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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: PAUL F. KUGLER
ASSOCIATE CHIEF COUNSEL (Passthroughs & Special Industries) CC:PSI

SUBJECT: Depreciation Method Change

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LEGEND

Taxpayer	=
A	=
B	=
C	=
D	=
E	=
Date 1	=
Date 2	=
Year 1	=
$a	=
$b	=
$c	=
$d	=
a	=
b	=

ISSUE

Whether the reallocation of basis from a depreciable asset to a nondepreciable asset constitutes a change in method of accounting.

CONCLUSION

A reallocation of basis from a depreciable asset to a nondepreciable asset results in a change in the timing of basis recovery and constitutes a change in method of accounting.

FACTS

C is a bank holding company and parent corporation of A and B, both wholly owned subsidiaries. Together, these entities make up the consolidated group which is known as Taxpayer. In Year 1, the tax year at issue, Taxpayer filed a consolidated corporate income tax return (Form 1120).

On Date 1, A purchased certain assets and assumed certain liabilities of D, a savings and loan institution. At the time, D was in receivership and was being liquidated by the Resolution Trust Corporation. On Date 2, B purchased certain assets and assumed certain liabilities of certain branches of E, a savings and loan institution. Both A and B paid a premium for the assets acquired; A paid a premium of $a for the assets of D and B paid a premium of $b for the assets of E.

In connection with the acquisitions of D and E, Taxpayer engaged an accounting firm to determine the value of the core deposit intangible asset acquired. The firm valued D and E’s core deposits to be $c and $d, respectively. The firm also estimated the useful life of the core deposits to be a years and b years, respectively.

In accordance with section 1060 as in effect at the time of the acquisitions, and utilizing the values assigned by the firm, Taxpayer allocated a portion of the premiums paid by A and B to the core deposit intangible, a depreciable Class III asset. The balance of the premiums paid was allocated to goodwill and going concern value, a nondepreciable Class IV asset. Commencing with the year each institution was acquired, and for each year thereafter, including the year at issue, Taxpayer claimed core deposit depreciation deductions under section 167 based upon the economic life established for the core deposits. Taxpayer did not depreciate the premium allocable to goodwill.

The Agent examining the acquisitions determined that Taxpayer overstated the fair market value of the core deposits acquired. Accordingly, the Agent disallowed the excess amount of the core deposit allocation and reallocated this amount to goodwill and going concern, a nondepreciable Class IV asset. In connection with the reallocation, the Agent also proposed a section 481(a) adjustment to disallow the net excess depreciation claimed by Taxpayer for the property in the taxable years before Year 1, which are closed under the period of limitation for assessment.

LAW AND ANALYSIS

A change in method of accounting is 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. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A “material item” is any item involving the proper time for the inclusion of the item in income or the taking of a deduction. Id. In determining whether timing is involved, the pertinent inquiry is whether the accounting practice permanently affects the taxpayer’s lifetime income or merely changes the taxable year in which taxable income is reported. See Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Rev. Proc. 97-27, 1997-1

C.B. 680, 681; Rev. Proc. 91-31, 1991-1 C.B. 566. If the practice merely changes the taxable year in which the income is reported and does not permanently affect lifetime income, the practice is a change in method of accounting.

Conversely, Treas. Reg. § 1.446-1(e)(2)(ii)(b) sets forth several adjustments that will not be considered a change in method of accounting, including:

(1) a 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);
(2) an adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction (i.e., corrections of items that are deducted as interest or salary but which are in fact payments of dividends, and of items that are deducted as business expenses but which are in fact personal expenses);
(3) an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset; and
(4) a change in treatment resulting from a change in underlying facts.

Treas. Reg. § 1.446-1(e)(2)(ii)(b) further provides that a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item and is to be treated as a change in method of accounting.

If a taxpayer's practice involves timing, a change from that practice is a change in method of accounting only if the taxpayer has adopted that practice.
Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that in most instances a method of accounting is not established for an item without such consistent treatment. For purposes of this regulation, the erroneous treatment of a material item in the same way in two or more consecutively filed tax returns represents consistent treatment of that item. See Rev. Proc. 97-27, 1997-1 C.B. 680, 681, § 2.01(2); Rev. Rul. 90-38, 1990-1 C.B. 57.

In the present case, the Agent proposes to adjust Taxpayer's return by adjusting a portion of the allocated cost of the asset from a depreciable Class III intangible asset (core deposits) to a nondepreciable Class IV asset (goodwill and going concern value). According to the Agent, Taxpayer erroneously treated this portion of the allocated cost of the asset as a depreciable Class III asset on its original federal tax returns for two or more consecutive years. Thus, Taxpayer has erroneously adopted depreciable property treatment as the method of accounting for the property at issue.

Taxpayer's erroneous treatment of the allocated cost of this asset as a depreciable Class III asset on its original federal tax return affects when, not whether, Taxpayer's cost of that asset will be deducted. By treating the asset as a depreciable Class III asset, Taxpayer was deducting the cost of the asset through depreciation deductions over the useful life of the asset. If Taxpayer had treated the asset as a nondepreciable Class IV asset, Taxpayer would deduct its cost at the time of disposition. Under either treatment, Taxpayer is entitled to the same basis recovery for the cost of the asset, but in different taxable years. Consequently, Taxpayer's erroneous treatment of the cost of the asset as a depreciable Class III asset on its original returns involves the timing of deductions. Thus, a change from treating the asset as a depreciable Class III asset, where the basis of the property is recovered through depreciation deductions over its useful life, to treating such property as a nondepreciable Class IV asset, where the basis of the asset is recovered at the time of its disposition, is a change in method of accounting under section 446(e) and the regulations thereunder.

The court's holding in Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989), aff'g 16 Cl.Ct. 193 (1989), cert. denied, 498 U.S. 823 (1990), supports the conclusion that the proposed change is a change in method of accounting. In Diebold, the taxpayer had treated replacement modules for automated bank teller machines as inventory on its original returns for the years in issue. The taxpayer subsequently filed amended returns treating the modules as capital assets and claiming depreciation deductions. The Federal Circuit held that the reclassification from inventory property to depreciable property is a change in method of accounting. The court explained:

> [T]here is no question that a change from treating the replacement modules as nondepreciable inventory, where there is no deduction until the modules are removed from service, to treating them as capital assets, where there is a depreciation deduction in each year of useful life, raises the question of the taxable year in which income is reduced by the cost or a portion of the cost of manufacturing the replacement modules, that is, a question of timing.

891 F.2d at 1583. If a change from nondepreciable property to depreciable property is a change in method of accounting, it follows that a change in the other direction is also a change in method of accounting.

Arguably, a change from treating the asset as a depreciable Class III asset to treating such property as a nondepreciable Class IV asset may involve a change in the characterization of the property and, as a result, may not be a change in method of accounting. See Saline Sewer Co. v. Commissioner, T.C. Memo. 1992-236 (whether fees from customers were nontaxable contributions to capital under section 118 or taxable customer connection fees); Coulter Elecs., Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd without published opinion, 943 F.2d 1318 (11th Cir. 1991) (whether transfers of leases to a bank constituted sales or pledges for loans). The Service, however, has rejected the argument that the accounting method provisions, including section 446(e), are not operative whenever an issue involves characterization. Section 2.01(3) of Rev. Proc. 97-27 states that a change in the characterization of an item may constitute a change in method of accounting if the change has the effect of shifting income from one period to another. Thus, a change in characterization that does not permanently affect taxable income but only its timing is a change in method of accounting.

The Service's position in section 2.01(3) of Rev. Proc. 97-27 is supported by the regulations and case law under section 446(e). Treas. Reg. 1.446-1(e)(2)(ii)(b) excludes from the accounting method rules only those characterization issues that permanently affect net income. As examples of these issues, the regulations mention: (1) whether payments are deductible interest or salary rather than nondeductible dividends; and (2) whether payments are deductible business rather than nondeductible personal expenses. The case law confirms that a change in characterization that does not permanently affect a taxpayer's lifetime taxable income but only its timing is a change in accounting method. See Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989) (a change from nondepreciable inventory to depreciable property is a change in method of accounting); Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993) (a change from "working gas" (inventory) to "cushion gas" (capital asset) is a change in method of accounting); Standard Oil Co. v. Commissioner, 77 T.C. 349, 410-411 (1981) (a change in depreciation method resulting from a change from section 1250 property to section 1245 property is a change in method of accounting); and H.E. Butt Grocery Co. v. United States, No. SA-98-CA-336-EP, 1999 U.S. Dist. LEXIS 20985 (W.D. Tex. July 30, 1999) (a change in the method of computing depreciation resulting from a change in classification under section 168(e) is a change in method of accounting).

Furthermore, the court in Cargill Inc. v. United States, 91 F. Supp. 2d 1293, 1298, (D.Minn. 2000), expressly rejected the argument that a "characterization exception" to the accounting method rules exists. The facts of Cargill involved a sale versus lease issue where the taxpayer attempted to change its treatment of the costs associated with the lease or sale from a current deduction for rental payments on a lease to capitalization of the payments and accelerated depreciation deductions for the purchase of an asset. To avoid the consent requirement of section 446(e), the taxpayer argued that the change it proposed was not a change in its "method of accounting" because it was only a change in the characterization of its interest. The court criticized and distinguished the holding in Coulter Elecs., Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd without published opinion, 943 F.2d 1318 (11th Cir. 1991), as well as the relevant holdings in Underhill v. Commissioner, 45 T.C. 489, 496-97 (1966), and Standard Oil Co. v. Commissioner, 77 T.C. 349, 382-83 (1981), on which the taxpayer relied, and stated that section 446(e) requires consent whenever the treatment of an item has timing consequences, unless there is an express provision to the contrary. Cargill, 91 F. Supp. 2d at 1298. The court found no provision of the Code containing a "characterization exception" to the consent requirement and held that the taxpayer's proposed change was a change in method of accounting that required the consent of the Commissioner under section 446(e). Id. at 1298.

In the present case, the change from treating the asset as a depreciable Class III asset to treating such property as a nondepreciable Class IV asset involves the timing of deductions. Thus, even if this change is a change in characterization, a change in method of accounting occurs in accordance with section 446(e) and the regulations thereunder and section 2.01(3) of Rev. Proc. 97-27.

Moreover, in the present case, none of the exceptions under Treas. Reg. § 1.446-1(e)(2)(ii)(b) apply. The change in treatment from depreciable property to nondepreciable property is not due to a change in underlying facts or to a correction of mathematical or posting errors. Even though Taxpayer erroneously valued the core deposit intangible, the proposal to change the valuation constitutes a change in method of accounting, and not a correction of an error, because such adjustment involves timing. See First Nat'l Bank of Gainesville v. Commissioner, 88 T.C. 1069 (1987); Rev. Rul. 77-134, 1977-1 C.B. 132. But see, Korn Industries, Inc. v. United States, 209 Ct. Cl. 559, 532 F.2d 1352 (1976); and Diebold, Inc. v. United States, 16 Cl. Ct. 193, 204 (1989).

Since the Agent proposes to adjust the treatment of a portion of the basis of the core deposit asset from a depreciable Class III asset to a nondepreciable Class IV asset, resulting in a change from recovering such basis through depreciation deductions over the property's useful life to recovering the basis at the time of the property's disposition, a change in method of accounting results and a section 481(a) adjustment is appropriate.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This Field Service Advice responds only to the question in the incoming request of whether a reallocation of basis from a depreciable asset to a nondepreciable asset constitutes a change in method of accounting. However, after reviewing the facts included in the request, we are concerned that the agent may be taking an incorrect position as to the reallocation. In the incoming request, we are told that the agent determined that the value of the core deposits should not have included the money market accounts and certificates of deposit, and accordingly, the value of the money market accounts and certificates of deposit were reallocated for basis purposes to nondepreciable goodwill and going concern. In light of Newark Morning Ledger v. United States, 507 U.S. 546 (1993), we do not recommend taking the position that the money market accounts and certificates of deposit at issue in the core deposit valuation are nondepreciable assets simply because they do not constitute part of the core deposit intangible. The Court in Newark Morning Ledger held that as long as a taxpayer can establish that a particular asset can be valued and that it has a limited useful life, a taxpayer may depreciate the value of the asset over its useful life. Id. at 566. While the money market accounts and the certificates of deposit at issue do not meet the definition of a "core deposit," they are a deposit base intangible, and, if valued and lifed, are depreciable assets. [redacted]

Please call if you have any further questions.

By: ____________________________

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