CBTM 4-7 3/19/03 9:58 AM Page 34

Tax Accounting

By James E. Salles

In alternative holdings in *Commissioner v. Brookshire Brothers Holding, Inc.,*[1] the Fifth Circuit has sided with taxpayers on two issues concerning changes in accounting methods.

Reclassifying Property as a Change in Method

The appellate court first affirmed the Tax Court's holding that a change in the classification of depreciable property under MACRS (section 168's Modified Accelerated Cost Recovery System) was not a change in method of accounting, lining up against the IRS in a developing split in the courts.

Background: Depreciation Accounting

Whether reclassifying depreciable property is a change in accounting method has been at issue in several recent cases. The basic problem is that the section 446 regulations have never caught up with changes in the depreciation rules.

Before the advent of ACRS (MACRS's predecessor) in 1981, depreciation was simple in theory if not in practice. Under section 167, taxpayer determined whether the property concerned had a useful life, what that useful life was, and the property's projected value at the end of that period (its "salvage value"). The difference between cost and salvage value was then depreciated over the useful life. Depreciation allowable in any particular year might be computed under any of several different depreciation *methods*, such as "straight-line," "150 percent declining balance," or "200 percent declining balance," but useful life and salvage value were determined by the taxpayer's estimates. From time to time, these might be adjusted prospectively.

Making these determinations property by property naturally spawned disputes, and the IRS began to issue published guidelines to promote uniformity and reduce litigation. From the 1960s, safe harbor "class lives" were prescribed in periodic revenue procedures.[2] These were later incorporated into an elective "class life asset depreciation range" (CLADR) system.[3] However, the basic rules remained the same.

ACRS, and later MACRS, displaced the section 167 depreciation regime completely for real property and tangible personal property, except for certain types of property that are depreciated other than over a term of years.[4] Under section 168, recovery periods now depend on the statutory class to which the property is assigned. While in many cases that assignment depends upon the useful life assigned to that type of property under the successors to the old CLADR revenue procedures,[5] taxpayers no longer make fact determinations about particular property.

The Method Change Regulations

Section 446(e) requires taxpayers to secure permission before changing methods of accounting. A change in method is a change in the timing of a given "item" of income, deduction, or credit. However, a given policy may produce different results when applied to different facts. A change in treatment is thus not a change in method if it results from a change in the underlying facts.[6] Consistently, the regulations provide that "a change in the method of accounting does not include an . . . adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years." Thus, under pre-1981 law, while changes in the actual depreciation method (for example, straight line, 150 percent declining balance, or 200 percent declining balance) applied to a particular property or depreciation account were

Jim Salles is a member of Caplin & Drysdale in Washington, D.C.

CBTM 4-7 3/19/03 9:58 AM Page 35

changes in method,[7] changes in the amortization *period* due to a change in an estimate of the property's remaining useful life were not.

Under ACRS and MACRS, depreciation *methods* are governed by specific statutory elections that are irrevocable as to the property concerned,[8] making their status as methods of accounting irrelevant. But what if the taxpayer mistakenly assigns a piece of property to one category (for example, "five-year property") and later seeks to reassign property to its correct class and compute depreciation accordingly? Unlike traditional adjustments in estimates of useful life, the change in classification can affect depreciation deductions for past years. One of the rationales for requiring consent to changes in methods has been the fact that income might otherwise be omitted when taxpayers change methods without permission, although the reduction in property basis for depreciation "allowed or allowable"[9] makes this outcome less likely in the depreciation context.

The Courts Split

The IRS's position is that the language in the regulations refers to determining useful lives under section 167 and has no application to changes in depreciation categories under section 168. This theory prevailed in district court in *H.E. Butt Grocery Co. v. United States*[10] and *O'Shaughnessy v. Commissioner*,[11] and before the Tenth Circuit in *Kurzet v. Commissioner*.[12] The court in *Butt Grocery* allowed the taxpayer to correct "posting errors" where it had used the wrong depreciation method because it had inadvertently assigned the wrong code to an asset, but did not permit it to reclassify some of the costs incurred in constructing new stores from real property to personal property on the basis of a "cost segregation" study. Similarly, the Tenth Circuit in *Kurzet* refused to permit the taxpayer to change the MACRS recovery period of a reservoir on their farm from 31½ years to 15 years, deferring to the IRS's interpretation of the regulation. On the same reasoning, *O'Shaughnessy* held that the IRS's reallocation of property between depreciation categories on audit was a change of method, and a cumulative adjustment was proper.

Wedged in between these cases, however, came the Tax Court's decision in *Brookshire Brothers*. The taxpayer in *Brookshire* filed amended returns for 1993 through 1995 reclassifying its gas stations from real to personal property, thereby shortening their recovery period to 15 years. The IRS processed the amended returns, but later sought to cut back the taxpayer's 1996 and 1997 deductions on the grounds that the taxpayer had changed methods and the IRS had never properly consented. The Tax Court held that "the similarities between a change in MACRS classification and a change in useful life [under pre-1981 law] are greater than the differences," and that the regulation's exclusion for "adjustment[s] in… useful life" covered both. The misclassification could therefore be corrected on a timely amended return, like any other error.[13]

The difference in the courts' analyses seems to reflect different views of the purposes of the regulation. The court in *Butt Grocery* seems to have assumed that the controversial passage reflected the general rule for factual determinations and therefore couldn't apply to MACRS classification, which is essentially a legal question. By contrast, Tax Court Judge Nims read the disputed passage as a relief provision, observing that the drafters "clearly intended to permit taxpayers to alter their depreciation schedules," and that the IRS's interpretation would "severely limit the intended relief" under post-1981 law. The Fifth Circuit has now affirmed on the same reasoning. The panel opinion noted that "we fully agree with the Tax Court that the applicable regulations were meant to allow taxpayers to make temporal changes in their depreciation schedules without prior consent of the Commissioner."

Unauthorized Changes in Barred Years

The Fifth Circuit's decision is also notable for its departure from the IRS position concerning unauthorized changes in accounting methods in barred years.

In general, the IRS can ignore an attempt at an

unauthorized change and require the taxpayer to compute tax liability under its old method, even if that method is improper. The IRS's authority to do this is grounded not on section 446(b), which empowers the Secretary to change a taxpayer's accounting method "if the method used does not clearly reflect income," but on section 446(e), which requires that taxpayers seek the Secretary's consent to any change. It does not matter that taxpayer's new method is correct (or that its old one is not).

Too Late?

It remains unclear how far the IRS can apply this principle in adjusting taxable years *after* the attempted change. The IRS position is that even if the year of the change itself is barred, the government can still challenge the taxpayer's continued use of the new method. The case law before *Brookshire Bros*. was vague—not to mention mostly unpublished—but could be read to be at least consistent with the IRS's position.

In *Tampa Tribune Publishing Co. v. Tomlinson*,[14] the IRS sought to deny the taxpayer's deductions for interest paid on the grounds that its switch from accrual to cash accounting 15 years earlier had been unauthorized. The court held for the taxpayer, but not on statute of limitations grounds. Rather, the court found that the IRS's actions over the intervening years amounted to *de facto* consent to the change.

In *Ed Smithback Plumbing v. United States*,[15] the taxpayer argued that section 267(a)(2) did not apply because the individual payee had changed to an accrual method in a past year. The court observed that he could not properly have changed from cash to accrual accounting in a past year because he had failed to secure the needed permission. However, the analysis in the opinion concentrated on the fact that the amended return that the taxpayer relied upon to document the change was "ambiguous" and there was no evidence the payee had ever accrued any item of income or deduction apart from inventory.[16] The taxpayer was not "forced" to revert to his old method because the court didn't believe that he had changed at all.

In *Textile Apron Co. v. Commissioner*,[17] the court disallowed the taxpayer's LIFO election and forced it to adopt FIFO, even though the year of first use of LIFO was not before the court and was apparently barred. *Textile Apron*, however, is distinguishable from the garden-variety change of method case because the statute requires an express election to use LIFO, which the taxpayer had not even attempted to make because it was relying on elections by its predecessor proprietorships.

Hospital Corporation of America v. Commissioner[18] appears to have presented an overlooked chance to test the IRS's theory. The taxpayer originally reported on the cash method, but a prior audit had been resolved by computing its liability under a "hybrid" method under which it accrued charges for hospital goods and supplies but continued to report medical services on the cash method. The taxpayer continued to use its hybrid method on later returns. The parties disputed whether the audit settlement represented IRS consent to (or imposition of) a method change or whether the taxpayer had changed methods without consent.

The IRS tried to impose full-fledged accrual accounting but was unsuccessful because the court held that the taxpayer's "hybrid" method clearly reflected income. If the past change were unauthorized, however, then the IRS's theory would have allowed it to ignore the attempted change and treat the taxpayer as if it were still on the cash method. To the extent the taxpayer was selling goods (as the court assumed without deciding), the cash method would clearly have been incorrect. This would have allowed the IRS to impose accrual accounting, as it has its choice of acceptable methods once the taxpayer's current method is determined to be improper. The IRS evidently did not make this argument expressly, however, or if it did, the court rejected it without detailed discussion.[19]

Ignoring a Change Versus Imposing a Change

Assuming the IRS can consider an unauthorized change in a barred year, what exactly can it

CBTM 4-7 3/19/03 9:58 AM Page 37

do? The IRS can simply ignore an unauthorized method change when adjusting the year of the change itself. There would therefore seem to be a good argument that it could follow the same principle in recomputing tax liability for a later taxable year. For example, if a taxpayer had previously changed from the cash to an accrual method without permission, the IRS could either accept the change or treat the taxpayer as still on the cash method. If the cash method were incorrect, the taxpayer could then be required to change methods under section 446(b), with the usual attendant consequences, including a cumulative adjustment under section 481.

The IRS, in its recent rewrite of the revenue procedures on involuntary and voluntary changes, seems to go a step further. Revenue Procedure 2002-18[20] appears to state that the IRS can accept the fact that the taxpayer changed methods in the past, but then force a change back to the old method on the grounds that the change was unauthorized. Forcing a taxpayer to change back to its old method is different from treating it as if it had been on the old method all along. The change back creates a cumulative adjustment and may have other collateral consequences as well. As discussed in an earlier column,[21] the authorities that the IRS cites for this proposition do not seem to go so far if the taxpayer's new method was correct.

The Fifth Circuit in *Brookshire*, however, did not seem to accept even that the IRS can challenge the propriety of a method change in a barred year. As discussed above, taxpayer's primary argument, which the Fifth Circuit upheld, was that the regulation made IRS consent unnecessary. In the alternative, however, the taxpayer argued that the IRS could not challenge any method change because it had already consented to the reclassification by processing the amended returns for 1993 through 1995. The court held for the taxpayer on this point too. However, declining to consider whether merely allowing a refund claim amounted to consent, the court instead focused on the statute of limitations:

> [W]e do not decide what preclusive effects, if any, the Commissioner's acceptance of amended returns or actions based on them might produce. Rather, we address the significance of the pervasive time bar in the federal taxation scheme . . . [W]e conclude that the Commissioner is barred from assessing a deficiency for the challenged tax years of 1996 and 1997 grounded solely on Brookshire's failure to obtain consent pursuant to IRC § 446(e): *Brookshire made no change in either of the challenged years;* if a change were made at all, it was in a prior year that was closed before the Commissioner assessed a deficiency.[22]

This portion of the opinion cites no authority apart from the statute and regulations, and *Brookshire Brothers* seems to be the first case in which a court—and a circuit court, at that—has squarely addressed how the statute of limitations applies to method changes. Other courts may disagree with the Fifth Circuit's reasoning. It is well settled, for example, that the IRS may recompute taxable income for barred years when this affects losses or credits that carry forward to the current year. However, the law is at least unsettled, and taxpayers should keep this aspect of the *Brookshire Brothers* holding in mind when confronted by an adjustment predicated on an unauthorized method change in the "dim and misty" past.

---

1. No. 01-60978 (5th Cir. 2003), 2003 WL 187605, *aff'g* 81 T.C.M. (CCH) 1799 (2001).

2. *See* Rev. Proc. 62-21, 1962-2 C.B. 418, *superseded by* Rev. Proc. 72-10, 1972-1 C.B. 721.

3. Regs. § 1.167(a)-11; Rev. Proc. 71-25, 1971-2 C.B. 553, *superseded by* Rev. Proc. 72-10, 1972-1 C.B. 721, *superseded by* Rev. Proc. 77-10, 1977-1 C.B. 548, *superseded by* Rev. Proc. 83-35, 1983-1 C.B. 745.

4. *See* I.R.C. § 168(f).

5. Rev. Proc. 83-35, 1983-1 C.B. 745, *obsoleted by* Rev. Proc. 87-56, 1987-2 C.B. 674.

6. *See* Reg. § 1.446-1(e)(2)(*b*).

7. Reg. § 1.167(e)-1(a); *see, e.g., Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349, 410-11 (1981); *Silver Queen Motel v. Commissioner*, 55 T.C. 1101 (1971), *acq.* 1972-2 C.B. 3; *Foley v. Commissioner*, 56 T.C. 765 (1971), *acq.* 1972-2 C.B. 2;

Rev. Rul. 72-491, 1972-2 C.B. 104.

8. I.R.C. § 168(b)(5), (g)(7).

9. *See* I.R.C. § 1016(a)(2).

10. 86 A.F.T.R.2d ¶ 2000-5048 (W.D. Tex. 2000), discussed in J. Salles, "Tax Accounting," 2(1) Corp. Bus. Tax'n Monthly 36, 40 (Oct. 2000).

11. 2002-1 U.S.T.C. ¶ 50,235 (D. Minn. 2001).

12. 222 F.2d 830 (10th Cir. 2000).

13. The Tax Court has since followed *Brookshire Bros.* in *Green Forest Manufacturing Co. v. Commissioner*, TCM 2003-75.

14. 57-1 U.S.T.C. ¶ 9421 (S.D. Fl. 1957) (unpublished).

15. 76-1 U.S.T.C. ¶ 76-1 U.S.T.C. ¶ 9139 at 83,143-44 (Ct. Cl. Tr. Div. 1975), *adopted in unpublished opinion*, 538 F.2d 347 (Ct. Cl. 1976) (memorandum opinion at 76-1 U.S.T.C. ¶ 9373).

16. *See id.* at 83,144 n. 17.

17. 21 T.C. 147 (1953) (reviewed).

18. 71 T.C.M. (CCH) 2319 (1996).

19. *See* 71 T.C.M. (CCH) at 2332 n.22 (consent irrelevant because IRS was seeking to impose a new method rather than force the taxpayer to revert to its old one).

20. Rev. Proc. 2002-18, § 2.06, 2002-13 I.R.B. 678, 682.

21. J. Salles, "Tax Accounting," 3(9) Corp. Bus. Tax'n Monthly 31, 31-32 (June, 2002).

22. 2003 WL 187605 at 4 (emphasis in original).