Revenue Ruling 90-38

Carrying charges; capitalized; binding election; subsequent deductions. Unless the Commissioner consents, a taxpayer may not change from an erroneous method of accounting retroactively by amending prior returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired. Rev. Rul. 70-539 revoked; Rev. Ruls. 75-56 and Rev. Rul. 76-325, 1976-2 C.B. 88 modified.

ISSUE AND FACTS

The Internal Revenue Service has reconsidered the position set forth in Rev. Rul. 70-539, 1970-2 C.B. 70. In Rev. Rul. 70-539, a corporation organized in 1966 and engaged in developing real estate capitalized interest, taxes, and other carrying charges by including them in the tax basis of real estate sold. Rev. Rul. 70-539 holds that the corporation did not make a valid election under section 266 of the Internal Revenue Code because it failed to file a statement with its returns for 1966, 1967, and 1968 identifying the items it was capitalizing as required by section 1.266-1 (c) (3) of the Income Tax Regulations. Because the corporation capitalized these items without making a valid election, Rev. Rul. 70-539 holds that the corporation may treat these items as current operating expenses on amended returns for 1966, 1967, and 1968. Rev. Rul. 75-56, 1975-1 C.B. 98, distinguishes Rev. Rul. 70-539 by holding that a taxpayer may not amend its returns to deduct erroneously capitalized expenses if the period for amending the first return reflecting the capitalized expenses has expired.

LAW AND ANALYSIS

Section 446 (e) of the Code and section 1.446-1 (e) of the regulations provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes.

Section 1.446-1 (e) of the regulations provides rules for determining what a method of accounting is, how an adoption of a method of accounting occurs, and how a change in method of accounting may be made. Section 1.446-1 (e) (2) (ii) (a) of the regulations provides:

> 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.

The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of section 1.446-1(e)(2) (ii) (a) of the regulations. See Diebold, Inc. v. United States,

891 F.2d 1579 (Fed. Cir. 1989). In addition, section 1.446-1 (e) (2) (i) indicates that the consistent, but erroneous, treatment of material items constitutes a method of accounting. See section 1.446-1 (e) (2) (iii), Examples (6)-(8); see also Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6th Cir.), cert, denied, 385 U.S. 822 (1966); Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert, denied, 368 U.S. 898 (1961); and Rev. Rul. 80-190, 1980-2 C.B. 161. Compare Rev. Rul. 72-491, 1972-2 C.B. 104, which holds that a taxpayer erroneously using an accelerated method of depreciation for "used" property may file an amended return using a proper method, provided the taxpayer has not filed the tax return for the succeeding tax year.

If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns before it has adopted a method of accounting. Section 1.446-1 (e) (1) of the regulations provides, for example, that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the tax year covered by such return. Similarly, the Supreme Court has held that once a permissible election as to a method of accounting for an item has been made on a return, it may not be changed after the time for filing the return has expired. See Pacific National Co. v. Welch, 304 U.S. 191, 82 L. Ed. 1282, 58 S. Ct. 857, 1938-1 C.B. 274 (1938), 1938-1 C.B. 274; see also Lord v. United States, 296 F.2d 333 (9th Cir. 1961); National Western Life Insurance Co. v. Commissioner, 54 T.C. 33 (1970); Rev. Rul. 74-154, 1974-1 C.B. 59.

Section 1.446-1 (e) (3) (i) of the regulations provides that (except as otherwise provided by administrative procedures prescribed by the Commissioner) in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115, Application for Change in Accounting Method, within 180 days after the beginning of the tax year in which the taxpayer desires to make the change.

If a taxpayer's treatment of an item is a method of accounting under these principles, section 446 (e) of the Code and section 1.446-1 (e) (3) of the regulations preclude a taxpayer from making a retroactive change in method of accounting by amending prior tax returns without the consent of the Commissioner. Section 446 (e) authorizes the Commissioner to consent to a retroactive change in method of accounting, whether the change is from a permissible method or an impermissible method. E.g., Barber v. Commissioner, 64 T.C. 314 (1975); Notice 89-15, 1989-1 C.B. 816; Notice 88-78, 1988-2 C.B. 394, modified by Notice 89-67, 1989-1 C.B. 723; Rev. Proc. 78-6, 1978-1 C.B. 558. Section 446 (e) does not give the taxpayer a right to demand that a change in method be made retroactively, however. See Diebold, Inc., 891 F.2d at 1583. Except in certain limited circumstances, and as specifically provided by revenue procedure or other administrative pronouncement, a taxpayer that seeks to change its method of accounting in accordance with section 1.446-1 (e) may only request to change the method of accounting prospectively. See section 1.446-1 (e) (3) (i); section 4.04, Rev. Proc. 84-74, 1984-2 C.B. 736, 741.

Under section 1.446-1 (e) (2) (i) of the regulations, consent to change any method of accounting used by a taxpayer is a matter within the discretion of the Commissioner. The Commissioner, however, may prescribe other administrative procedures, subject to such limitations, terms and conditions as are deemed necessary to obtain the Commissioner's consent, to permit taxpayers to change their accounting method to a permissible method. See section 1.446-1 (e) (3) (ii). Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer

and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 1.446-1 (e) (3) (i).

The corporation under consideration in Rev. Rul. 70-539 adopted a method of accounting when it filed the second consecutive tax return in which it erroneously capitalized charges for interest, taxes, and other carrying charges associated with real estate. In that ruling, the corporation, which was required to obtain the Commissioner's consent to change the erroneous method, was permitted by the Service to change the method which capitalized charges to a method that treated the charges as current expenses by timely amending all prior returns reflecting the erroneous capitalization. However, upon reconsideration, the Service has determined that the special procedure under section 266 of the Code contained in Rev. Rul. 70-539 is not an appropriate departure from the general requirements of section 446 (e) and the regulations. The Service has further determined that, in the circumstances described in Rev. Rul. 70-539, consent should be granted only for a prospective change of accounting method and only pursuant to an application for consent made under the generally applicable rules of section 1.446-1 (e) (3) (i).

HOLDING

A taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired. Thus, a taxpayer that, for two or more consecutive tax years, has capitalized interest and other carrying charges under section 266 of the Code without making a valid election as required by applicable regulations has nonetheless adopted a method of accounting with respect to the interest and carrying charges. The taxpayer may not change that method of accounting by filing amended returns for those prior tax years. Instead, the taxpayer may only change the method of accounting with the consent of the Commissioner pursuant to section 1.446-1 (e) of the regulations.

Consistent with the above, the Service will not follow Gimbel Bros., Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), in which the court permitted the taxpayer to file amended returns for prior open years to effect a change in method of accounting for a material item.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 70-539 is revoked.

Rev. Rul. 75-56, 1975-1 C.B. 98, is modified to eliminate any inference that the statute of limitations must expire before the taxpayer has adopted a method of accounting under section 266 of the Code and, as modified, is revoked as obsolete.

Rev. Rul. 76-325, 1976-2 C.B. 88, is modified to delete the references to Rev. Rul. 70-539.

PROSPECTIVE APPLICATION

Under the authority contained in section 7805 (b) of the Code, amended returns that were timely filed before April 30, 1990, the date this Revenue Ruling appears in the Internal Revenue Bulletin, to correct an impermissible capitalization method for expenses under section 266 with respect to all returns reflecting the impermissible method, will be accepted by the Service.