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Internal Revenue Service

Employee Plans Technical Advice Memorandum

T:EP:RA:A

Taxpayer =
Taxpayer's Address =

Taxpayer's Identification Number =
Years Involved = 1990 – 1992

Issue

Whether an examination imposed change in the proper time for deducting contributions made to collective bargained pension plans is a change in method of accounting?

Facts

Taxpayer filed its tax returns on a fiscal year basis with a taxable year ending on the last day of February.[1] Taxpayer makes contributions to various multi-employer pension plans pursuant to negotiated collective bargaining agreements.[2] The pension plans are qualified within the meaning of § 401 of the Code. Contributions to the plans are required to be made on a monthly basis in accordance with the terms of the contracts with the unions.

Prior to the tax year 8102, Taxpayer's deductions for pension contributions were based on contributions made to the pension plans on account of hours of service performed during the taxable year. Beginning with tax year 8102, Taxpayer deducted not only the contributions made to the pension plans on account of

[1] For purposes of this memorandum, the taxable years ending in February will be referred to by the last two digits of the year and the month. Thus, for example, the taxable year ended February 28, 1982, will be referred to as the 8102 year.
[2] The information furnished with the request for technical advice does not provide either the names or the number of plans involved. However, such information is not critical to the legal analysis.

hours of service performed during the taxable year, but also the pension contributions made prior to the due date for the tax return (generally an 8½ month period), without regard to whether the contributions were on account of hours of service performed during the taxable year. For tax year 8102, this meant a deduction for 20 contributions. For tax year 8202 and thereafter, Taxpayer deducted the 3 contributions actually made during the tax year and after the due date of the return for the prior year, plus the 9 contributions made during the first 8½ months of the following year. Under the decisions in Lucky Stores Inc. and Subsidiaries v. Commissioner, 107 TC 1(1996), recons. denied, T.C. M. 1997-70, aff'd., 153 F. 3d 964 (9th Cir. 1998), cert. denied, 119 S. Ct. 1755 (May 17, 1999), Airborne Freight Corp. v. United States, 153 F. 3d 967 (9th Cir. 1998), cert. denied, 119 S. Ct. 1755 (May 17, 1999), and American Stores Company v. Commissioner, 108 TC No,12 (1997), aff'd., 170 F. 3d 1267 (10th Cir. 1999), cert. denied, 145 L. Ed 2d 153 (October 4, 1999), the contributions made after the end of the taxable year which were not made on account of services performed during the taxable year are not properly deductible in the taxable year.

As a result of an examination, Taxpayer will be required to change the taxable year in which it deducts contributions that are both (1) made after the end of the taxable year and (2) attributable to service rendered after the end of the taxable year. Taxpayer will deduct only contributions made to the plans during the tax year and contributions made to the plans after the end of the tax year, but not later than the extended due date of the tax return for the taxable year, which were made on account of hours of service performed during the taxable year. Since the tax years are closed years, this change will be made for the tax year . As a result, deductions taken in the tax year for contributions made during the first 8½ months of the tax year that were attributable to services rendered in the tax year , are not properly deductible in the tax year and will be disallowed. Under the new method of accounting, Taxpayer would then claim a deduction in the tax year for the contributions actually paid during the first 8½ months of the tax yea . that were attributable to services rendered in the tax year .. These deductions were previously deducted in the tax year , which is now a closed year under the statute of limitations.

Technical advice has been requested with respect to whether the required change constitutes a change in accounting method as defined in § 446 of the Code, requiring an adjustment under §481(a) to prevent a duplication of deductions.

Law and Analysis

The Service believes that the required change constitutes a change in accounting method as defined in § 446. The Service proposes that Taxpayer change its method of accounting for pension contributions and take into account an adjustment under §481(a) to prevent a duplication of deductions.

Under § 446(e) and § 1.446-1(e)(2)(i) of the Income Tax Regulations, a taxpayer must secure the consent of the Commissioner before changing the method of accounting used to compute taxable income. 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. 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. See § 1.446-1(e)(2)(ii)(a). "[T]he consistent treatment of a recurring, material item, whether that treatment be correct or incorrect" constitutes a method of accounting. FPL Group, Inc. and Subsidiaries v. Commissioner, 115 T.C. 554, 561 (2000).

Prior to the tax year Taxpayer's deductions for pension contributions were based on contributions made to the pension plans on account of hours of service performed during the taxable year. In tax year Taxpayer changed its method of accounting for pension contributions. The Service contends that for tax year and subsequent years, Taxpayer's pension contribution deductions consisted of all contributions actually made during the tax year that were not deducted in a previous tax year and all contributions actually made during the period from the end of the tax year to the date on which Taxpayer's tax return was filed. The Service believes that the factors for determining whether a contribution was deducted in a tax year were (1) the date on which the contribution was made and (2) whether the contribution was deducted in the previous tax year. This method did not distinguish contributions made on account of hours of service performed during the taxable year from contributions made on account of hours of service performed after the end of the taxable year.

Under § 404(a)(6), pension plan contributions made after the end of a taxable year are deemed made on the last day of the taxable year if they are made on account of services performed during the taxable year and if they are made not later than the due date of the tax return, including extensions thereof ("the § 404(a)(6) grace period"). However, the mere fact that contributions are made within the § 404(a)(6) grace period does not cause them to be made "on account of" the preceding taxable year; nor does such fact automatically make them deductible in the preceding taxable year. Contributions that are made "on account of" services provided in the year in which they are made, may not be deducted in the preceding taxable year under § 404(a)(6). Lucky Stores Inc.; Airborne Freight Corp. and American Stores Company. As a result of an examination, Taxpayer is required to change the year in which it deducts its pension plan contributions. In accordance with § 404(a)(6), Taxpayer will deduct in a taxable year only those contributions that are made on account of hours of service performed during the taxable year and that are either paid during the tax year or within the § 404(a)(6) grace period. Because Taxpayers consistent treatment of a recurring, material item, constitutes a method of accounting and the required change involves the proper time for the taking of a deduction, the Service believes that this change in when pension contributions are deducted constitutes a change in Taxpayer's accounting method for pension contributions.

Taxpayer maintains that the required change in treatment does not constitute a change in accounting method. Taxpayer's first argument is that the change is a "change in characterization" and not a change in accounting method. Taxpayer argues that it is changing its determination of which tax year the pension contributions are "on account of" under § 404(a)(6) and that once a factual determination is made as to whether a contribution is made on account of a particular taxable year, the issue of when the contribution is deductible is governed by statute. In support of its argument, Taxpayer cites Underhill v. Commissioner, 45 T.C. 489 (1966), and Standard Oil Co. (Indiana) v. Commissioner, 77 T.C. 349, (1981). However, in our view, Underhill and Standard Oil do not support this proposition.

The "change in characterization" argument and the decisions in Underhill and Standard Oil were addressed in Cargill Incorporated v. United States, 91 F. Supp. 2d, 1293 (D. Minn. 2000). In Cargill, the taxpayer leased a facility from the Port of Portland. The Port issued Industrial Development Bonds to finance an expansion to the facility. The taxpayer initially treated the IDB-financed portion as a lease, and deducted the payments as rent. Later, however, the taxpayer changed its characterization of the payments and filed amended returns claiming refunds on the grounds that it was the owner of the IDB-financed portion of the expansion and was entitled to depreciation deductions and an investment tax

credit. The Service denied the taxpayer's claims because the taxpayer was attempting an unauthorized change in method of accounting.

The taxpayer, citing Underhill and Standard Oil, argued that the change was not a change in its method of accounting, but rather a change in the characterization of its interest in the property. The Cargill court stated that it "does not find these cases persuasive" because they "ultimately rest on the erroneous premise that consent is not required if the taxpayer's previous treatment of the item was improper." 91 F. Supp. 2d 1293, 1298. The court observed that "[t]hese cases hold that, where tax law requires an item to be treated in a certain way, the treatment of that item in accordance with applicable law is a "characterization" issue rather than an accounting issue, regardless of the timing consequences." Id. The court stated that § 446(e) requires consent "whenever the treatment of an item has timing consequences 'except as otherwise expressly provided'" in the Code. Id. Since the taxpayer had not cited any provision of the Code that provided a "characterization exception", the Court concluded that "no such exception exists." Id. Likewise, in Convergent Technologies, Inc., T.C.M. 1995-320, Judge Tannenwald, who wrote the decision in Underhill, indicates that Underhill stands for the outdated proposition that the Commissioner's consent is not needed to change from an impermissible method of accounting. Thus, Standard Oil and Underhill have no continuing vitality. Reliance on those cases is misplaced.

Taxpayer's second argument is that the Service's adjustments are merely the application of Taxpayer's existing accounting method to a change in facts. Under this argument, Taxpayer has always used the accounting method that the Service proposes to require and simply made errors when it treated some of its post-year-end contributions as being made "on account of" the prior year. The re-determination of which year the contributions are "on account of" is a change in the underlying facts. Now that the correct facts are known, the time for deducting the contributions changes. According to Taxpayer, the change in treatment is required not because of a change in accounting method, but because the existing method requires a different treatment based on the corrected facts. Here, Taxpayer relies on W. A. Holt Company v. United States, 368 F.2d 311(5th Cir. 1966), aff'g, 65-2 USTC paragraph 9464 (WD TX 1965) and McPike, Inc. v. United States, 15 Cl. Ct. 94 (1988).

In Holt, the taxpayer wrote off bad debts under the specific charge off method. For the years 1950-56, the taxpayer took deductions for some accounts which were not worthless. The taxpayer contended that its practice of charging off non-worthless accounts was a method of accounting. The court held that charging off accounts which were not in fact worthless was not a method of accounting and, accordingly, no change in accounting method occurred when the Service

required the taxpayer to write off only accounts that were actually worthless. In Holt, however, the taxpayer randomly selected debts to write off. The debts written off had no common characteristics that distinguished them, as a group, from the debts which were not written off. Here, in contrast, Taxpayer routinely followed a consistent pattern of deducting in the prior tax year all contributions made during the § 404(a)(6) grace period. There is no evidence that Taxpayer evaluated the contributions to determine whether factually they were made on account of services performed during the prior tax year or during the year of the contribution. There was no tax year after tax year , in which Taxpayer deducted some, but not all of the contributions made during the § 404(a)(6) grace period. This consistent treatment of all of the contributions, even if incorrect, constitutes a method of accounting for Taxpayer's pension contributions.

In McPike, the taxpayer was engaged in the expansion of a golf course. The taxpayer analyzed individual time sheets to determine the type of activity involved so that the cost could be capitalized if it related to a construction activity, and could be deducted if the cost related to maintenance. As a result of a prior examination, incorrectly allocated payroll costs were reallocated by the Service. The taxpayer then changed its allocation method for subsequent years to conform to the allocation adopted as part of the audit settlement. The taxpayer argued that this constituted a change in accounting method. The court differentiated between a procedure used to learn the facts about a taxpayer's

taxpayer's "time sheet examination procedure for determining how much employee time was spent on a particular activity is not a method of accounting, but its treatment of the data (whether capitalization or deduction) derived from the examination does constitute an accounting method."[3] 15 Cl. Ct. 94, 99.

In McPike, the taxpayer analyzed individual time sheets to determine the type of activity involved so that its method of accounting could be applied to determine the treatment of the item. Unlike the taxpayer in McPike, Taxpayer did not make an analysis of its pension plan contributions to determine whether one contribution was factually different form the next so that its method of accounting could be applied to determine the treatment of the contribution. Taxpayer's only determination concerned the assignment of the contributions to taxable years,

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[3]The facts and arguments presented in McPike are somewhat confusing and the court's holding could be construed to be the same as the since-rejected holdings of Underhill and Standard Oil. In distinguishing McPike, we are not acquiescing in the holding insofar as it can be construed as tantamount to the holdings in Underhill and Standard Oil.

i.e., the timing of the deductions. This constitutes a method of accounting, not a procedure for determining facts.

We believe that the instant case is more like Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993) and FPL Group, Inc. v. Commissioner, 115 T.C. 554 (2000). In Pacific Enterprises, two subsidiaries owned pipelines and underground storage reservoirs for natural gas. They maintained a static volume of gas in the pipelines and reservoirs that provided the pressure needed to deliver gas ("working gas") to their customers. Both subsidiaries accounted for these pressuring gases ("cushion gas" in reservoirs and "line pack gas" in pipelines) as capital assets. The companies reclassified a portion of their working gas to cushion gas, based on engineering reports that some of that gas was needed to maintain pressure in the reservoir and could not be sold to customers without harming the efficiency of the reservoir. The taxpayer did not obtain the Service's approval for the reclassification. The Service determined that the reclassification was a change in accounting method.

The taxpayer in Pacific Enterprises maintained that it did not change its method of accounting when it re-estimated the "underlying fact" of the actual cushion gas volume in its reservoirs. Pacific Enterprises argued that the reclassifications should be considered corrections of mathematical or posting errors under § 1.446-1(e)(2)(ii)(b). The court held that the reclassification of working gas to cushion gas was a change in accounting method under § 446(e) because the reclassification deferred income by changing the method of identifying a material item of inventory and that the "reclassification is material, not only because of the large dollar amount involved but also because it was a change that affected the timing of income." 101 T.C. 1, 23.

Pacific Enterprises was using an inventory accounting method to account for gas that was in fact performing the function of cushion gas. The method it wanted to use was the correct method of accounting for cushion gas. Similarly, Taxpayer here is treating all contributions made after the end of the tax year as being made "on account of" services provided during the tax year even if some of the contributions are not in fact on account of services provided during the tax year. The change to begin distinguishing between contributions made "on account of" the preceding tax year from contributions made "on account of " the year in which the contribution is made, directly affects the time for deducting the contributions. Accordingly, like the change from an inventory method to a non-depreciable capital asset method for a certain volume of natural gas in Pacific Enterprises, this change is a change in method of accounting.

In FPL Group, the taxpayer filed consolidated returns with Florida Power, its wholly owned subsidiary. Florida Power, as a regulated electric utility, is required

to follow regulatory accounting for financial reporting purposes. For regulatory purposes, property at Florida Power's electric generating plants (electric plants) is considered as consisting of "retirement units" and "minor items of property". A retirement unit is the overall unit of property while the minor items of property are the associated parts or items that compose a retirement unit. Examples of retirement units include air- conditioning systems, bridges, elevators, and cars. Under regulatory rules expenditures for the addition or replacement of a retirement unit are required to be capitalized, while the replacement of a minor item of property is generally deducted as a repair expense. Except for certain specific adjustments, Florida Power used the same characterization of expenditures for tax reporting purposes that it did for regulatory accounting and financial reporting purposes. FPL filed amended returns to re-characterize as repair expenses, retirement unit expenditures that Florida Power had consistently characterized as capital expenditures on the consolidated tax returns. The court found this to be a change in accounting method.

In its determination, the Tax Court noted that "the basic principles apply for purposes of determining a method of accounting; namely, that a consistent method used to determine the tax treatment of a material item is a method of accounting." 115 T.C. 554, 565. Even though some of the retirement unit expenditures probably were repairs, by consistently following the regulatory accounting rules for retirement units on its tax returns, the taxpayer had established an accounting method. Re-characterizing as repairs those expenditures which had been consistently treated as capital expenditures resulted in a change in the treatment of a material item, and, therefore, a change in accounting method. It was not a correction of an error or a change in underlying facts. Here, Taxpayer consistently deducted all contributions made during the § 404(a)(6) grace period, without regard to whether the contributions related to hours of service performed during the taxable year or hours of service performed after the end of the taxable year. Here, like the taxpayer in FPL Group, Taxpayer routinely followed a pattern in identifying the contributions to be deducted in a tax year. This consistent treatment of all of the contributions, even if incorrect, constitutes a method of accounting for Taxpayer's pension contributions. Accordingly, a change in the criteria for determining which pension contributions made during the § 404(a)(6) grace period will be deducted in a tax year results in a change in the treatment of a material item, and, therefore, a change in accounting method.

Conclusion

Through its consistent pattern of deducting all contributions made during the § 404(a)(6) grace period in the prior tax year Taxpayer established a method of accounting for its pension plan contributions. The required change to deducting

only those contributions that were made on account of hours of service performed during the taxable year and made during the tax year or during the § 404(a)(6) grace period involves the proper time for the taking of a deduction. Accordingly, the examination imposed change in the proper time for deducting Taxpayer's contributions made to the collective bargained pension plans is a change in method of accounting.

This memorandum only applies to the taxpayer involved. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This memorandum has been coordinated with the Associate Chief Counsel, Income Tax and Accounting (CC:ITA) and the Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities (CC:TEGE:EB:QP1).

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