Tax Accounting

By James E. Salles

In this month's column:

- The Tax Court applies tax accounting prin ciples to inventory valuations in *Bank One Corporation v. Commissioner*;[1] did the court change the taxpayer's method?
- In *O'Shaughnessy v. Commissioner*,[2] The Eighth Circuit adopts the Tax Court's posi tion that changing a property's MACRS classification is not a change in accounting method

Valuations as Accounting Methods: *Bank One*

Tax Court Judge Laro's long-awaited opinion in *Bank One Corporation v. Commissioner*[3] made its appearance in May. Most prominently, *Bank One* is the first reported decision addressing how securities dealers should value swaps and other derivative contracts under section 475's mark-to-market regime. Of less groundbreaking importance—although possibly of broader concern—is the court's implication that changing the taxpayer's formula for estimating fair market value was a change in accounting method. Space considerations do not permit a detailed recapitulation of the lengthy opinion, but the discussion below provides an overview of the parties' positions and the court's holding on the valuation issue before turning to the question of whether the court imposed a change in method.

Background: Mark-to-Market Accounting

Securities dealers have traditionally been allowed to use "mark-to-market" accounting (that is, to mark up inventory based on market values as well as mark it down below cost, as is done under the "lower-of-cost-or-market method).[4] Section 475 required them to do so, effective generally from calendar 1993.[5] The definition of "securities" was also extended to include contract positions that previously might not have been considered "securities" or even "property" at all, such as short positions, and entitlements and obligations under notional principal and other derivative contracts.[6]

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The issue in *Bank One* was how the First National Bank of Chicago (FNBC), a member of taxpayer's predecessor's consolidated group, marked swap contracts to market during 1990–1993. The opinion focused on interest rate swaps, which accounted for the bulk of the transactions at issue, although FNBC also engaged in currency and commodity swaps. The years 1990–1992 were not subject to section 475, but the taxpayer had evidently elected to apply mark-to-market accounting, a common practice in the industry despite technical issues about the predecessor regulations' scope.[7] The opinion framed the issue as whether FNBC's valuation methods "clearly reflected income" under the general mandate of section 446. However, the valuation issues addressed by the court are equally applicable under section 475.

Over time, there had grown up an active primary market for swaps, particularly interest rate swaps, at standardized terms. There was, however, no real secondary market for swaps, because they were rarely assigned—parties generally exited their positions by entering into offsetting contracts or, less frequently, buying out their counterparty—so existing swaps' year-end market values could not be determined by direct market observation. So how were they to be determined? The section 475 regulations issued in 1996[8] do not address valuation, so dealers have been left to rely on "common law" valuation principles and industry accounting practice.

Swap dealers used specialized software to value their positions. The software analyzed market data (such as interest rate indices and swap bid-ask spreads) to infer market assumptions about future interest rates. Those rates were then used to project any variable cash flows under the swap agreement, and then to calculate the present value of all the cash flows to arrive at the swap's "mid-market value," which was commonly used for a variety of internal and control purposes. For book purposes, some dealers used published quotations for standardized transactions and made specific adjustments for differences in terms. Others used the "mid-market values," with or without various adjustments, which might either be made directly to the book value or disclosed separately.

Bank One

FNBC determined swaps' book value by reducing "mid-market value" by allowances for counterparty credit risk and projected administrative costs, amortizing these adjustments and the corresponding income over the lifetime of the swap. The main question in the case was whether this practice was acceptable and, if it were not, what adjustments could properly be made to the computer-generated "mid-market values" in applying section 475. Examining the relevant pronouncements, the court concluded that the accounting "fair value" standard was broader than the tax concept of "fair market value." Thus, a valuation method that sufficed for book purposes might not necessarily satisfy section 475, and the court had to make an independent evaluation of the taxpayer's methods. Surveying the literature and considering expert testimony, the court agreed with the taxpayer that adjustments for credit risks and administrative costs were proper.

The court, however, objected to numerous aspects of the taxpayer's calculations. For administrative convenience, FNBC was computing "market" as of about 10 days before the actual year-end, and excluding certain "nonperforming" swaps. In computing credit allowances, it did not take into account offsetting swaps or negotiated "credit enhancements" that might reduce exposure, and did not adjust values for the effects of FNBC's own credit rating or fluctuations in the counterparty's ratings. The adjustments were calculated with a one-month lag, and in some cases amortized over average lives rather than each swap's term. Finally, the court held that only the projected *incremental* administrative costs should affect the swaps' value, while the taxpayer had been including some fixed indirect costs. The court ordered the parties to submit revised calculations of "fair market value."

"Safe Harbor" In Sight?

Some commentators have criticized *Bank One* as an exercise in judicial lawmaking, and noted potential problems in applying the court's methodology to anything other than the "plain vanilla" interest rate swaps that made up most of FNBC's portfolio.[9] However, the opinion can also be seen as a straightforward attempt to come to grips with a number of highly technical issues in the face of a persistent guidance vacuum.

That vacuum may be about to end. For 10 years, the IRS has ignored Congress' exhortation to "authorize the use of valuation methods [under section 475] that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes."[10] However, on the day *Bank One* was released, there appeared an "advance notice of proposed rulemaking" (akin to the similar notice that heralded the proposed "*INDOPCO* regulations"), asking for comments on a proposed book conformity safe harbor.[11] The advance notice stated that "three broad principles" would apply to any such safe harbor:

- It would have to satisfy section 475's basic mandate: to determine securities' fair market value at year-end;
- The same figures would have to be used for financial statements and other business purposes so the taxpayer would have "a strong incentive to report values fairly"; and
- There would have to be a satisfactory mechanism for tying the book figures used to the tax return and ensuring that conformity was applied consistently to all securities.

The IRS requested comments about on what securities or commodities should be covered; the range of practices permitted under GAAP and whether they conform to section 475; whether and what other methodologies might exist for determining "fair market value"; the types of "book" figures that might be acceptable; and the necessary record-keeping requirements.

Valuation Changes as Method Changes

A secondary, but interesting, question about Bank One is whether the taxpayer has undergone a change in accounting method under the Tax Court opinion. The parties may have assumed so, but that is far from a foregone conclusion.

The IRS and the courts have consistently treated various arbitrary and mechanical methods of deriving the "cost" and/or "market value" of inventory or other property as methods of accounting. Changes from one such method to another, or from such a method to calculating a true "cost" or "market value," are changes in method.[12] The point was recently illustrated in Hitachi Sales Corp. v. Commissioner,[13] which involved a taxpayer that was supposedly on the "lower of cost or market" method of inventory accounting but had its own idiosyncratic interpretation of both. The court held that both the taxpayer's determination of "cost" on the basis of 125% of the invoice price and its arbitrary 90% write-downs to reflect "market" were methods of accounting. The taxpayer was stuck with its standard cost method, because the IRS did not object to it. The IRS did object to the write-downs, and the court imposed a section 481 adjustment when they were disallowed.

A "method of accounting," however, is merely a consistent policy for dealing with recurring type of receipt or outlay. The same rule applied to different facts will produce different results, and a change in outcome that reflects a change in the underlying facts does not indicate a change in method.[14] For example, although "a change in the method or basis used in the valuation of inventories" is a change in accounting method,[15] increasing a burden rate under a standard cost system to reflect increased overhead is just a "change in treatment resulting from a change in the underlying facts."[16] Similarly, the regulations implementing the "unit-livestock-price" method provide that annual adjustments in the unit price to reflect variations in the cost of raising livestock do not require consent,[17] because "[s]uch a change is not a change in method of accounting, but an application of the unit-livestock-price method, similar to the application of a standard cost method."[18]

Consistently with the above principles, the courts have recognized an exception to the rule that a change in valuation practices is a change in accounting methods in situations where both the old and new methods represent different ways of arriving at the best available estimate of fair market value. The leading case is probably Baltimore & Ohio Railway Co. v. United States,[19] involving the taxpayer's valuation of its "relay rail" (rail re-used on lower-trafficked lines) under the "retirement-replacement-betterment" method of accounting. The taxpayer switched from valuing relay rail at 75% of replacement cost to a formula approved by the Tax Court in another case.[20] The Court of Claims held that there was no change in accounting method because the change was not, as the government contended, from an "assigned value method" to a "fair market value estimation method" but from one way of estimating fair market value to another.

The courts and the IRS may be more prone to conclude that there has not been a change in method if the change in the taxpayer's practices reflects a marked change in market conditions (or, perhaps, available information about market conditions).[21] For example, in the early Tax Court case of D. Loveman & Co. v. Commissioner,[22] the parties seem to have assumed that the taxpayer did not change accounting methods when it changed how it calculated replacement cost to reflect different buying patterns during the Korean War. A somewhat similar situation was involved in PLR 9222017,[23] which allowed insurance companies to value foreclosed properties at appraised value rather than, as previously, based upon the outstanding debt. State regulators had ordered the change for book purposes because of market conditions, and the National Office held that using the same values for tax purposes did not represent a change in method because "[t]axpayers are still taking into account . . . an estimate of the fair market value of the property."

Implications of *Bank One*

It is not entirely clear how far the exception for a change from one "fair market value estimation method" to another extends. Bank One reflects the general principle that tax accounting estimates must be based on the "best available" information.[24] Conceivably, the IRS might argue that only a valuation method that reflects "best practice" qualifies as a "fair market estimation method," so that changing from a practice that does not meet that standard is an accounting method change.

The taxpayer in B&O, however, seems to have been shifting from a "less than ideal" formula for estimating fair market value to a "better" one. Furthermore, trying to distinguish Loveman and PLR 9222017 as involving changes in underlying facts would risk proving too much. Market conditions do not change overnight, and almost any change is going to apply a new formula to essentially the same facts to which the old formula applied on the day before. The better reading of the sparse authorities is probably that there has been no method change if the surrounding circumstances (which might include a change in market conditions) indicate that both methods represent bona fide attempts at estimating fair market value.

The Bank One court held that section 475 imposed a method of accounting, and that section 446's "clear reflection" standard governed the taxpayer's attempts to estimate market value, rejecting the argument that the case was "only" about valuation. The opinion did not as clearly state that redetermining the taxpayer's adjustments to "mid-market value" changed its method. The court did, however, express agreement an IRS expert's conclusion that "FNBC's mark-to-market method was not, in fact, a mark-to-market method," suggesting that it was being put on mark-to-market accounting for the first time. It will be interesting to see whether and how the issue surfaces in any subsequent proceedings.

In any event, the IRS should address the issue in any forthcoming guidance under section 475. Any "safe harbor" should specifically provide that electing taxpayers will be deemed not to have changed methods if their book valuation methods change. This conclusion could be justified on the grounds either that any conforming method is necessarily a "fair market value-based" method or that "following the books" is itself a method of accounting,[25] so long as the taxpayer continues to meet the conditions imposed by the election.

MACRS Reclassification Held Not Method Change

The IRS continues to encounter problems convincing the courts that changing the category to which property is assigned under section 168's "modified accelerated cost recovery system" ("MACRS") is a change in method of accounting. Its latest defeat on the issue occurred before the Eighth Circuit in *O'Shaughnessy v. Commissioner*.[26]

Background

Until 1981, notwithstanding administrative safe harbors,[27]allowable depreciation remained a factual question. Adjustments to depreciation schedules reflecting taxpayers' revised estimates of useful lives and salvage values generally were made only prospectively.[28] Section 168 made depreciation a legal issue by prescribing available recovery periods and methods depending on the class to which the property is assigned. The taxpayer's choice of a proper treatment for a particular property is irrevocable.[29] Normally, however, taxpayers would be entitled to correct use of an *unauthorized* period or method like any other mistake, unless prevented by some other rule of law.

Enter the method of accounting issue. Taxpayers need IRS permission to change methods,[30] and normally will not be allowed to do so "retroactively," even if their old method is wrong.[31] If a taxpayer assigns property to the wrong depreciation class and selects a recovery period and method accordingly, is that adopting an accounting method?

Before 1981, changing a recovery period based upon changes in the estimate of a property's useful life was clearly *not* a change in method. The regulations expressly said as much—and still do.[32] The IRS maintains that this passage has nothing to do with post-1981 depreciation under section 168. Since at least 1993[33] it consistently has taken the position that reclassifying property from one MACRS category to another is a change in method of accounting.[34] This argument prevailed before the Tenth Circuit in *Kurzet v. Commissioner*,[35] and before district courts in *H.E. Butt Grocery Co. v. United States*[36] and *O'Shaughnessy.* The IRS then ran into trouble. In *Brookshire Brothers Holding, Inc. v. Commissioner*,[37] the Tax Court held that the regulation still applied and that a change in recovery period was still not a change in method of accounting, even if it reflected a change in the property's classification. The Fifth Circuit affirmed on appeal. The Eighth Circuit's reversal in *O'Shaughnessy* now hands taxpayers another victory.

O'Shaughnessy

The change of method issue arose in *O'Shaughnessy* not because the taxpayer sought to change recovery periods but because the IRS made it do so—after it had begun depreciating the property. The change involved the taxpayer's allocation of its purchase price in a 1992 transaction, but the first year that was actually adjusted was 1994. The IRS asserted a cumulative adjustment under section 481 to make up for the "excess" depreciation that the taxpayer had already taken in 1992 and 1993. The taxpayer accepted the purchase price reallocation but disputed the section 481 adjustment on the grounds that there had been no change in method of accounting.

The taxpayer's main argument before the trial court seems to have been that it made a "mathematical or posting error," and it apparently only raised the Regulations' treatment of changes in useful life in a supplemental submission after the Tax Court decided *Brookshire Brothers*.[38] The district court, relying on *Butt Grocery* and *Kurzet*, agreed with the IRS that the reclassification was a change in method. The Eighth Circuit, however, followed *Brookshire Brothers* and held that changing MACRS recovery periods was not a change in method of accounting.

The holding, in fact, may reach further than just changes between MACRS categories. Some of the amounts that the *O'Shaughnessy* court reallocated were originally allocated to "startup costs," and probably amortized under section 195, and "supplies," which presumably were not depreciated at all.[39] Neither party seems to have noted this as possible grounds for distinguishing *Brookshire,* probably because it is not. Under pre-1981 law, the Tax Court relied on the same regulatory language about changes in estimates of useful life in holding that starting to depreciate an asset previously treated as having an indeterminate useful life was not a change in accounting method.[40] The IRS position is, of course, that switches between nondepreciable and depreciable asset treatment under current law are changes in method.[41] However, there would seem little basis for distinguishing such situations from "plain" changes of recovery periods[42] (unless, perhaps, the asset is being put in or taken out of inventory[43]). And so far as distinguishing amortization and depreciation, IRS procedures seem to treat the two as interchangeable and changes involving either (except, presumably, for "pure" adjustments to useful life) as changes in method.[44]

1. 120 T.C. 104 (2003).
2. 2003 WL 21361060 (8th Cir. 2003), *rev'g on this issue, aff'g on another*, 2002-1 U.S.T.C. ¶ 50,235 (D. Minn. 2001).
3. 120 T.C. 104 (2003).
4. *See* Reg. § 1.471-5.
5. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13223(a).
6. I.R.C. § 475(c)(1)-(2).
7. *Cf.* Reg. § 1.471-5.
8. T.D. 8700, 1997-1 C.B. 108.
9. *See, e.g.,* L. Sheppard, "*Bank One:* Judge Laro's Third Way Accounting Method," 99 Tax Notes 786 (May 12, 2003).
10. H.R. Rep. No. 103-213, at 616 (1993), *reprinted at* 1993-3 C.B. 393, 494 (conference report on OBRA93).
11. Announcement 2003-35, 2003-21 I.R.B 956 (May 2, 2003).
12. Reg. §§ 1.446-1(e)(2)(iii) (Ex. (7)-(8)) (changes from deducting 20% from inventory cost and from "base stock" system); *Thomas v. Commissioner*, 92 T.C. 206 (1989) (change from arbitrarily writing down inventory to 1/4 of manufacturing cost); *First National Bank of Gainesville v. Commissioner*, 88 T.C. 1069 (1987) (write-down of quarry by-product from $1 to $.10 per ton); Rev. Rul. 72-82, 1972-1 C.B. 134 (change from using 50% to 90% of "real" market).
13. 67 T.C.M. (CCH) 2659 (1994), *subsequent proceedings at* 69 T.C.M. (CCH) 1958 (1995).
14. Reg. § 1.446-1(e)(2)(ii)(*b*).
15. Reg. § 1.446-1(e)(2)(ii)(*a*).
16. Reg. § 1.446-1(e)(2)(iii) (Ex. (4)); *see also, e.g.*, Reg. § 1.263A-1(f)(3)(i)(A) (a "periodic adjustment to a burden rate that merely reflects current operating conditions" is not a method change).
17. Reg. § 1.471-6(f), *as amended by* T.D. 9019, 2002-47 I.R.B. 874.
18. Notice of Proposed Rulemaking, REG-125626-01, 2002-1 C.B. 604, 605 (preamble to 2002 amendments to Reg. § 1.471-6(f)).
19. 603 F.2d 165 (Ct. Cl. 1979).
20. *Chesapeake & Ohio Railway Co. v. Commissioner*, 64 T.C. 352, 392 (1975).
21. *Cf. ESCO Corporation v. United States*, 750 F.2d 1466 (9th Cir. 1985) (taxpayer switched to estimating workers' compensation claims when it first developed a sufficiently sophisticated forecasting methodology).
22. 34 T.C. 776 (1960), *aff'd without opinion*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962).
23. PLR 9222017 (Feb. 26, 1992).
24. *E.g., Chicago, Burlington & Quincy Railroad Co. v. United States*, 455 F.2d 993, 1018-19 (Ct. Cl. 1972), *rev'd and rem'd on another issue*, 412 U.S. 401 (1973).
25. *Cf. FPL Group v. Commissioner*, 115 T.C. 554 (2000), discussed in J. Salles, 2(6) Corp. Bus. Tax'n Monthly 31, 31-32 (March, 2001), where the court held that following regulatory accounting to be a method, even though there were constant minor changes in specific practices.
26. 2003 WL 21361060 (8th Cir. 2003), *rev'g on this issue, aff'g on another*, 2002-1 U.S.T.C. ¶ 50,235 (D. Minn. 2001).
27. *See, e.g.*, Reg. § 1.167(a)-11 (elective "class life asset depreciation range" (CLADR) system).
28. *See, e.g.*, Reg. § 1.167(b)-2(c) (illustrating the effects of a change in useful life on calculations under the "declining balance" method); *see also, e.g.*, Reg. § 1.446-1(e)(2)(ii)(*b*) ("such items are traditionally corrected by adjustments in the current and future years").
29. I.R.C. § 168(b)(5), (g)(7).
30. I.R.C. § 446(e); Reg. § 1.446-1(e)(2).
31. Rev. Proc. 2002-9, § 2.04, 2002-1 C.B. 327, 335; Rev. Proc. 97-27, § 2.04, 1997-1 C.B. 680, 682.
32. Regs. § 1.446-1(e)(2)(ii)(*b*) ("a change in the method of accounting does not include . . . an adjustment in the useful life of a depreciable asset").
33. *See, e.g.*, IRS Pub. 538, "Accounting Periods and Methods," (1993), as cited in *Kurzet*, 222 F.3d at 844, although the parenthetical specifically referring to post-1981 property has since disappeared, *compare* Pub. 538 (Mar. 2003) at 17.
34. *See, e.g.*, CCA 200248016 (Nov. 29, 2002); CCA 200246006 (Aug. 5, 2002); unnumbered FSA, 1996 WL 33320874 (Aug. 14, 1996); *see also, e.g.*, Rev. Proc. 2002-9, Appendix, § 2.01(1)(b), 2002-1 C.B. 327, 349 (automatic consent for certain changes from improper to proper depreciation methods); IRS Publication 946, "How to Depreciate Property," 2002 return edition, p. 13; TAM 9708003 (Feb. 21, 1997); CCA 199921045 (Apr. 1, 1999) (all noting application of consent requirement and/or § 481).
35. 222 F.3d 830 (10th Cir. 2000).
36. 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).
37. 81 T.C.M. (CCH) 1799 (2001), *aff'd*, 320 F.3d 507 (5th Cir. 2003), discussed in J. Salles, "Tax Accounting," 4(7) Corp. Bus. Tax'n Monthly 34.
38. *See* 2002-1 U.S.T.C. ¶ 50,235 at 83,481 n.5.
39.*See* Reg. § 1.162-3.
40. *Kansas City Southern Railway v. Commissioner*, 76 T.C. 1067, 1155-56 (1981); *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497, 802-07 (1980).
41. *E.g.*, TAM 200017046 (Sept. 10, 1999) (changing from treating developer's streets and sewage improvements as tangible assets depreciable over 15 years to intangible assets with indeterminate useful lives a change in method).
42. The Regulations state that changing from *expensing* outlays to depreciating them is a change in method, Reg. § 1.446-1(e)(2)(ii)(*b*) (last sentence), but say nothing about changing between reclassifying an asset as depreciable or not.
43. *Cf.* Reg. § 1.446-1(e)(2)(ii)(*a*) (any change "involving the method or basis used in the valuation of inventories" is a change n method).
44. Rev. Proc. 2002-9, Appendix § 2.01(1), 2002-1 C.B. 327, 349.