Tax Accounting

BY JAMES E. SALLES

A recent Tax Court decision, *Pelton & Gunther, P.C. v. Commissioner*, 78 T.C.M. (CCH) 578 (1999), involves the treatment of a law firm's advances on behalf of its clients. The case illustrates an intriguing argument to avoid a change of accounting method and the immediate cumulative adjustment to income that goes with it.

BACKGROUND

A cash basis taxpayer ordinarily takes an expenditure into account when the amount is paid—as long as it is the taxpayer's expenditure. The payment is treated as a loan to the third party if the taxpayer pays the amount on behalf of another party and has a right to reimbursement.

Many law firms, especially plaintiffs' law firms, routinely make advances to clients and write off the expenditures if there is no recovery. Numerous cases have held that in those circumstances the initial expenditures are advances, and the law firm becomes entitled to a deduction only when the account is written off. See, e.g., *Canelo v. Comm'r*, 53 T.C. 217 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971).

Exception for "Gross Fee" Arrangements

The courts have recognized an exception for "gross fee" arrangements if:

1. The parties agree from the outset that the expenditures will be for the account of the lawyer; and
2. State ethics rules permit the attorney to assume responsibility for the payment.

Thus, an attorney was held entitled to a current deduction for outlays in *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995). Here the lawyer negotiated "gross fee" retainer agreements and gave up the right to a specific reimbursement of expenses in exchange for a higher percentage of the final recovery, if any.

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Pelton & Gunther, P.C.

Pelton & Gunther's (P&G's) facts were slightly different from those of the typical plaintiff's firm. P&G was a defense firm, most of whose work involved representing members of the California State Automobile Association (CSAA). The CSAA would normally pay an up-front retainer of $400 when P&G accepted a case. P&G would collect no further fee until the case was resolved.

P&G would be entitled both to reimbursements for its expenses and to an hourly fee when the case was resolved. Thus, P&G was legally entitled to reimbursement for its expenses. Unlike many plaintiffs' lawyers operating under contingent fee arrangements, P&G could ordinarily count on collecting its reimbursement, albeit perhaps years later. On these facts, the court held that P&G could not currently deduct the expenses it incurred on behalf of its CSAA clients, and indeed imposed a negligence penalty for its attempt to do so.

The interesting part of the Tax Court holding involved the court's treatment of expenses that P&G had deducted in now-barred years. The IRS treated the taxpayer as having made a change of accounting method, that is, a change from deducting the expenses as incurred to treating the expenses as a receivable from CSAA. The IRS imposed a cumulative adjustment to income under Code Section 481.

ACCOUNTING METHODS

The concept of an accounting method dates from at least 1918, when taxpayers were expressly permitted to use accrual accounting if that was the method by which they "regularly computed income in keeping their books." The basic rules remain the same. Code Section 446 grants taxpayers an initial choice among accounting methods that are otherwise permissible and "clearly reflect income." Code Section 446(e) imposes a requirement that the taxpayer secure permission to change its accounting method once a method is adopted.

The modern era of change-of-method law and lore dates from the 1954 Code, which added Code Section 481. Code Section 481 for the first time statutorily imposed a cumulative adjustment on a change in accounting method. The IRS had earlier imposed such changes as a condition for granting consent to a change.

The 1954 Code also added Code Section 446(c), which expressly listed among accounting methods, besides the traditional cash and accrual methods, "any other method permitted by this chapter" and "any combination of . . . methods permitted under regulations." Code Section 446(c) clarified that the term *accounting method* and the consent requirement were not confined to a taxpayer's initial choice of an overall cash or accrual method.

Changes in Accounting Method

Treasury Regulations Section 1.446-1(e)(2)(ii)(*a*) defines a change in accounting method as "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 such 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." It is not defined in terms of magnitude, as accountants and others familiar with the financial accounting concept of materiality frequently assume.

Erroneous methods are methods nevertheless. Changes from such methods require the Commissioner's consent, and involve a cumulative adjustment,[1] although corrections of mere "mathematical and posting errors" are excluded.[2]

The regulation also states that to be considered an accounting method, a treatment must "in most instances" exhibit a "pattern of consistent treatment of an item." Courts in general and the Tax Court in particular, however, have shown an increasing willingness to find a change in accounting method has occurred from any timing change that would otherwise pose the potential for whipsaw of either the taxpayer or the IRS. For example, in *Superior Coach of Florida v. Commissioner*, 80 T.C. 895 (1983), the taxpayer entered a figure for inventory in the prior year "felt to be a close approximation by management." The taxpayer was held to change methods the first time it took a proper inventory,[3] even though its previous practice could hardly be considered a "practice of consistent treatment" of much of anything.

THE TAX COURT'S HOLDING

The court in *Pelton & Gunther* held that the change from deducting the expenditures to treating the expenditures as a receivable was not a change in accounting method. In a broad sense the case was about timing. P&G would have to recognize less income on the ultimate recovery if P&G was not permitted to deduct the expenditures as they were incurred. The court noted, however, that the deductions that P&G took were not deferred; they were permanently disallowed.

The court held that the P&G expenditures were not nondeductible because they were not P&G's expenses and thus not deductible to it at all. Deduction was not denied because the expenditures failed to meet the Section 461 requirements or because the expenditures had to be capitalized because they provided a future benefit. Thus, the change enforced by the IRS was not a change in the timing of reporting an item of income or deduction. The deductions that were disallowed were a different "item" than the portion of the subsequent recovery that, under the IRS's treatment, P&G would now be entitled to exclude. Consequently, a cumulative adjustment could not be imposed under Code Section 481.

Collateral Issues

The fact that this change was not a change in accounting method does not mean that future taxpayers in the position of P&G will escape scot-free. There remains the doctrine of equitable estoppel, or the duty of consistency. Under these rules, a taxpayer may be held to be consistent on subsequent returns, in most cases, only if the taxpayer's return makes a representation that has a factual element, for example, in this case, that the requirements for deduction were met.[4]

When the initial reporting takes the form of an erroneous deduction, this doctrine overlaps with the tax benefit rule.[5] Thus, if the taxpayer deducted the expenses, improperly or not, it would be required to report income when the expenses were recovered. The *Pelton & Gunther* court came as close as it could to holding that this argument would have succeeded if the IRS had raised it. This situation happened in *Hughes & Luce, LLP v. Commissioner,* 68 T.C.M. (CCH) 1169 (1994), *aff'd*, 70 F.3d 16 (5th Cir. 1995), *cert. denied*, 116 S. Ct. 1824 (1996). Both courts held that Hughes & Luce, having erroneously deducted client advances in barred years, had to report the recoveries as income in the years in

which they were received. The Tax Court reached this result under the duty of consistency. The Fifth Circuit reached this result under the tax benefit rule.[6]

There is nonetheless a difference between being required to report income as recoveries occur over several years (income that would have been reported anyway under the taxpayer's old treatment) and being required to swallow a cumulative adjustment all at once. Law firms facing similar adjustments can now cite both *Pelton & Gunther* and *Hughes & Luce* for the proposition that they should be allowed to remain on their old reporting as to any deductions taken in years that are now barred.

IMPLICATIONS

The decision has broader implications. The regulations have long distinguished between the correction of timing errors and "permanent" errors, such as reclassifying particular types of expenditures as personal expenses or dividends. In the long run, of course, some of these permanent errors may be timing issues as well; for example, a distribution may affect corporate earnings and profits or basis. However, the distinction remains critical to application of the "change of method" rules.

Pelton & Gunther makes it clear that the change in treatment must involve the timing of the same item of income or deduction. The mere fact that the disallowance involves something that recurs regularly and that it has timing implications is not enough. The IRS has focused increasingly on the change-of-method rules in recent years.[7] The Tax Court's holding may cause agents to pause before reflexively asserting that any timing adjustment represents a change in method.

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1. E.g., People's Bank & Trust Co. v. Comm'r, 415 F.2d 1341, 1344 (7th Cir. 1969).

2. Treas. Reg. § 1.446-1(e)(2)(ii)(*b*); North Carolina Granite Corp. v. Comm'r, 43 T.C. 149 (1964).

3. See also, e.g., TAM 8541004 (June 21, 1985), in which the taxpayer was held to have changed methods when it charged from writing down individual inventory items it deemed obsolete to using an aging schedule.

4. Beltzer v. United States 495 F.2d 211 (8th Cir. 1974); LeFever v. Comm'r, 103 T.C. 525, 541–45 (1994). The rule does not apply if the IRS was aware of the relevant facts as a result of, e.g., an audit or ruling request. See, e.g., Century Data Sys., Inc. v. Comm'r, 86 T.C. 157 (1986); Joplin Bros. Mobile Homes v. United States, 524 F. Supp. 800 (W.D. Mo. 1981).

5. E.g., Unvert v. Comm'r, 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982); Hughes & Luce, LLP v. Comm'r, 68 T.C.M. (CCH) 1169 (1994), aff'd, 70 F. 3d 16 (5th Cir. 1995), cert. denied, 116 S. Ct. 1824 (1996).

6. The mitigation provisions of I.R.C. §§ 1311-1314 might also apply if their requirements were met.

7. See, e.g., Notice 98-31, 1998-22 I.R.B. 10, proposing formalized procedures on IRS-initiated accounting method changes.