Tax Issues Related To Change In Method of Accounting

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Internal Revenue Code section 446 and related Treasury regulations govern general rules for defining methods of accounting and changes in methods of accounting. However, many taxpayers do not follow this tax statute properly, and as a result, they may have to pay penalties-sometimes substantial. The recent court case of *James H. Hawse, et ux v. Commissioner*, T.C Memo 2015-99, is an example of this issue. Here, the United States Tax Court addressed the issue of misinterpreting section 446(e) and distinguishing between the correction of an error and changes in methods of accounting. The court upheld a $5.4 million tax deficiency judgment against a married couple, James and Cynthia Hawse, based on Mr. Hawse's sole ownership of a California auto dealership, JHH Motor Cars Inc. (a subchapter S corporation) and denied their claim for a refund. The decision of the court was based on IRC section 446, related regulations, IRS administrative procedures and court cases.

Therefore, the taxpayer wanted to change from the LIFO method of accounting to the specific identification accounting method for the inventory of JHH. JHH filed form 3115 with the IRS to seek its consent for the change in method of accounting. It complied with the Form 3115 except for attaching a statement explaining how its proposed new method of identifying and valuing its vehicle inventory was consistent with the requirement of Treasury Reg. §1.472-6.

The sale did not occur in 2001, and JHH continued to use the specific identification method for its inventory from 2001 to 2007. However later it amended the tax returns for the corresponding years to correct what the taxpayer claimed was an error of using the specific identification method and attempted to revert back to the LIFO inventory method and requested a refund. After JHH claimed refunds on its 2002 and 2003 amended returns, there was an examination/audit of the client for 2002 and 2003. The IRS sent a notice of deficiency for the years covered under amended returns. JHH filed a petition with the Tax Court.

The case involved three issues:

- Whether JHH received an automatic consent from the IRS to change its method of accounting for its vehicle inventory from the LIFO to specific identification method for the tax years in issue,
- If not, whether JHH changed its method of accounting to the specific identification method from 2001 to 2007, and
- If so, whether there was a second change in its method of accounting when JHH attempted to revert to the LIFO method of accounting for its vehicle inventory by filing amended tax returns for 2002 and 2003.

Section 446(a) states that "the taxable income of a taxpayer shall be computed on the basis of the accounting method under which he/she computes his/her income regularly for keeping his/her books." Under section 446(e), if a taxpayer plans to change his/her method of accounting, he/she must obtain the consent of the IRS before computing his/her taxable income under the new method.

In analyzing the first issue, the court relied on Rev. Proc. 99-49 and determined whether JHH met all the terms and conditions. According to Rev Proc.99-49, secs.1, 4.01, if a taxpayer wants to change from an accounting method described in the appendix of the Rev. Proc. to a new method of accounting described in that appendix, he/she must seek consent from the IRS. If the taxpayer has non-LIFO inventory for which he/she already uses one of the permitted methods, i.e. FIFO or specific identification method, that method would be the only permitted method to which the taxpayer may seek to change its LIFO inventory under Rev. Proc. 99-49, sec.10.01 (1)(b)(i)(A).

To obtain automatic consent from the IRS, a taxpayer must submit Form 3115 signed by an individual with authority to bind the taxpayer before or with his/her timely filed income tax return for the year of change and file a copy of the same 3115 form with the IRS national office no later than the date on which the original tax return is filed. The taxpayer must then cite the applicable section of the revenue procedure appendix on the form and attach a statement to the form identifying the taxpayer's new method of identifying his/her inventory and valuing his/her inventory and describing in detail how the new method of accounting conforms to the requirement of Rev. Proc. 99-49. Finally, if a section 481(a) adjustment is required, the taxpayer has to make the adjustment over a four-year period beginning with the year of election.

JHH did not comply with all the requirement of Rev. Proc. 99-49. It did not cite the applicable section of the Revenue procedure's appendix on Form 3115 and did not attach a separate statement describing how its proposed new method of identifying and valuing its inventory conformed to the requirements of Rev. Proc.99-49. Therefore, the US Tax Court held that because JHH did not comply with all the terms of Rev. Proc. 99-49, its application for automatic consent failed.

However, if a taxpayer changes his/her method of accounting without requesting the consent of the commissioner, the commissioner would have two choices:[1]

- Require the taxpayer to abandon the new method of accounting and compute taxable income using the old method by complying with section 446(e).
- Accept the change in method of accounting and require the taxpayer to make necessary section 481(a) adjustments to avoid amounts being duplicated or omitted.

In this case, the IRS chose the second option.

On the issue of change in method of accounting, the taxpayer contended that there was no change in method of accounting because it failed to obtain the consent of the IRS. However, under Treasury Reg. 1.446-1(e) (2)(ii)(a), a change in method of accounting includes either a change in the overall plan of accounting for calculating gross income or a change in the treatment of any material item used in the overall plan. A change in the treatment of a material item will not change the lifetime income of the taxpayer, but instead will accelerate or postpone the reporting income of the taxpayer. The same rule applies to valuing inventory.

In *Johnson v. Commissioner,*[2] the court reported that if the change in reporting method affects the amount of taxable income for two or more taxable years without altering the taxpayer's lifetime taxable income, it constitutes a change in method of accounting. In the JHH case, the court held that because the taxpayer followed the specific identification method for seven consecutive years, it established a new method, i.e. the specific identification method for valuing its inventory, notwithstanding its failure to secure consent of the IRS.

On the issue regarding reverting to the LIFO method of accounting, the taxpayer argued that attempting to revert to the LIFO method reflects a correction of error and no consent of the IRS is required. According to the opinion of the court, JHH changed the treatment of vehicle inventory to adhere to its previous LIFO method on its amended returns, and this change constitutes a change in method of accounting. In addition, a change from the specific identification to LIFO method constitutes a change in the overall plan of identifying and valuing items and, therefore, a change in method of accounting. Finally, the two changes JHH proposed to make in its amended returns involve material items. The first change was to reverse the section 481(a) adjustments for recapture of the LIFO reserve that was made for 2001, 2002, and 2003 income tax returns. The second change was for deducting the LIFO reserve amounts for tax years 2001 through 2003. JHH's reversal of section 481 adjustments and deduction of the LIFO reserve retroactively

[1] Sunoco, Inc., T.C. Memo. 2004-29

[2] Johnson, 108 T.C. 448,(1997)

postponed its recognition of the LIFO reserve. Therefore, these two changes relate to timing of reporting income and change in treatment of material items. Therefore, the US Tax Court held that the changes JHH made on its amended returns constitute a retroactive change in method of accounting for which IRS consent is needed. [3]

As a result, the IRS was entitled to reject the amended returns of JHH and JHH was not entitled to its claimed refunds.

This case provides an important message to taxpayers and tax practitioners on various facts related to change in method of accounting. If we go deep into this case, the taxpayer took tax advice from the advisor, its accounting service provider and the advisor consulted an auto dealership industry professional, to examine whether there was a change in method of accounting in 2001 after the failure of the taxpayer for obtaining consent of the IRS. The taxpayer and his tax advisors misinterpreted section 446(e), which generally states that a taxpayer must secure consent before changing its accounting method. Therefore, taxpayers as well as the tax practitioners should understand the language of the statute clearly before deciding upon tax matters.

[3] Huffman, 126 T.C. 322 (2006)