even if the statute of limitations does not bar the taxpayer from filing an amended return for the first year of improper treatment of the item. Diebold, 891 F.2d at 1583; Rev. Rul. 90-38.

If there is a change in a taxpayer's method of accounting, whether initiated by the taxpayer ("voluntary") or by the Service ("involuntary"), I.R.C. § 481 requires an adjustment in the year of change to correct any duplications or omissions caused by the accounting method change. I.R.C. § 481(a). This adjustment is cumulative, and in the case of involuntary method changes, encompasses all applicable tax years back to 1954. Rev. Proc. 97-27. Furthermore, if the method change is involuntary, the taxpayer must include the entire section 481(a) adjustment in income in the year of change, which is the taxpayer's earliest taxable year under examination. Id.

In this case, Taxpayer was required to recognize income each year since Year 1 for the full amount of subscription monies received on his behalf by Company. Instead, Taxpayer improperly declared as income only the amounts that he actually withdrew from his accounts with Company, and did not declare the funds that he left in his accounts. Thus, Taxpayer improperly deferred indefinitely the recognition of this income. This deferral was a method of accounting within the meaning of I.R.C. § 446. By filing two consecutive tax returns failing to recognize this improperly deferred income, Taxpayer adopted this practice as a method of accounting. Furthermore, because Taxpayer's method of accounting did not clearly reflect income and is contrary to I.R.C. § 451, the Service correctly changed it under I.R.C. §§ 446(b) and 446(e) to more clearly reflect income.

Having changed Taxpayer's method of accounting, the Service was required by I.R.C. 481(a) to adjust his income to correct any duplications or omissions caused by the change in method. Because this was an involuntary change of Taxpayer's method of accounting, the Service correctly applied the entire section 481(a) adjustment to Taxpayer's income for Year 2, his earliest taxable year under examination.

Please call if you have any further questions.

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