



CPA Says Error, IRS Says Method
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Mathematical Error or Accounting Method?

The issue this week involves the question of the difference between a mathematical error and an accounting method—an issue whose answer was to determine if the taxpayers in the case of *Huffman v. Commissioner*, a case decided last week by the Sixth Circuit Court of Appeals, sustaining the Tax Court's 2006 decision in this case (126 T.C. 322). We'll look at the basic issue of a method of accounting, errors, the difference in the two and how both the Tax Court and the Sixth Circuit analyzed which side of the divide the situation in the *Huffman* case fell on.

Accounting Methods

Internal Revenue Code §446 governs the general rules for methods of accounting. The general rule of §446(a) indicates that the taxpayer's taxable income shall generally be computed under the method of accounting the

taxpayer uses to compute its income in keeping its books. However, §446(b) provides that if the taxpayer has no method of accounting that has been regularly used, or the method used does not clearly reflect income, the taxpayer shall compute its income under a method of accounting that, in the opinion of the IRS, does clearly reflect income. §446(c) provides a list of broadly available methods of accounting for a taxpayer, while §446(d) provides that if a taxpayer is involved in more than one trade or business, each one may use a different method of accounting.

The code indirectly imposes a consistency requirement for methods of accounting. Taxpayers generally need the permission of the IRS to change a method of accounting. Those two provisions provide:

(e) Requirement respecting change of accounting method

Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

(f) Failure to request change of method of accounting

If the taxpayer does not file with the Secretary a request to change the method of accounting, the absence of the consent of the Secretary to a change in the method of accounting shall not be taken into account--

(1) to prevent the imposition of any penalty, or the addition of any amount to tax, under this title, or

(2) to diminish the amount of such penalty or addition to tax.

Thus once we have something that is identified as a method of accounting, we must continue to use it until such time as the IRS allows us to change that method. Note that while §446(b) gives the IRS the right to force a taxpayer to change from a method that does not clearly reflect income, the provision doesn't allow a taxpayer itself to make such a change without complying with the provisions of §446(e) to request permission to change.

That is true even if the method of accounting being used is an impermissible method of accounting—nothing in §446 allows taxpayers to “fix” being on an

impermissible method without the permission of the IRS.¹

Should consent be obtained, or should the taxpayer's method of accounting be found impermissible and the IRS propose to move the taxpayer to a method that does clearly reflect income, the mechanics of handling the conversion from one method to another to assure that items are not double reported or never reported are found in §481.

Generally §481(a) indicates that we need to create an adjustment to deal with these issues. That provision says:

(a) General rule

In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

§481(b) outlines the basic three year spread mechanism for "substantial" changes, but then goes on to authorize the IRS to write regulations to generally govern the mechanics of implementing this section. It reads:

(c) Adjustments under regulations

¹ Note that the IRS does regularly publish and update "automatic approval for change" and "nonautomatic approval" Revenue Procedures. On October 29, 2007 the IRS published Notice 2007-88, proposing a revision to these procedures—ones the notice indicates are currently "contained principally in Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432 ("automatic consent process") and Rev. Proc. 97-27, 1997-1 C.B. 680, as modified and amplified by Rev. Proc. 2002-19, as amplified and clarified by Rev. Proc. 2002-54 ("nonautomatic consent process")."

In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required by subsection (a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

These provisions are needed because the general rule for taxes is that each year stands on its own—we have an annual accounting for taxes, along with general limitation on assessment and claims for refund that runs for three years from the due date of the return (or the date the return was filed).

Sometimes it's not easy to determine what exactly is a method of accounting (which is subject to the permission requirement and the §481 pickup of the cumulative adjustment) and the following items which don't require either:

- Estimate—as we know from the recitation we find in full disclosure GAAP statement notes, accounting necessarily involves a number of estimates. If we simply have a modification of an estimate, that is not a method of accounting, but simply a change in estimate. So long as the method of computing the estimate produced a valid result for year 1, that year cannot be adjusted by the IRS, even if in year 2 the taxpayer used a different way to come up with the required estimate—and the taxpayer won't need permission to make such changes in how it came up with the estimates for the return.
- Mathematical or posting errors—if a taxpayer merely fouls up their books and manages to erroneously charge \$100 of office supplies to federal income tax expense, that is not a method of accounting issue. Errors can be corrected via an amended income tax return—there is no IRS permission required to correct such an error, unlike the need to get permission to change an accounting method. Similarly, on examination the IRS can force the taxpayer to recognize the effect of correcting this matter without having to clear the “clearly reflects income” hurdle it must clear to invoke §446(b)'s authority to change a taxpayer's accounting method.

This latter category is the key matter in the case at hand—did we have a mathematical error or an accounting method?

Mathematical Errors

Reg. §1.446-1 contains much more detail about what is and is not a method of accounting—the other regulations under §446 contain guidance in narrow areas, so that if an issue doesn't fall into one of those narrow areas, Reg. §1.446-1 will

govern the question of whether or not we have an accounting method—and, by extension, how changes can be made.

Reg. §1.446-1(e)(2)(ii) contains our basic guidance on what is an accounting method, telling us indirectly how to determine if we have a method:

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 that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.460-4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change

Some key factors emerge from this definition. First, the item involves needs to be *material* which is defined to mean it involves the *timing* of the inclusion of an item of income or taking a deduction on the return. Second, generally there is a need for a consistent treatment to establish a method of accounting (though the regulation does grant that it's possible one might be created without such consistent treatment). The definition makes it clear that §441's coverage is not limited to the overall method of accounting (such as cash vs. accrual), but also applies to more detailed items that impact the timing of inclusion or deduction for a specific item.

But the regulation goes on to note that mathematical errors are excepted:

(b) 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 that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and § 1.1016-3(h).

Note that once again, we have an emphasis on the issue of timing in the matter of deciding what is what.

Huffman Case

In the case of *Huffman v. Commissioner*, CA6, 2008 TNT 44-9, we have a group of auto dealers that had used a variation on the LIFO method of computing their inventory for a large number of years. Each year the same CPA had performed the computations of the LIFO inventory using a consistent approach that the CPA believed agreed the requirements in the regulations for the computation of LIFO inventory under the dollar-value, link-chain LIFO method.

Unfortunately, it turned out the CPA didn't really understand the method properly. While we won't go into the details of computing inventory under this method, there is a specific step required in the mechanical computations outlined under this method where an index must be applied to the increment computed—and the CPA never did this. This failure had the effect of understating the taxpayer's inventory each year, and therefore causing income to be understated on a cumulative basis.

Mechanically the difference would eventually wash out if the dealerships were to close down and get their inventory to zero—but so long as the dealerships stayed in business, a push forward of income that should have already been

recognized of six figure amounts existed for each of the four dealerships.

The taxpayer claimed that this was clearly a mathematical failure on the part of the CPA, and that as such the IRS could collect tax on the difference in income for each of the three years still open to assessment, but the difference in inventory that existed at the beginning of the first open year was a windfall that was simply “lost” to recovery by the IRS, much as would have been an accidental misclassification of \$1,000 of nondeductible expense as a deductible item in those years (though obviously a bit more significant).

The IRS felt differently—the IRS claimed that the taxpayer’s consistent use of a calculation that did not reflect the use of the index was a method of accounting—albiet one that was not allowed under the law, and which did not clearly reflect income. It may have been a mistake—but it was a mistake that due to its consistent use became a method of accounting. Thus §481 came into play, and the adjustment was taxable to the taxpayer.

The Sixth Circuit agreed with the Tax Court. The court noted that the change from the accountant’s method of calculation LIFO inventory to the proper application of the dollar-value, link-chain method was the type of change that Section 481 was designed to capture, and that the regulations exclusion at §1.446-1(e)(2)(ii)(b) of a mathematical or computational error did not provide an exclusion for this transaction. The consistent application of the steps the accountants took to calculate the LIFO inventory took this beyond a mere mathematical error, and into the realm of an accounting method.

The court notes:

To define "correction of mathematical error" to include the correction in this case would lead to a contradiction within the regulation. In effect, taxpayers argue that "mathematical error" arises any time there is a discrepancy between a computed value and the correct value. This definition would, for example, include the circumstance described in Example 6. As discussed, Example 6 of § 1.446-1(e)(2)(iii) describes a situation where a taxpayer, consistently and for a number of years, improperly computed the value of inventory by omitting overhead costs. The taxpayer's error would thus be considered a "mathematical error" under taxpayers' definition, yet the regulation provides that a correction of that error constitutes a "change in method of accounting." The example thus implicitly rejects the idea that the "mathematical error" or "computational error" exception applies in those circumstances. The facts of the instant case are sufficiently analogous to Example 6 to warrant a conclusion that neither exception applies here.

The taxpayers attempted to find support in the case of *Korn Industries* (532 F.2d 1352, 1356 (Ct. Cl. 1976)) a case the court summarized in a footnote as noted below:

In *Korn Industries*, the Court of Claims held that a "change in method of accounting" had not occurred when a taxpayer, for four years, deviated from the method of accounting for inventories that it had previously used by omitting three items from its finished goods inventory. The three items, however, were included in raw materials inventory, work in-process inventory, and supplies inventory. 532 F.2d at 1353.

However, the Sixth Circuit did not find this persuasive, noting:

Finally, the asserted inadvertence of the accountant's error is not relevant to the determination of whether there was a "change in method of accounting." Taxpayers rely on the Court of Claims decision in *Korn Industries, Inc. v. United States* for the proposition that inadvertence should be considered in determining whether § 481 applies. See 532 F.2d 1352, 1356 (Ct. Cl. 1976). *Korn Industries*, however, has been characterized by the Federal Circuit as a case of "posting error" and thus is not directly relevant to taxpayers' arguments regarding mathematical and computational error. See *Diebold, Inc. v. United States*, 891 F.2d 1579, 1582 (Fed. Cir. 1989).

In any event, there is simply no basis in the text of § 481 or § 1.446-1 for a conclusion that inadvertence or intent is relevant to the inquiry of whether a change in accounting method has occurred. As the Tax Court noted in *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 913 n.5 (1983), to the extent that *Korn Industries* provides for an exception to § 481 for the correction of good-faith mistakes, commentators have questioned the authority for such an exception. Indeed, such considerations are inconsistent with the very purpose of § 481 -- to allow for all adjustments necessary to prevent amounts from being omitted or duplicated as a result of a change in accounting method.