INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-119433-99/CC:DOM:IT&A:B7

Chief, Appeals Office

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

X =
Y =
Year 1 =
Year 2 =
Year 3 =

ISSUE:

Does the modification that X seeks to make to its Year 1 and Year 2 allocation of its basis in certain mortgages between mortgages sold and mortgage servicing rights retained, in situations where section 1286 of the Internal Revenue Code applies, constitute the correction of an error or a change in X's method of accounting?

CONCLUSION:

The change in the methodology used by X in Year 1 and Year 2 to allocate basis between mortgages sold and mortgage servicing rights retained involves a change in X's method of accounting under section 446(e), which requires the consent of the Commissioner. X may not change from its established method of accounting by filing amended returns, even though the method that it had previously utilized was not consistent with the requirements of Rev. Rul. 91-46, 1991-2 C.B. 358, Rev. Proc. 91-50, 1991-2 C.B. 778, and section 1286.

FACTS:

X is a wholly owned subsidiary of Y. X uses an overall accrual method of accounting and is included in consolidated federal income tax returns filed by Y. X is engaged in the mortgage banking business. As a mortgage banker, X originates mortgages for sale in the secondary mortgage market and sells and services mortgages. Mortgages are originated in two ways, either directly by X, or alternatively by a third party mortgage originator and then acquired by X. Mortgages originated under both methods are pooled by X and sold into the secondary mortgage market. X typically retains the right to service the mortgages sold.

Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 contain rules which are applicable to mortgage servicing contracts. Rev. Rul. 91-46, which applies to taxpayers who sell mortgages and at the same time enter into a contract to service the mortgages for amounts received from interest payments thereon, provides special rules, in conjunction with section 1286, that apply when a mortgage servicing contract entitles a taxpayer to receive amounts that exceed reasonable compensation for the services to be performed. Rev. Proc. 91-50 provides an elective safe harbor for determining the extent to which amounts that a taxpayer is entitled to receive under a mortgage servicing contract represent reasonable compensation for the services to be provided.

X filed a Form 3115, Application for Change in Accounting Method, with Y's Year 1 consolidated return and obtained consent, pursuant to the automatic consent procedures of Rev. Proc. 91-51, 1991-2 C.B. 779, to change its method of accounting in relation to mortgages sold where it retained mortgage servicing rights, effective for its Year 1 taxable year, to a method in accordance with Rev. Rul. 91-46 and section 1286. X also made an election, effective for its Year 1 taxable year, to apply the safe harbor rules of Rev. Proc. 91-50 to amounts received under mortgage servicing contracts by attaching a statement to that effect to the Year 1 return.

In its Year 1 and Year 2 taxable years, X applied the new method of accounting (compliance with the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286) only to mortgages that were originated by it directly. X did not apply the new method to mortgages originated by third parties. X accounted for these mortgages in its Year 1 and Year 2 tax returns as though no change in accounting method was ever made. X continued to allocate a portion of the purchase price of mortgages sold to retained mortgage servicing rights regardless of whether or not excess servicing charges existed.

X filed another Form 3115 and received consent to an additional change in its method of accounting, which involved the method of computing the amount of basis to be allocated to retained mortgage servicing rights, effective for its Year 3 taxable year. X had been allocating its total basis in mortgages originated by third parties and then acquired by X between the mortgages that it sold in the secondary market and the mortgage servicing rights which it retained in a manner inconsistent with the requirements of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286. Under X's new method of accounting, X began to allocate a portion of the basis in an acquired mortgage to retained mortgage servicing rights only when and to the extent required by Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286. This change, granted pursuant to the terms of Rev. Proc. 91-51, was implemented on a cut-off basis and thus covered only mortgages sold on or after the first day of Year 3, the year of change. The method of accounting for mortgages sold before Year 3 was not affected by the change and no section 481(a) adjustment was involved.

Y filed amended returns for its Year 1 and Year 2 taxable years, based upon its purported correction of an error in those returns. Y seeks to "correct" X's allocation of the basis of purchased mortgages between mortgages sold in Year 1 and Year 2 and mortgage servicing rights retained, which occurred in connection with the asserted failure to allocate basis in a manner that complied with the requirements of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286. X contends that it allocated too much basis to retained mortgage servicing rights and too little basis to mortgages sold. A change in basis allocation, relating to the mortgages sold in Year 1 and Year 2, would give rise to an adjustment in the amount of gain or loss which had to be recognized in those years. It is this adjustment to gain or loss which is reflected in the amended returns filed by Y. Y is also seeking to adjust the tax basis of mortgage servicing rights retained by X in Year 1 and Year 2 which would then be carried into subsequent taxable years.

LAW AND ANALYSIS:

Section 446(e) and section 1.446-1(e)(2)(i) of the Income Tax Regulations require that, except as otherwise expressly provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

Section 1286 provides for the tax treatment of stripped bonds. Rev. Rul. 91-46 explains the application of section 1286 to certain mortgage transactions.

Section 1.446-1(e)(2)(ii)(a) provides that a change in the 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 used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. 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.

Section 1.446-1(e)(2)(ii)(b) 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). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item in income or the taking of a deduction.

Certain mortgage transactions engaged in by X trigger the application of section 1286, which provides for the tax treatment of stripped bonds. Rev. Rul. 91-46 provides that the sale of a mortgage, if mortgage servicing rights are retained which involve the receipt from interest payments of amounts in excess of reasonable compensation for services to be rendered, is a transaction subject to the provisions of section 1286. When this occurs, the mortgages sold are “stripped bonds” and the retained rights to receive mortgage interest other than as reasonable compensation for services to be performed are “stripped coupons” within the meaning of, and subject to the requirements of, section 1286. Section 1286(b) then applies to determine the proper allocation of the basis in the mortgages immediately before sale between the mortgages sold (bonds) and excess servicing rights retained (coupons), as indicated in Rev. Rul. 91-46.

X had permission to apply the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 to the sale of all mortgages where excess servicing rights were retained, beginning with its Year 1 taxable year. X had received consent to use the method of accounting prescribed by Rev. Rul. 91-46 and section 1286 as a result of its filing pursuant to Rev. Proc. 91-51. X had also made a valid election to use the safe harbor provisions of Rev. Proc. 91-50 to determine the extent to which amounts that it was entitled to receive under mortgage servicing contracts represented reasonable compensation for services to be rendered. Any amounts which were to be received in excess of the safe harbor amount should have been accounted for as a stripped coupon, as provided by Rev. Proc. 91-50.

However, for Year 1 and Year 2, X applied the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 only to the sale of mortgages originated by it directly. X did not apply these provisions to the sale of mortgages originated by and acquired from third parties. Instead, X continued to apply its previous method of accounting when making basis allocations between mortgages sold and mortgage servicing rights retained upon the sale of mortgages originated by third parties. X asserts that this method produced basis allocations which did not comply with the requirements of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286. The issue presented in this case is whether a change from the method that X actually used in Year 1 and Year 2 to account for the sale of mortgages originated by third parties where excess servicing rights were retained to the method required by Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 involves the correction of an error or a change in method of accounting.

As provided in section 1.446-1(e)(2)(ii)(a), a change in method of accounting includes a change in the treatment of any material item. A material item is defined therein as any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. If a taxpayer’s accounting practice does not permanently affect 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. 99-49, 1999-52 I.R.B. 725; Rev. Proc. 91-31, 1991-1 C.B. 566. X's allocation of its basis in mortgages originated by third parties between mortgages sold and mortgage servicing rights retained affects the taxable year in which income is reported. Thus, X's accounting practice relative to these mortgages involves timing and represents a method of accounting.

The existence of a method of accounting is also established by X's consistent application of an impermissible method of accounting in Year 1 and Year 2 for the sale of mortgages originated by third parties where excess servicing rights were retained. The treatment of a material item in the same way in determining gross income or deductions in two or more consecutively filed tax returns, without regard to whether the method used is permissible or impermissible or any subsequent change in such status, represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(ii)(a) and establishes a method of accounting for purposes of section 1.446-1(e)(2)(i). Rev. Proc. 99-49; Rev. Rul. 90-38, 1990-1 C.B. 57. Although X had permission to apply the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 to the Year 1 and Year 2 sale of mortgages originated by and then acquired from third parties, and in fact was required to do so, X did not. The method of accounting actually and consistently applied in those two tax years, which was also the same method used prior to Year 1, represents X's method of accounting for that material item.

Rev. Proc. 91-51 provides that a change to comply with the requirements of Rev. Rul. 91-46 and section 1286 is a change in method of accounting. X sought and received consent to a change in method of accounting relative to the sale of mortgages originated by third parties for Year 3. Any change to the method used in Year 1 and Year 2 likewise would involve a change in method of accounting, not the correction of an error.

Section 446(e) and section 1.446-1(e)(2)(i) provide that a taxpayer must secure consent before changing a method of accounting, whether or not such method is proper or is permitted under the Code or the regulations. Amended returns may not be used to change a method of accounting, even if the method previously applied was erroneous. See Rev. Rul. 90-38, which held that a similarly situated taxpayer could not retroactively change from an erroneous to a permissible method of accounting by filing amended returns. Instead, the taxpayer was required to secure consent to a change in method of accounting. See also Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990), where the court determined that a change in the taxpayer's classification of certain property was a change in method of accounting requiring consent, and that any claim for refund by way of amended returns would represent an impermissible change in method of accounting. The court noted that even if the prior method was erroneous, any correction would still be considered a change in method of accounting to which consent would be required. Id. at 1583. Accord Commissioner v. O. Liquidating Corporation, 292 F.2d 225, 231 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961) .

X argues that it should be permitted to correct an error in its application of Rev. Rul. 91-46, Rev. Proc. 91-50 and section 1286 by extending its use of these provisions to sales of mortgages originated by third parties and sold in Year 1 and Year 2 in cases where excess servicing rights were retained. Correction of an error is defined in section 1.446-1(e)(2)(ii)(b) to 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). However, what X is attempting to do is not in the nature of the correction of a mathematical or posting error or an error in the computation of tax liability. Instead, X is seeking to change the method by which it allocates the basis of mortgages originated by third parties between mortgages sold and mortgage servicing rights retained. This change affects the treatment of a material item which had been accounted for up to that point on a consistent basis and thereby constitutes a change in method of accounting.

Despite the relatively narrow definition of an error in the regulations, there have been a few cases where courts have deemed a change in the treatment of items that had initially been accounted for in a manner inconsistent with an overall election to constitute the correction of an error and not a change in method of accounting. X relies on these cases, coupled with the language in section 4.04 of Rev. Proc. 91-50 which indicates that the safe harbor election is applicable to all contracts, in support of its position. X argues that it is merely correcting an error in order to conform with its election. However, this position is clearly inconsistent with the definition of an error in section 1.446-1(e)(2)(ii)(b) and the terms of section 1.446-1(e)(2)(ii)(a), which provides that consistent treatment of a material item establishes a method of accounting. The Service has previously indicated that it does not agree with the position that correction of an error, not a change in method of accounting, is involved in situations where some items were treated in a manner inconsistent with an overall election, as is noted in the examination of the primary cases that X relies on which follows.

Gimbel Brothers, Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), involved a taxpayer that had made an election to use the installment method. However, the taxpayer had previously excluded a certain type of charge account from its application of the installment method. It is important to note that it was then the policy of the Internal Revenue Service that sales made on that type of account did not qualify for installment reporting. This policy was later changed, in response to a court decision, by the issuance of new regulations. The taxpayer filed refund claims, arguing that extension of the installment method to the excluded charge accounts in the years covered by its election of the installment method involved the correction of erroneous reporting. The court held that the taxpayer’s election covered all installment sales, which encompassed sales on the excluded accounts, and that extension of the installment method thereto represented the correction of an error and not a change in accounting method. The court in Gimbel Brothers appeared to be influenced by the taxpayer’s adherence to the former policy of the Service and a desire, given the policy change, to grant the taxpayer the full benefit of the installment statute, which would allow it to defer the obligation to pay taxes until the proceeds of sale were received and avoid any difficulty and uncertainty involved in valuing a multitude of department store accounts. Rev. Rul. 90-38 states that the Service will not follow Gimbel Brothers.

In Standard Oil Company (Indiana) v. Commissioner, 77 T.C. 349 (1981), acq. in result, 1989-2 C.B. 1, the taxpayer had elected to deduct intangible drilling costs but had capitalized certain "other" costs of constructing offshore drilling platforms. The court characterized the taxpayer's requested revision of its previous treatment of these other costs as a correction of its failure to report similar items consistently and not a change in accounting method. The Service acquiesced in Standard Oil in result only, since, as was the case in Gimbel Brothers, it does not follow the reasoning which permits correction of an error in the case of less than complete application of an election. Thus, the rationale upon which X attempts to rely has been consistently rejected by the Service.

Finally, X believes that Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320, supports its position. X argues that, like the taxpayer in Convergent Technologies, it should not be required to obtain consent to make its change and that the question of whether it had the opportunity to regularly use the method of accounting to which it had permission to change in Year 1 should be a consideration. However, X's situation is distinguishable from that in Convergent Technologies, where the court stated that characterization, not timing, was involved. The court determined that the taxpayer's earlier method and the method advocated by the Commissioner were both erroneous and did not clearly reflect income. In addition, particular importance was placed on the fact that the Commissioner was trying to impose a different method on the taxpayer, a context in which the court believed consent would not be required. Based on those specific facts, the court permitted a change to what it believed was a proper method without consent. In X's case, the Service is not challenging X's method of accounting and attempting to impose a different method on it, as was the situation in Convergent Technologies. Instead, the Service is merely requiring X to obtain consent before changing from its existing method of accounting, in accordance with the clear requirements of the Code and regulations. In addition, X consistently used the method from which it seeks to change not only in Year 1 and Year 2 but previously, which is a time interval that without question establishes it as a method of accounting.

Consistent but improper treatment by X of mortgage basis allocations, a material item, in Year 1 and Year 2 gave rise to a method of accounting. Any change in a method of accounting requires consent. X's use of an impermissible method of accounting for its basis in mortgages sold in Year 1 and Year 2 does not qualify as an error which can be corrected through the filing of amended returns for those years.

CAVEATS:

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