INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
May 11, 2000

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CASE MIS No.: TAM-114382-99/CC:DOM:IT&A:B5

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer:
date a:
month b:
year c:
year d:
date e:
date f:
date g:
month h:
J:
K:
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State

ISSUES:

(1) What is the proper time under § 461 of the Internal Revenue Code and the regulations thereunder for Taxpayer to accrue a liability for repairs made pursuant to a warranty?

(2) If it is determined that Taxpayer's present treatment of its warranty liability is improper, would a change in the treatment of Taxpayer's warranty liability constitute a change in method of accounting under § 1.446-1(e)(2)(ii)(a) of the Income Tax Regulations?

CONCLUSIONS:

(1) Taxpayer should accrue a liability for repairs under a warranty when the repair services are provided. At the time the repair services are provided, the fact of the liability has been established, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

(2) A change in the present treatment of Taxpayer's warranty liability to the method of accruing the liability when the repair services are provided constitutes a change in method of accounting under § 1.446-1(e)(2)(ii)(a).

FACTS:

Taxpayer was incorporated on date a, and is a wholly owned subsidiary of corporation, J.

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Taxpayer is the sales, marketing, administrative, and service headquarters J. Taxpayer purchases and sells and other products. are obtained from and Taxpayer conveys all P brand products to L, which in turn acts as a distributor and sells to a network of independently owned and operated

L provides a product warranty to its and to the ultimate consumer with respect to P that are sold Specifically, L warrants that each new will be free of defects in materials or workmanship during the warranty period.[1] The warranty further provides that any P in will make any repairs and adjustments, using new or remanufactured parts, to correct defects covered by this warranty. This warranty is made, and the obligation to abide by the warranty, arises at the time of the sale from L to the and extends to the consumer purchaser.[2]

The P network furnishes warranty services and necessary parts to consumers on behalf of L. L pays for repairs made pursuant to the warranty. L is reimbursed by Taxpayer for its warranty claims, which are based on warranty claims from However, Taxpayer generally is responsible for all are required to submit claims for reimbursement to L prior to receiving a reimbursement payment. L, in turn, submits a claim for reimbursement to Taxpayer. Taxpayer pays 100% of the claims made by L.

The P and the P describe the general responsibilities of a with regard to defects and set out the warranty claim documentation requirements. states that, for a performance of warranty repairs, L will pay the for parts and accessories or will provide the with parts and accessories required in connection with the repairs and will pay for labor in

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[1] The warranty includes a a a and a The warranty specifically describes what is covered and what is not covered under each type of warranty.

[2] Taxpayer represents that the defects in material and workmanship that are repaired under the warranty exist at the time of the sale of the from L to the The revenue agent questions, as a matter of fact, whether all defects that are detected and repaired during the warranty period existed at the time the was sold to the The validity of Taxpayer's representation on this point, however, does not control our conclusion in this technical advice memorandum. Thus, it is unnecessary to probe the accuracy of Taxpayer's representation.

accordance with the provisions set forth in the Sections x and y of the provide general guidelines for determining whether a repair is covered by warranty and a list of items not covered by warranty. Section z provides that L reserves the right to deny all or any part of a claim on the basis of inaccurate or misrepresented information, improper repair procedures, or failure to comply with warranty preparation, submission, or documentation requirements.

The provides guidance to in using the warranty processing system for filing claims manually.[3] The advises to verify whether or not are covered by warranty before beginning the repair order. The repair order is the key source document for preparing warranty claims. The repair order requires the following information: (1) repair order date; (2) identification number; (3) (4) owner's signature; (5) delivery or in-service date; (6) customer's name, address, and phone number; (7) description of repairs (includes the condition of the problem, the cause of the problem, and the repair(s) made to correct the problem); (8) trouble code; (9) labor operation number; (10) labor hours; (11) technician identification; (12) parts information; and (13) sublet repairs/sublet fluids. The must then prepare a claim on the L based on the information compiled on the repair orders. The provides that claims should be submitted to L within seven days after the repair is completed and that claims will be processed by L up to 90 days after the repair was completed.

To keep apprised of the status of their warranty claims, L mails a status report to twice each month, which contains information on accepted, pending, and rejected warranty claims. Accepted claims are claims that are accepted for payment. Pending claims are claims that require minor correction and resubmission before payment is possible. These claims only require submission/entry of the corrected portion. Rejected claims are claims that require complete resubmission or entry due to major claim errors. Taxpayer represents that, in general, L makes every effort to satisfy all valid warranty claims. Taxpayer does not track the specific numeric rejection rate for claims that ultimately are rejected. Taxpayer represents, however, that the number of claims received from the and ultimately rejected by L (and consequently not paid by L) is de minimis.

For book purposes, Taxpayer projects and records an estimated warranty liability at the time the is sold by L to the For tax purposes, Taxpayer aggregates the warranty payments made during the taxable year, adds the payments

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[3] There is a separate manual for that use a computerized warranty processing system.

made during the first 8 ½ months of the following year, and subtracts the payments made during the current year that were included in the prior year's warranty liability.

LAW AND ANALYSIS:

ISSUE (1)

Section 461(a) provides that the amount of any deduction or credit allowed under subtitle A shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy (together, the "all events test"), and economic performance has occurred with respect to the liability.

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(2)(A) provides that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as such person provides such services or property. See also § 1.461-4(d)(2)(i). Section 1.461-4(d)(6)(i) provides that services or property provided to a taxpayer includes services or property provided to another person at the direction of the taxpayer.

Section 461(h)(3) (the "recurring item exception") provides that, notwithstanding the general rule of § 461(h), an item shall be treated as incurred during any taxable year if –

(i) the all events test with respect to such item is met during such taxable year,
(ii) economic performance with respect to such item occurs within the shorter of –
  (I) a reasonable period after the close of such taxable year, or
  (II) 8 ½ months after the close of such taxable year,
(iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and
(iv) either –
  (I) such item is not a material item, or
  (II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance

occurs.
See also § 1.461-5.

Under its present method of accounting, Taxpayer aggregates the warranty payments made during the taxable year, adds the payments made during the first 8 ½ months of the following year, and subtracts the payments made during the current year that were included in the prior year's warranty liability.[4] Taxpayer argues that its present method is proper because the all events test is met at the time a is sold by L to the Specifically, Taxpayer contends that its warranty liability is fixed at the time of sale because any defects in material and workmanship covered by the warranty exist at the time of sale.

The revenue agent argues that Taxpayer's warranty liability is not fixed when the is sold by L to the because several conditions precedent exist. Specifically, the agent argues that it is only after a performs a repair, properly files a claim, and receives approval from Taxpayer that a fixed warranty liability exists. The agent points to the specific documentation requirements set forth in the P as evidence that the claim filing and approval processes are not ministerial acts.

The agent has not specifically raised an issue with regard to whether the amount of Taxpayer's liability can be determined with reasonable accuracy at the time of the sale. Thus, the primary dispute between Taxpayer and the agent is when Taxpayer's liability for warranty repairs becomes fixed. Once the fixed liability determination is made, we must determine whether Taxpayer is using the proper economic performance rule with respect to its warranty liability.

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[4] Taxpayer's present method of accounting assumes that economic performance occurs as Taxpayer makes payments and that the recurring item exception applies to the warranty liabilities.

Whether Taxpayer's Liability is Fixed When the is Sold

Taxpayer's primary argument is that the existence of defects and its contractual obligation to correct those defects together fix Taxpayer's warranty liability at the time the is sold to the Taxpayer states:

> The Taxpayer's warranty is an express warranty. In essence it is a promise made by the Taxpayer to the purchaser . . . of the covered Generally speaking, the promise made by the Taxpayer is relied upon by every purchaser who enters into a contract for sale of a covered with the Taxpayer or a subsequent owner of the Because the Taxpayer's representation is relied upon by a party to the contract (i.e., the purchaser), the Taxpayer has a contractual duty to perform its promise. Such duty arises at the point in time the contract for sale is entered into by the Taxpayer (i.e., at the time of sale).
>
> Based on the fact that an obligation arises at the time of sale, either to a representative or to an independent customer, all events that fix the fact of the liability occur in the year the is first sold. Any future payments made for warranty repairs arise out of the enforceable promise made at the time of the initial sale, and out of a defect in materials or workmanship existing at the time of such sale.

In support of its position that its liability is fixed by its contractual obligation under the warranty, Taxpayer cites Ohio River Collieries Company v. Commissioner, 77 T.C. 1369 (1981), In Ohio River, the taxpayer engaged in strip mining coal in Ohio. Under Ohio law, strip miners were required to file a reclamation plan accompanied by a surety bond equal to the total estimated reclamation costs. The court held that the taxpayer could deduct its accrued reclamation costs under the all events test in the year in which the mining ceased rather than in the year in which the reclamation activities occurred. Other courts have held similarly. See Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951). In each of these cases, the taxpayer's liability for reclamation costs was fixed by a state law requiring strip miners to rehabilitate the land devastated by their mining operations. Further, the state in each case required strip miners to post a bond to cover their estimated reclamation costs. Thus, once the strip mining was performed, the reclamation liability was fixed by state law, and the strip miner was required to reclaim the land or forfeit the bond.

As the reclamation cases show, state statutes can create a fixed liability in certain situations. See also United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) (casino could deduct amounts guaranteed for payment on progressive slot machines but not yet won because the liability was fixed by state gaming regulations); Gold Coast Hotel & Casino v. United States, 158 F.3d 484 (9th Cir. 1997) (casino could deduct value of slot club points won by slot club member but not yet redeemed because the liability was fixed by state gaming regulations once a member accumulated a certain number of points).[5] However, the reclamation cases do not support Taxpayer's argument. These cases are factually distinguishable from Taxpayer's situation because Taxpayer's warranty liability is not fixed in advance, either by statute or by its warranty. Because of the bond posted by the strip miners in the reclamation cases, the miners would definitely either perform the reclamation and actually incur the costs or forfeit the bond. See, e.g., Ohio River, 77 T.C. at 1374 ("Either the strip miner performs the reclamation or he forfeits the bond. There is nothing whatever in this record to support respondent's argument that petitioner might do neither."). Thus, there were no condition precedents to the strip miner's liability after the strip mining had been performed, and it was merely a matter of time before payment was made by the strip miners, either through land reclamation or bond forfeiture. The Supreme Court has noted that the timing of payment is irrelevant when a taxpayer uses an accrual method of accounting. See Hughes, 476 U.S. at 604. In Taxpayer's case, however, it is not merely a matter of time before Taxpayer incurs costs related to its warranty liability. As more fully discussed below, there are several conditions precedent to the fixing of Taxpayer's liability.

Further, Taxpayer's argument is that its warranty liability is fixed by the mere existence of the warranty at the time of the sale. Even in cases where a taxpayer's liability was fixed by statute, the courts have looked to what event triggers the liability under the statute. For example, the reclamation cases do not hold that strip miners can deduct reclamation costs upon enactment of the strip mining statute or the mere existence of the statute. It was the strip mining itself, and not the statute alone, that created the reclamation liability. See Ohio River, 77 T.C. at 1374. Similarly, the taxpayers in Hughes and Gold Coast were not entitled to deduct their liabilities under state law until a condition precedent occurred that triggered the liability under the particular statute at issue. In Hughes, the event creating the taxpayer's liability was the last play of the machine before the end of the fiscal year, since that play fixed the jackpot amount irrevocably. 476 U.S. at 602. In Gold Coast, the taxpayer's liability was fixed under state law once a slot club member accumulated 1,200 points (the minimum amount needed to redeem a prize). 158 F.3d at 488. In neither case was the liability necessarily fixed by the mere existence of the statute.[6] Similarly, in this case, even

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[5] See also Kaiser Steel Corp. v. United States, 71 F.2d 1304 (9th Cir. 1983) (where state law imposed an obligation to provide workers compensation to employees, taxpayer could accrue future workers compensation payments when the injuries occurred); Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975) (same).

[6] See also Kaiser Steel, 71 F.2d at 1306 (even though state law required the taxpayer to provide workers compensation benefits to employees, the fact of the

though the warranty exists at the time a is sold, Taxpayer's liability under the warranty is not triggered until certain conditions precedent occur.

<u>Conditions Precedent to Taxpayer's Warranty Liability</u>

In its submission, Taxpayer states that "if the express promise offered by the Taxpayer at the time of the initial sale of the did not exist, and if a defect did not exist, no warranty repair cost would ever be incurred." We agree with Taxpayer's statement as far as it goes. These two conditions, however, (the existence of the warranty and the existence of the defect) are merely the first two conditions precedent that must be satisfied with regard to Taxpayer's warranty liability. Taxpayer's warranty creates a contractual obligation to make any repairs and adjustments to correct defects covered by the warranty during the warranty period. Thus, according to the specific terms of Taxpayer's warranty, its liability is not fixed merely by the existence of the warranty and the existence of the defect. Instead, Taxpayer's liability is contingent upon several additional conditions precedent that must occur to fix liability under the warranty.

In addition to the warranty and the existence of the defect, the first condition that must occur is that the must be sold by the to a customer. In addition, the defect must manifest itself to the customer within the warranty period. Further, the customer must decide to bring the to a for repairs and must actually bring the to a within the warranty period. Finally, the must repair the defects in the that are covered by the warranty. Thus, unless a provides repair services under the warranty (the last link in the chain of events creating a fixed liability), no warranty repair cost is ever incurred by Taxpayer.[7] Accordingly, Taxpayer's warranty liability is not fixed under the all events test unless and until the provides repair services under the warranty.

This conclusion is consistent with case law regarding future repair costs. For example, in <u>World Airways, Inc. v. Commissioner</u>, 62 T.C. 786, <u>aff'd</u>, 564 F.2d 886 (9th Cir. 1977), the taxpayer was an air carrier that was required to overhaul its aircraft at prescribed intervals in accordance with maintenance programs established by the Federal Aviation Administration. The taxpayer's program provided for the overhaul of its airframes and engines upon the completion of a prescribed number of flight-hours. No payments were required or made by taxpayer to the companies performing the

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liability was not established until the injury occurred); <u>Crescent Wharf</u>, 518 F.2d at 774 (same).

[7] The agent argues that additional conditions precedent are the filing a claim with <u>L</u> and <u>L</u> processing and approving the claim. As discussed more fully below, we disagree with the agent on this point.

overhauls unless and until an overhaul was actually performed by them. The taxpayer accrued and deducted as an expense a portion of the estimated costs for the future overhauls of its aircraft engines and airframes, based on the number of flight-hours. The court held that the estimated costs of the overhauls to be performed in future years were not fixed liabilities within the requirements of the all events test.

The taxpayer's position in World Airways is similar to Taxpayer's position in the instant case. In World Airways, the taxpayer argued that its liability for the estimated overhaul costs was fixed and definite at the end of each taxable year because at that time it was subject to an existing contractual obligation to TWA and APS (the companies performing the overhauls) for the payment of the accrued overhaul costs. 62 T.C. at 797. In response to this argument, the court stated:

> We think it clear, however, that there is no merit to this contention. While contracts with TWA and APS did exist during the relevant years, these contracts merely obligated TWA and APS to perform the overhauls at the appropriate future date and specified an overhaul expense per flight-hour to be used in computing the initial payment. . . . Petitioner was under no obligation to make any payment unless an overhaul was actually performed.

Id. See also Kaiser Steel, 717 F.2d at 1308 ("In [World Airways], however, involving the proper year for deduction of a reserve the taxpayer had established for airplane overhaul, the taxpayer was under no contractual obligation to make any payments unless the engines were actually overhauled. 62 T.C. at 802. Thus, no obligation to pay ever came into existence"). Similarly, in the instant case, unless and until a performs repair services under the warranty, Taxpayer has no obligation ever to make any payments under its warranty. See also Diversified Auto Services, Inc. v. Commissioner, T.C. Memo 1982-108 (1982) (taxpayer's warranty liability was not fixed because the taxpayer was under no obligation to make payment on the warranty unless and until certain conditions precedent were met); Bell Electric Co. v. Commissioner, 45 T.C. 158, 166 (1965) (taxpayer's warranty liability accrues when expenditures are in fact made or incurred in carrying out the obligations under the warranty).

<u>Whether the Filing and Approval of the Claim are Conditions Precedent</u>

Having determined that Taxpayer's warranty liability is fixed at the time the performs the repair services, we must address the revenue agent's argument that Taxpayer's liability is not properly accruable until the files a claim with <u>L</u> and <u>L</u> approves the claim. The agent contends that the approval of the claim is the last link in the chain of events creating a fixed liability. The agent states that, similar to the circumstances analyzed in <u>United States v. General Dynamics Corp.</u>, 481 U.S. 239 (1987), Taxpayer requires the to follow a very precise claim submission process that is not ministerial in nature. <u>General Dynamics</u> involved the submission of health insurance claims by employees to the taxpayer's self-insured health insurance plan. While the Court did not challenge the Claims Court's factual conclusion that the processing of the claims was "routine," "clerical," and "ministerial" in nature, it held that a claim must be submitted in order for the liability to reimburse employees for medical expenses to be fixed under the all events test. The Court noted that some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Thus, the filing of the claim was not a mere technicality.

In the instant case of warranty liabilities, the agree beforehand to provide warranty services and to conform their warranty services to the standards set by <u>L</u>. The specifically states that, for a performance of warranty repairs, <u>L</u> will pay the for parts and accessories or will provide the with parts and accessories required in connection with the repairs and will pay for labor in accordance with the provisions set forth in the Further, <u>L</u> provides the with guidelines for determining whether a repair is covered by warranty and lists the items not covered by warranty. Thus, the inform customers that the repairs are covered by the warranty and undertake to provide repair services for under warranty with the understanding that they will be paid by <u>L</u> for these services. There is no reason for the not to seek payment for the repairs they determine are covered by warranty. In this context, a submission of a claim is merely verification that the event establishing the fact of Taxpayer's liability (the provision of warranty repair services) has occurred. Thus, the filing of the claim by the is a ministerial act, not a condition precedent that is necessary to establish Taxpayer's liability. <u>See</u> Rev. Rul. 98-39, 1998-33 I.R.B. 4 (accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year in which the services are performed, even though the retailer does not submit the required claim form until the next year).

Moreover, approval of the claim is not a condition precedent to Taxpayer's liability. The agent points out that L reserves the right to deny all or any part of a claim on the basis of inaccurate or misrepresented information, improper repair procedures, or failure to comply with warranty preparation, submission, or documentation requirements. However, Taxpayer has represented that, in general, L makes every effort to satisfy all valid warranty claims and that the number of claims received from the and ultimately rejected by L (and consequently not paid by L) is de minimis.[8] Taxpayer's representation is supported by L's practice of mailing status reports to twice a month, which contain information on accepted, pending, and rejected warranty claims. Accepted claims are claims that are accepted for payment. Pending claims are claims that require minor correction and resubmission before payment is possible. Rejected claims are claims that require complete resubmission or entry due to major claim errors. The content of these status reports, primarily the information regarding rejected claims, support Taxpayer's representation that it attempts to satisfy all warranty claims and that the number of claims ultimately rejected (after a has been given the notice and opportunity to correct claims that are initially rejected) is de minimis.[9] Thus, the approval of a claim is also a ministerial act and does not prevent Taxpayer's liability from being fixed when the provides repair services covered by the warranty.

Economic Performance

Under its present method of accounting, Taxpayer aggregates the warranty payments made during the taxable year, adds the payments made during the first 8 ½ months of the following year, and subtracts the payments made during the current year that were included in the prior year's warranty liability. Thus, Taxpayer's present method of accounting assumes that its warranty liability is fixed when the is sold, that economic performance occurs as payment is made, and that the recurring item exception applies to its warranty liabilities. We have determined that Taxpayer does not have a fixed liability when the is sold, but instead has a fixed liability when the performs repair services under the warranty. Thus, the remaining

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[8] As noted above, the Supreme Court in General Dynamics did not challenge the Claims Court's factual conclusion that the processing of employee's medical claims was "routine," "clerical," and "ministerial in nature." The Claims Court made these findings despite the fact that approximately 10% of claims were rejected by the claims administrators and ultimately were not paid.

[9] If Taxpayer properly accrues a warranty liability when the performs repair services but L ultimately rejects the claim filed by the Taxpayer must report in income the amount of the warranty liability it previously accrued.

question is whether Taxpayer is using the proper economic performance rule with respect to its warranty liability.

Section 461(h)(2)(A) provides that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as such person provides such services or property. See also § 1.461-4(d)(2)(i). Section 1.461-4(d)(6)(i) provides that services or property provided to a taxpayer includes services or property provided to another person at the direction of the taxpayer. In the instant case, Taxpayer (through L) directs the to provide repair services to customers who own under warranty. Thus, Taxpayer's liability arises out of the providing of repair services to Taxpayer by another person (the) and economic performance occurs as the provide repair services. Taking this conclusion into consideration with our conclusion regarding when Taxpayer's warranty liability is fixed, Taxpayer should accrue its warranty liability when the repair services are provided by the At the time the repair services are provided, the fact of the liability has been established, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[10]

ISSUE (2)

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. In determining whether a taxpayer's accounting treatment of an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. See Rev. Proc. 91-31, 1991-1 C.B. 566.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year, if the computation is under a method of accounting different from the

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[10] Because we have concluded that the all events test and economic performance occur at the same time, the recurring item exception is not applicable.

method under which the taxpayer's taxable income for the preceding taxable year was computed, there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. See also § 1.481-1(a)(1). Section 1.481-1(a)(1) provides that a change in method of accounting to which § 481 applies includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item.

As a result of our determination that Taxpayer accrues its warranty liability prematurely, Taxpayer is required to change the time at which it deducts the warranty liability for federal income tax purposes. Taxpayer presently treats the all events test as being met when the   is sold and treats economic performance as occurring when payments are made. Taxpayer also uses the recurring item exception to the economic performance rules. Under the proper treatment for its warranty liability, Taxpayer will treat the all events test as being met when the repair services are provided, and will also treat economic performance as occurring at that time. Under this treatment, Taxpayer will not be using the recurring item exception to the economic performance rules. As a result of this change in treatment, part of Taxpayer's warranty liability will be deferred from one year to a later year or years. This change constitutes a change in the proper time for the taking of a deduction. This change will have no affect on Taxpayer's total lifetime income, but may change the taxable year in which Taxpayer deducts its warranty liability expenses. Moreover, the new timing rule will be applied consistently to all of Taxpayer's warranty liability expenses, whether the expense is incurred under the new timing rule in a prior, the current, or a subsequent taxable year. Thus, this change in treatment constitutes a change in method of accounting. § 1.446-1(e)(2)(ii)(a).

At the conference, Taxpayer's representatives suggested that the agent's proposed change may not be a change in method of accounting. Taxpayer's representatives noted that the regulations under § 446 recognize that there are some changes that involve the question of the proper time for the taking of a deduction, but that are not considered accounting method changes. Taxpayer's representatives also noted that there have been court cases where the taxpayer was required or permitted to change the time at which a deduction was taken or income was reported, but the courts nonetheless found that the change was not a change in method of accounting. Taxpayer's representatives declined to explain why the change in the instant case was not a change in method of accounting, but remarked that the agent's position would be inconsistent with the Tax Court's decision in Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988).

After considering all relevant authorities, we conclude that the timing change in this case constitutes a change in method of accounting. It does not fall within any of the exceptions set forth in the § 446 regulations and is not similar to any court case concluding that a timing change was not a change in method of accounting. For the sake of brevity, we discuss only the court case mentioned by Taxpayer's representatives.

In Hallmark Cards, the taxpayer's standard contract for the sale of merchandise provided that title transferred upon shipment to the customer. Valentine merchandise was shipped to customers in the later part of the year preceding Valentine's Day. The terms of contracts for the sale of Valentine merchandise, however, provided that title to the merchandise would transfer on January 1 of the following year.[11] The taxpayer reported sales of merchandise in the taxable year in which title transferred under the terms of the applicable contract. The Service argued that the title transfer provision in the Valentine merchandise contracts was a ministerial act or formality and the sale occurred no later than December 31 of the year of shipment. The Service also argued that the taxpayer used an impermissible hybrid method to account for sales of merchandise. According to the Service, the taxpayer's predominant method of accounting for merchandise sales was the "shipment method" whereby sales were reported upon shipment of the merchandise, but the taxpayer used the "title method" whereby sales were reported when title transferred to report sales of Valentine merchandise. The Tax Court held that the taxpayer had consistently reported sales of merchandise at the time of title transfer. Although the different terms of the Valentine merchandise contracts deferred the taxable year in which sales of Valentine merchandise was reported, the proper time for reporting sales of merchandise, i.e., upon transfer of title, remained constant.

Hallmark Cards provides no relief to Taxpayer for two reasons. First, there has been no change in the underlying facts. Taxpayer has not modified its agreements with its customers in a way that would change the taxable year in which its warranty liability accrues.[12] Thus, the agent will not apply Taxpayer's existing method of accounting to new or different facts. Instead, the agent will apply a new timing rule to the established facts. Second, when a change in underlying fact occurs, there is no need for an adjustment to prevent duplications or omissions because none will occur. Income or deductions from all transactions, whether occurring before and after the change in underlying fact, will be reported at the appropriate time under the taxpayer's established

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[11]Prior to 1958, all of the taxpayer's merchandise sale contracts provided for title transfer upon shipment. The taxpayer modified its Valentine sale merchandise contracts in 1958.

[12]In addition, there is no evidence of any other type of change in Taxpayer's underlying business operations that would change the taxable year for deductions of warranty liability expenses.

accounting method.[13] Thus, even if the facts of this case presented a change in underlying fact in a year under examination, Taxpayer would avoid the application of § 481 but would not be entitled to deduct any warranty liability deducted in a prior year. The amount of warranty liability expense deductible in the year in which the underlying fact changed would not include any amount that was deducted in the immediately preceding taxable year or any amount that would be deductible in later taxable years. Thus, warranty liability deductions taken by Taxpayer in the year in which the underlying fact changed would be reduced, which would, in turn, increase Taxpayer's taxable income by a like amount.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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[13] See § 1.446-1(e)(2)(iii) Example 3; Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988); Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq., 1967-2 C.B. 2. In contrast, when a change in method of accounting occurs, the new method of accounting will be applied beginning in the year of change as if the taxpayer had always used the new method of accounting. Some transactions that were accounted for under the prior method of accounting may be accounted for a second time under the new method of accounting. Some transactions that were not accounted for under the prior method of accounting may also not be accounted for under the new method of accounting. Consequently, income or deductions from transactions occurring before the transaction may be omitted or duplicated.