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Memorandum

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to: Barry Shott
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Change in Accounting Methods

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subject: Denial of Consent for Change in Accounting Method

In accordance with section 9.12(2) of Rev. Proc. 2007-1, 2007-1 I.R.B. 1, this Chief Counsel Advice advises you that consent for a change in accounting method has been denied to a taxpayer within your jurisdiction. Pursuant to § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Taxpayer =

Service Fee =

Statement =

Amount A =

Amount B =

Amount C =

Number Y =

Number Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

This memorandum refers to a Form 3115, Application for Change in Accounting Method, filed by Taxpayer requesting permission to change its method of accounting for deducting losses related to real estate that has been acquired via foreclosure, or in lieu of foreclosure, for the Year 8 taxable year.

FACTS

Taxpayer's primary business operations are in the financial markets, with a portion of its business involving the purchase of residential mortgages in the secondary market. Taxpayer uses an overall accrual method of accounting.

As a result of its purchase of residential mortgages, Taxpayer regularly acquires ownership of parcels of real estate through foreclosure proceedings or by arrangements in lieu of foreclosure. Such real property, known as "real estate owned" (REO), is held for sale.

Under its present method of accounting, Taxpayer periodically revalues its REO and writes down its value when it obtains evidence that the property is worth less than its basis. In other words, Taxpayer deducts an unrealized loss amount if the REO is valued at less than the taxpayer's basis, without having disposed of the property, under a lower-of-cost-or-market (LOCOM) method of accounting. This method of accounting is the same as Taxpayer's financial statement method of accounting for REO.

Under its proposed method, Taxpayer will not write down the value of REO when it obtains evidence that the real estate is worth less than its basis. Specifically, Taxpayer will not take deductions for declines in value of REO while the real estate is still owned by Taxpayer. Instead, losses in value that are incurred while Taxpayer owns the REO, if any, will be taken into account only upon the disposition of the property.

Taxpayer was under examination for the Year 3 through Year 7 taxable years at the time it filed the Form 3115. The Form 3115 was filed during the 90-day window period pursuant to section 6.01(2) of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432). Additionally, Taxpayer's income tax returns for the Year 1 through Year 2 taxable years were under consideration by appeals offices on the date the Form 3115 was filed, and Taxpayer was before a federal court with respect to an income tax issue on the date the application was filed.

Taxpayer submitted a statement with the Form 3115 certifying that, to the best of Taxpayer's knowledge, the method of accounting requested in the application was not an issue under consideration by the examining agent, the appeals officer, or the federal court, nor was the issue an issue that has been placed in suspense by the examining agent. See sections 3.08 and 6.01(2)(b) of Rev. Proc. 97-27.

Taxpayer is under continuous examination by the Service in the Coordinated Industry Case (CIC) program. The current examination cycle covers the Year 5 through Year 7 taxable years. The first formal meeting involving the examination team and Taxpayer for the current cycle occurred on Date 1. At the meeting the examination team delivered to Taxpayer various "Planning Input Documents" for issues to be

examined for the Year 5 through Year 7 taxable years. One of these Planning Input Documents (the Planning Document) related to Taxpayer's REO.

The relevant portions of the Planning Document read as follows:

PLANNING INPUT DOCUMENT

Section A: Potential Issue Statement:

Taxpayer's bad debt loss includes losses and expenses related to real estate acquired (Number Y to Number Z properties each year) as a result of foreclosures. These losses should be examined to ensure proper computations are made and that expenses are properly deducted. (Also relate to Bad Debt – Estimated Losses) REO acquisitions and inventory have increased significantly from Year 4 to Year 7 Q1.

Section B: Amounts per return- Total Bad Debts deducted

Year 5	*Amount A*
Year 6	*Amount B*
Year 7	*Amount C*

* * *

Section E: Uniform Issue Code: 166.01-00

* * *

Section G: Scope of Examination: The scope will include only acquisitions and sales during the exam cycle and will be further limited to a small percentage of properties after the initial review.

Section H: Procedures:

1. Review last cycle bad debt workpapers including Service Fee adjustment and estimated losses for information related to REO.
2. Review books and records and perform a coa [chart of accounts] search utilizing "PUP" [database search software] for REO expenses, bad debts and sales of foreclosed properties.
3. Request IDR requesting tax files for bad debts, reports of REO acquisitions and sales and company policy manual.
4. Test a sample of transactions to determine if there is tax compliance.
5. Complete Issue Closing Section.

Taxpayer deducted the unrealized losses related to REO on the “bad debts” line of its income tax returns for the Year 5 through Year 7 taxable years and for prior years as well. The tax returns contained no separate disclosure identifying the nature of the unrealized loss deductions that were reported as part of the bad debt amount. Further, since the tax treatment followed the financial statement treatment for the item, the tax returns contained no relevant Schedule M-1 item indicating Taxpayer’s method of accounting for the item.

Following Taxpayer’s filing of the Form 3115 on Date 2, the examination team requested a written position from Taxpayer to explain why, with respect to the above-referenced Planning Document, there was not an issue under consideration pertaining to the method of accounting for REO losses when the Form 3115 was filed. Taxpayer provided the examination team with Statement explaining Taxpayer’s reasons for concluding that the Form 3115 did not involve an issue under consideration. The examination team and Taxpayer continued to disagree on the issue.

The National Office reviewed the issue and made a tentatively adverse determination with respect to the issue under consideration matter, and informed Taxpayer of such determination on Date 3. On Date 4, Taxpayer was provided a conference of right in the National Office as it had requested in the Form 3115. At the conference of right, Taxpayer stated its principal arguments, some of which had been included in the Statement. These arguments are discussed in the analysis below.

LAW

Section 446(e) provides that, except as otherwise expressly provided in Chapter 1 of the Internal Revenue Code (Code), 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.

Section 1.446-1(e)(2)(i) of the Income Tax Regulations states that, except as otherwise expressly provided in Chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Code or regulations thereunder.

Section 1.446-1(e)(3)(ii) provides that the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their methods of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted.

Rev. Proc. 97-27 contains the general procedures under section 446(e) for taxpayers seeking to obtain the advance consent of the Commissioner to change a method of accounting. Section 1.02(1) of Rev. Proc. 97-27 states that the revenue procedure provides incentives to encourage prompt voluntary compliance with proper tax accounting principles by providing more favorable terms and conditions if the taxpayer files its request for a change in accounting method before the Service contacts the taxpayer for examination.

A taxpayer under examination may request permission to change a method of accounting under limited circumstances. As relevant in the instant case, section 6.01(2) of Rev. Proc. 97-27 provides that a Form 3115 may be filed during the first 90 days of any taxable year ("90-day window") if (1) the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year, and (2) the method of accounting the taxpayer is requesting to change is not, at the time the From 3115 is filed, an issue under consideration or an issue the examining agent has placed in suspense.

Section 3.08(1) of Rev. Proc. 97-27 provides that a taxpayer's method of accounting for an item is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the item as an issue under consideration. For example, a taxpayer's method of pooling under the dollar-value, last-in, first-out (LIFO) inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but it is not an issue under consideration as a result of an examination plan that merely identifies LIFO inventories as a matter to be examined. Similarly, a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. The question of whether a method of accounting is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001-2, 2001-1 I.R.B. 79 (or any successor).

ANALYSIS

Taxpayer filed its Form 3115 under the 90-day window provision of section 6.01(2) of Rev. Proc. 97-27. The 90-day window provision would not be available to Taxpayer if its method of accounting for REO losses was an issue under consideration when the Form 3115 was filed. Taxpayer's method of accounting for REO losses was an issue under consideration when its Form 3115 was filed if Taxpayer had received written notice from the examining agents specifically citing the treatment of REO losses as an issue under consideration.

The Planning Document is the only pertinent written document received by Taxpayer from the examination team before the filing of the Form 3115. There is no dispute that the Planning Document constitutes written notification under section 3.08(1) of Rev. Proc. 97-27 since it constituted part of the examination plan for the current examination cycle that Taxpayer received from the Service on Date 1.

The Planning Document specifically cites Taxpayer's treatment of its REO losses and indicates that such treatment will be considered as part of the examination. Section A of the document refers to "Taxpayer's bad debt loss," including "losses and expenses related to real estate acquired (Number Y to Number Z properties each year) as a result of foreclosures." Further, section A states that "[t]hese losses should be examined to ensure proper computations are made and that expenses are properly deducted." Finally, the section says that "REO acquisitions and inventory have increased significantly from Year 4 to Year 7 Q1."

A reasonable reading of the foregoing statements included in Section A alone would indicate that Taxpayer's method of accounting for REO losses would be subject to examination. Moreover, Section G of the Planning Document informs the reader that the scope of the examination "will include only acquisitions and sales during the exam cycle and will be further limited to a small percentage of properties after the initial review." Read in conjunction with Section A of the document, it is reasonable for the reader to conclude that the "acquisitions and sales" referred to as within the scope of the examination includes the "real estate acquired (Number Y to Number Z properties each year) as a result of foreclosures" in Section A.

Finally, Section H of the Planning Document informs the reader of the procedures that the examination team will apply during the audit. It should be obvious to the reader that Taxpayer's method of accounting for REO losses would be subject to examination given that the examination team will, with respect to the relevant cited procedures:

> "2. Review books and records and perform a coa [chart of accounts] search utilizing "PUP" [database search software] for REO expenses, bad debts and sales of foreclosed properties;
>
> 3. Request IDR requesting tax files for bad debts, reports of REO acquisitions and sales and company policy manual; and
>
> 4. Test a sample of transactions to determine if there is tax compliance."

In sum, the Planning Document fairly informs Taxpayer that its treatment of REO losses would be an issue to be considered in the examination. Taxpayer's method of accounting for REO losses was thus an issue under consideration within the meaning of section 3.08(1) of Rev. Proc. 97-27.

Taxpayer disagrees, and raises various arguments why the Planning Document was not sufficient to place under consideration its method of accounting for REO losses, alleging that the document lacks the specificity required by section 3.08(1) of Rev. Proc. 97-27.

The LIFO Example Analogy

Taxpayer's first set of arguments center on the first of the examples in section 3.08(1). The example states that an examination plan that identifies LIFO inventory pooling as a matter to be examined is sufficient to place a taxpayer's method of dollar-value LIFO inventory pooling under consideration, whereas an examination plan that merely identifies LIFO inventories as a matter to be examined is not sufficient to place dollar-value LIFO inventory pooling under consideration.

Taxpayer identifies three levels of increasing specificity in the example: (i) LIFO inventories; (ii) LIFO pooling; and (iii) dollar-value LIFO pooling. Taxpayer then, referring only to Section A of the Planning Document, draws an analogy between those levels and the fact pattern at issue: (i) bad debts; (ii) the carrying value of REO; and (iii) LOCOM valuation of REO. The Planning Document is insufficiently specific to place its LOCOM valuation of REO (level iii) under consideration, Taxpayer argues, because it references bad debts (at level i of specificity) rather than the carrying value of REO (at level ii).

Initially, we disagree with Taxpayer's assertion that the Planning Document merely references bad debts. As discussed above, the Planning Document references REO losses and REO expenses. Accordingly, the proper level i in Taxpayer's attempted analogy is really REO losses, which seems very difficult to distinguish from the carrying value of REO, which is Taxpayer's Level ii.

More fundamentally, however, Taxpayer's analogy fails because the facts at issue and the LIFO example are materially different. A written inquiry referencing REO losses raises only two basic parameters -- how REO is valued and when loss recognition occurs – and these are arguably just different faces of the same coin because the choice of valuation methodology (LOCOM or cost) implies the timing of loss recognition (periodic recognition for unrealized losses or recognition only upon disposition). By contrast, inventory accounting is characterized by complexity and a multiplicity of methods and sub-methods. Thus, a written notice identifying LIFO inventories encompasses numerous methods of accounting, e.g., dollar-value LIFO pooling method, LIFO index computation method, method of determining current-year cost for dollar-value LIFO, method of valuing increments for specific goods LIFO, method of defining items under dollar-value LIFO, scope of specific goods categories under specific goods LIFO, the costing of the LIFO inventory, and determining the time sales are deemed to occur.

The material differences between REO losses and LIFO inventories render the LIFO example irrelevant to the facts at issue. The LIFO example stands for the principle that the specificity requirement of section 3.08(1) of Rev. Proc. 97-27 can be violated if the class of accounting methods identified in the written notice (all methods for LIFO inventories) is unreasonably broad with respect to the matters to be placed under consideration (dollar-value LIFO pooling methods). This principle is simply not applicable to the Planning Document, which identifies an area (REO losses) that is not unreasonably broad with respect to the matters that are placed under consideration.

As further support for its argument, Taxpayer analogizes the statements in Section A of the Planning Document to Statements 1 and 2 of the IDR analyzed in PLR 200142001, where the Service found those statements to be insufficiently specific to create an issue under consideration. We note that a private letter ruling is directed to a specific taxpayer regarding a certain transaction or set of facts, and may not be cited or relied upon as precedent under section 6110(k)(3). We believe, moreover, that the conclusions reached in PLR 200142001 with regard to Statements 1 and 2 would be inapposite to the facts at issue because the IDR related to LIFO inventories and the rationale for finding Statements 1 and 2 to be lacking in specificity was an analogy to the LIFO example in section 3.08(1). As discussed above, we find analogies to the LIFO example of section 3.08(1) to be unpersuasive in this situation.

Bad Debt Characterization

Taxpayer's second argument is that the Planning Document lacks specificity because it references "bad debts" (pursuant to § 166) rather than REO "losses" or carrying values (pursuant to § 165). Taxpayer further points out that the Planning Document includes a uniform issue code of 166.01-00, which relates to bad debts.

Moreover, Taxpayer asserts in its Statement, as well as it did at the conference of right, that Section A of the Planning Document constitutes a "general statement about bad debts [that] does not have the specificity required by Rev. Proc. 97-27 to consider the LOCOM Issue an issue under consideration. The statement discusses an inquiry into the mechanics of computing expenses and the proper deductions that relate to bad debt losses. It says nothing about the carrying value of real estate owned."

We note initially that the mislabeling of the REO writedowns of which Taxpayer now complains is ultimately traceable to Taxpayer itself. Taxpayer affirms that all deductions concerning the unrealized losses related to REO had been included within the bad debt deduction line item on its income tax returns for the Year 5 through Year 7 taxable years and for prior years, and that the returns contained no additional disclosure concerning the nature of the deductions, such as "losses from carrying value of REO," or similar terminology. Further, since the tax treatment followed the financial statement treatment for REO losses, the returns contained no relevant Schedule M-1 items indicating Taxpayer's method of accounting for the item.

Taxpayer thus maintained a consistent pattern of characterizing its REO losses as bad debts in all of the returns under examination. Taxpayer can hardly claim to be puzzled when the examining agents referenced Taxpayer's own characterization of REO losses in written communications regarding the tax returns in which such characterizations were used. Section A of the Planning Document accurately states that Taxpayer's bad debt loss for the taxable year under examination "includes losses and expenses related to real estate acquired (Number Y to Number Z properties each year) as a result of foreclosures." The reference here to "bad debt" does not undermine the specificity of the Planning Document; it actually enhances specificity by identifying not only the transactions or assets involved but also the particular treatment (albeit an incorrect one) that they received on the tax returns under examination.

Taxpayer's argument that the Planning Document lacks specificity if it adopts Taxpayer's own incorrect characterization of its REO writedowns in a communication directed to Taxpayer implies that the agent drafting the Planning Document was obliged to look behind the tax returns, somehow determine that the REO writedowns were not correctly classified, and reflect such insight in the Planning Document. We do not believe that section 3.08(1) of Rev. Proc. 97-27 imposes any such requirement, particularly in the early phases of an examination. The treatment of an item may be an issue under consideration before the examiner determines exactly what method of accounting a taxpayer is using for the item or whether such method is improper or deficient in some respect.

Finally, we note that section 3.08(1) provides that the written notice must specifically cite "the treatment of the item" as an issue under consideration. This language does not require that the written notice explicitly or correctly identify the particular accounting method or tax characterization that taxpayer is actually or purportedly applying to the item; the nature of such treatments and their propriety are the objects of the inquiry itself. The Planning Document satisfied this language by identifying losses related to REO as the item; the identification of "losses" as the correct treatment of the item was not required to achieve the requisite specificity.

CONCLUSION

Based on the facts of this case, we conclude that Taxpayer's method of accounting for REO losses was an issue under consideration, within the meaning of section 3.08(1) of Rev. Proc. 97-27, when Taxpayer filed the Form 3115 on Date 2. Accordingly, Taxpayer is not eligible to request permission to change its method of accounting under the 90-day window provisions of Rev. Proc. 97-27.

Please call (202) 622-4970 if you have further questions.

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