INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-117173-02
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Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Parent =

Subsidiary =

Product =

Unaffiliated Product Dealer =

Year 1 =

Year 2 =

Year 3 =

ISSUES:

(1)(a) Under the circumstances described below, do the intercompany transaction regulations require Parent to defer the deduction of its rate support payments to Subsidiary in Year 1?

(1)(b) Under the circumstances described below, do the intercompany transaction regulations require Subsidiary to accelerate its inclusion of income related to the rate support payments made by Parent in Years 2 and 3?

(2) Under the circumstances described below, is Parent prohibited from changing its treatment of its rate support payments to Subsidiary for Years 1, 2, and 3 without the consent of the Commissioner?

CONCLUSIONS:

(1)(a) Under the circumstances described below, based on the decision in General Motors v. Commissioner, 112 T.C. 270 (1999), the Service will not apply Treas. Reg. section 1.1502-13 (1966) to cause Parent to defer the deduction of otherwise currently deductible expenses in Year 1.

(b) Under the circumstances described below, Treas. Reg. section 1.1502-13 (1995) applies to the rate support transactions in Years 2 and 3; however, application of that regulation does not require Subsidiary to accelerate its inclusion of discount income from the retail installment sales contracts.

(2) Under the circumstances described below, Parent is prohibited from changing its treatment of its rate support payments to Subsidiary for Years 1, 2, and 3 without the consent of the Commissioner.

FACTS:

The information submitted indicates that Parent is the common parent of an affiliated group filing consolidated tax returns on a calendar-year basis. Subsidiary, a wholly-owned subsidiary of Parent, is a member of Parent's consolidated group. Parent and Subsidiary maintain separate books and records, are engaged in separate trades or businesses, and report their income for federal income tax purposes using the accrual method of accounting.

Parent is in the business of distributing Product, related parts, and accessories. Parent distributes Product primarily through Unaffiliated Product Dealers who purchase Product from Parent for resale to retail customers.

Subsidiary is a captive finance company and provides financing for retail customers of Unaffiliated Product Dealers. When a retail customer purchases Product from an Unaffiliated Product Dealer, the retail customer has the option to execute a retail installment sales contract ("RISC") with the Unaffiliated Product Dealer, under which the retail customer agrees to pay for Product over the term of the RISC. Subsidiary's principal business is to acquire these RISCs from Unaffiliated Product Dealers.

Parent is responsible for promoting Product sales. In order to stimulate interest in Product and increase sales volume, Parent provides various incentives to retail customers. These incentives include cash rebates, discounts, and below-market-rate financing. In general, when both a cash rebate and below-market-rate financing are available, the retail customer must choose between these options. The retail customer is not eligible for both incentives.

When a retail customer buys Product that is subject to a cash rebate, the cash rebate is paid directly by Parent to the retail customer. Parent treats the payment of a cash rebate as a sales incentive (i.e., a marketing expense). When a retail customer buys Product subject to below-market-rate financing, Parent makes a cash payment (the "rate support payment") to Subsidiary, the purpose of which is to reimburse Subsidiary for having purchased the RISC from the Unaffiliated Product Dealer for more than its fair market value.[1] Parent also treats the rate support payment to Subsidiary as a sales incentive (i.e., a marketing expense).

During the years in issue, Parent sponsored and Subsidiary participated in a below-market-rate financing program (the "retail financing program"). This retail financing program was for retail customers who purchased from Unaffiliated Product Dealers specified Products that the Unaffiliated Product Dealers had previously purchased from Parent.

A. THE STRUCTURE OF THE RETAIL FINANCING PROGRAM.

The retail financing program involved Parent, Subsidiary, Unaffiliated Product Dealers who elected to participate in the program, and retail customers who obtained below-market-rate financing when purchasing a specified Product from those dealers. The retail financing program was structured as follows:

(1) Parent sold a specific Product to an Unaffiliated Product Dealer.

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[1] When a RISC carries a below-market interest rate, the RISC's fair market value is less than its face amount at issuance.

(2) An Unaffiliated Product Dealer sold the Product to a retail customer. The retail customer made a cash down payment and executed a RISC with the Unaffiliated Product Dealer for the remaining purchase price at a below-market interest rate established by Parent.

(3) The Unaffiliated Product Dealer assigned the RISC to Subsidiary in exchange for a cash payment from Subsidiary equal to the face amount of the RISC. Unaffiliated Product Dealers were not legally required to assign any RISC to Subsidiary, and Subsidiary was not legally required to accept any RISC offered by Unaffiliated Product Dealers. However, Subsidiary accepted assigned RISCs from Unaffiliated Product Dealers, provided the retail customer and the terms of the RISC met its credit standards. When Subsidiary acquired a RISC from an Unaffiliated Product Dealer, Subsidiary paid or credited the Unaffiliated Product Dealer the face amount of the assigned RISC at the time of purchase even though the RISC carried a below-market interest rate (i.e., the RISC's fair market value was less than the RISC's face amount at issuance).

(4) Subsidiary billed Parent for an amount equal to the excess of (i) the amount Subsidiary paid for the RISC (the RISC's face amount) over (ii) the RISC's value on the date the Unaffiliated Product Dealer assigned the RISC to Subsidiary. This excess amount is hereafter referred to as the "rate support amount."

(5) Parent paid the rate support amount (the "rate support payment") to Subsidiary on a monthly basis as an up-front, lump sum amount.

B. THE TAX RETURN TREATMENT OF THE PROGRAM BY PARENT AND SUBSIDIARY.

The information submitted indicates that, during Years 1-3, on its books, Parent accrued each rate support payment as a marketing expense in the year of the transaction with Subsidiary. Solely for purposes of this Technical Advice Memorandum, we assume that this sales incentive would be deductible currently by Parent if it were filing separate income tax returns.[2] Subsidiary did not treat each rate support payment as income in the year of its receipt. Rather, Subsidiary recorded an amount (equal to

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[2] Application of the intercompany transaction regulations may change tax accounting treatment of items that are otherwise deductible, includible, etc. under a member's otherwise applicable method of accounting. See Treas. Reg. secs. 1.1502-12, 1.1502-13(b)(2) (1966) and 1.1502-13(a)(3) (1995). The questions presented under Issue 1 do not go to the proper time for taking into account items under the members' separate methods of accounting; rather, the questions concern whether the intercompany transaction regulations might override the members' timing of items under their separate methods of accounting.

the rate support payment) as unearned discount income from the retail customers and took that amount into income over the term of the associated RISC. Subsidiary took a fair market value basis in the RISC, instead of a basis equal to the RISC's face amount (the amount paid to the Unaffiliated Product Dealer).[3]

Parent and Subsidiary treated the rate support payments as intercompany transactions pursuant to Treas. Reg. section 1.1502-13.[4] In each of the years at issue, in an effort to comply with the applicable regulations, Parent deferred its deductions for the rate support payments so that the deductions would match Subsidiary's discount income earned over the term of the RISCs to which the rate support payments related.

C. TAXPAYER'S PROPOSED POSITION.

During the course of the audit cycle for Years 1-3, Taxpayer filed claims with the Internal Revenue Service seeking immediate (rather than deferred) deductions for the amount of the rate support payments to Subsidiary. Taxpayer now asserts that the intercompany transaction regulations do not require deferral of Parent's deductions. In addition, Taxpayer asserts that the timing change for the deduction of the rate support payments is not a change in method of accounting that requires the prior approval of the Commissioner.

1. Issue 1(a) – 1966 Regulations.

No Intercompany Transaction. Taxpayer primarily maintains that the rate support payments from Parent to Subsidiary do not constitute intercompany transactions under Treas. Reg. section 1.1502-13(a)(1). Taxpayer bases its position on the holding of General Motors Corp. v. Commissioner, 112 T.C. 270 (1999).

2. Issue 1(b) – 1995 Regulations.

a. No Corresponding Item of Income or Intercompany Transaction. Taxpayer maintains that in order for Treas. Reg. section 1.1502-13(c)(2) to apply in the context of the rate support payments, the following basic elements must exist: (1) an intercompany transaction (that gives rise to (2) and (3)); (2) a member's transfer of property or services (Parent's rate support payment) that results in an item of deduction

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[3] Because Subsidiary's basis in the RISC is less than the RISC's face amount, Subsidiary earns both stated interest income and discount income from the RISC as payments are received from the retail customer

[4] For Year 1, the relevant authority is Treas. Reg. section 1.1502-13(a)(1) (1966). For Years 2 and 3, the relevant authority is Treas. Reg. section 1.1502-13(b)(1) (1995).

taken into account in one taxable year; and (3) a member's receipt of the property or services (Subsidiary's receipt of the rate support payment) that results in a "corresponding item" of income in a different taxable year.[5]

Taxpayer argues that the matching rule of Treas. Reg. section 1.1502-13(c)(2) does not apply because: (i) the rate support payments are not income to Subsidiary, but instead reduce Subsidiary's bases in the RISCs; (ii) the discount income that Subsidiary earns from retail customers is not a "corresponding item of income" to Parent's deduction; and (iii) the discount income is not earned from an intercompany transaction with Parent but is earned from a third party, the retail customer.

b. Clear Reflection of Income. Taxpayer emphasizes that the purpose of the regulations under section 1502 is to ensure that the tax liability of a consolidated group may be determined in such manner as to clearly reflect the group's tax liability. Taxpayer maintains that the retail financing program was intended to generate current sales of Product. Taxpayer argues that treating Parent's rate support payments as a non-deferred current deduction clearly reflects the group's income by matching the rate support payment to Parent's current sales being generated. Taxpayer argues that deferral of the rate support payments would distort the group's economic income.

3. Issue 2.

No Change in Method of Accounting. Taxpayer asserts that the timing change for the deduction of the rate support payments is not a change in method of accounting that requires the prior approval of the Commissioner.

LAW AND ANALYSIS:

The filing of consolidated returns is a privilege extended to affiliated groups. I.R.C. sec. 1501. By electing to file consolidated returns, members of a consolidated group consent to be bound by the regulations issued under section 1502. Sec. 1501.

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[5] Taxpayer designates Parent as "S" and Subsidiary as "B" in the terminology of the 1995 intercompany transaction regulations. We note that these designations should be reversed. See Treas. Reg. sec. 1.1502-13(b)(1)(i) and (c)(7)(ii), ex. 13 (1995).

A. DEFERRAL OF DEDUCTIONS FOR PARENT'S RATE SUPPORT PAYMENTS TO SUBSIDIARY IN YEAR 1.

Treas. Reg. section 1.1502-13 (1966)[6] provides:

> (a) Definitions. * * * (1) "Intercompany transaction." * * * the term "intercompany transaction" means a transaction during a consolidated return year between corporations which are members of the same group immediately after such transaction. * * *
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> * * * * * * *
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> (b) Treatment of intercompany transactions other than deferred intercompany transactions. * * * (2) Special rule. If, in an intercompany transaction (other than deferred intercompany transactions), one member would otherwise properly take an item of income or a deduction into account for a consolidated return year earlier than the year (whether consolidated or separate) for which another member of the group can properly take into account the corresponding item of income or deduction, then both the item of income and the deduction shall be taken into account for the later year (whether consolidated or separate). * * *

The information submitted indicates that during Year 1, Parent and Subsidiary treated Parent's rate support payments to Subsidiary in the retail financing program as (i) a reduction in the bases of the RISCs assigned to Subsidiary (resulting in discount income)[7] and (ii) intercompany transactions (other than deferred intercompany transactions) under Treas. Reg. section 1.1502-13(a)(1). As a result, Parent deferred its deductions for those payments in Year 1, pursuant to Treas. Reg. section 1.1502-13(a)(1) and (b)(2).

Taxpayer now claims that the application of Treas. Reg. section 1.1502-13(a)(1) and (b)(2) to Parent's rate support payments to Subsidiary in Year 1 was erroneous. Therefore, Taxpayer maintains that it was entitled to take into account immediately in its consolidated return the full amount of the deductions for those rate support payments.

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[6] Unless otherwise stated, for Year 1, all references to Treas. Reg. section 1.1502-13 are to the consolidated return regulations effective for transactions occurring in years beginning prior to July 12, 1995 (hereinafter, the "1966 regulations").

[7] Subsidiary did not take the rate support payments into income currently. Rather it recorded an amount (equal to the rate support payments) as discount income earned from the retail customers and took the payments into income over the term of the RISCs.

The Tax Court recently addressed this issue in General Motors Corp. v. Commissioner, 112 T.C. 270. Under facts substantially similar to those at issue here, the Tax Court held, inter alia, that, under the 1966 regulations, rate support payments did not constitute intercompany transactions. Thus, Treas. Reg. section 1.1502-13(b)(2) did not require General Motors to defer its deductions for rate support payments to its captive finance subsidiary. General Motors Corp., 112 T.C. at 304.

Based upon the decision in General Motors, the Service will not apply Treas. Reg. section 1.1502-13(b)(2) (1966) to Parent's rate support payments to Subsidiary. Consequently, Parent is not required to defer under Treas. Reg. section 1.1502-13 the deduction of otherwise currently deductible expenses in Year 1.[8]

B. ACCELERATION OF INCOME INCLUSION FOR SUBSIDIARY'S RECEIPT OF DISCOUNT INCOME RELATED TO RATE SUPPORT PAYMENTS IN YEARS 2 AND 3.

Treas. Reg. section 1.1502-13 (1995)[9] provides:

> (a) In general – (1) Purpose. This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).
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> (2) Separate entity and single entity treatment. Under this section, the selling member (S) and buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The amount and location of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The timing, and the character, source, and other attributes of the intercompany items and corresponding items,

[8] See Issue 2, below, for discussion of whether Parent may change, without authorization from the Commissioner, from deferral to current deduction of Parent's rate support payment.

[9] Unless otherwise stated, for Years 2 and 3, all references to Treas. Reg. section 1.1502-13 are to the consolidated return regulations effective for transactions occurring in years beginning on or after July 12, 1995 (hereinafter, the "1995 regulations).

although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

(3) Timing rules as a method of accounting -- (i) In general. The timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See section 1.1502-17. * * * S's or B's application of the timing rules of this section to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole * * * on consolidated taxable income is clearly reflected.

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(b) Definitions. For purposes of this section –

(1) Intercompany transactions – (i) In general. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include –

(A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not the gain or loss is recognized;

(B) S's performance of services for B, and B's payment or accrual of its expenditure for S's performance;

(C) S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditure; and

(D) S's distribution to B with respect to S stock.

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(2) Intercompany items. – (i) In general. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. * * * An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

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(iii) Amounts not yet recognized or incurred. S's intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting. For example, if S is a cash method taxpayer, S's intercompany income might be taken into account under this section even if the cash is not yet received. Similarly, an amount reflected in basis (or an amount equivalent to basis) under S's separate entity method of accounting that is a substitute for income, gain, deduction or loss from an intercompany transaction is an intercompany item.

(3) Corresponding items. – (i) In general. B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. * * * An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

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(4) Recomputed corresponding items. The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation, and the intercompany transaction were between those divisions. For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have if S or B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes).

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(c) Matching rule. For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

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(2) Timing – (i) B's items. B takes its corresponding items into account under its accounting method. * * *

(ii) S's items. S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

> (3) Divisions of a single corporation. As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). * * *

The precise accounting issue as to the rate support transactions described herein is different under the 1995 regulations than under the 1966 regulations.[10] As illustrated in General Motors v. Commissioner, supra, under the 1966 regulations, at issue was the current deduction of Parent's expense. See Treas. Reg. sec. 1.1502-13(b)(2) (1966). In contrast, under the 1995 regulations, it is clear that Parent's otherwise deductible expense (corresponding item) is not to be deferred. See Treas. Reg. sec. 1.1502-13(c)(2)(i) (B takes its corresponding items into account under its accounting method). Rather, the issue is whether Subsidiary is required to accelerate its income to match Parent's deduction in order to clearly reflect the income of the consolidated group. See Treas. Reg. sec. 1.1502-13(c)(2)(ii) (S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item).

Based on the foregoing, under Treas. Reg. section 1.1502-13, the two possible resolutions in the case at hand are: (1) Parent currently deducts the rate support payment and Subsidiary takes discount into income over the term of the RISC (i.e., under Subsidiary's otherwise applicable separate method of accounting), or (2) Parent currently deducts the rate support payment and Subsidiary accelerates the related discount income, to match Parent's deduction. Deferral of Parent's item is not an option.

The information submitted indicates that during Years 2 and 3, Parent and Subsidiary treated Parent's rate support payments to Subsidiary in the retail financing program as (i) a reduction in the basis of the RISCs assigned to Subsidiary (resulting in discount income)[11] and (ii) intercompany transactions under Treas. Reg. section 1.1502-13(b)(1). As a result, Parent deferred its deductions for those payments in Years 2 and 3, in an attempt to comply with Treas. Reg. sections 1.1502-13(a), (b), and (c).

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[10] We note that for Years 2 and 3, the Examination Division and Taxpayer have framed the issue in terms of Parent's current deduction of the rate support payments. Based upon the changes made to the intercompany regulations in 1995, we have reframed the issue to focus upon Subsidiary's inclusion of the discount income related to these rate support payments.

[11] Subsidiary recorded an amount (equal to the rate support payment) as discount income earned from the retail customers and took the payments into income over the term of the RISCs.

Taxpayer now claims that the application of Treas. Reg. section 1.1502-13(c)(2) to Parent's rate support payments to Subsidiary in Years 2 and 3 was erroneous. Taxpayer maintains that the intercompany transactions regulations do not apply to the rate support payments because (1) the rate support payments do not constitute intercompany transactions, and (2) neither the rate support payments nor the discount income on the RISCs constitute "corresponding items" to Subsidiary. Further, Taxpayer argues that, even if the 1995 intercompany transactions apply, Parent must currently deduct the rate support payments in order to clearly reflect the income of the consolidated group. Therefore, Taxpayer maintains that it was entitled to currently deduct on its consolidated return the full amount of the rate support payments.

As indicated above, based upon the Tax Court's decision in <u>General Motors</u>, the Service will not apply the 1966 intercompany transaction regulations to Parent's rate support payments. However, the Tax Court's discussion and analysis in <u>General Motors</u> is expressly limited to the 1966 regulations,[12] and thus is inapplicable to the 1995 regulations. The intercompany transaction regulations were significantly altered in 1995. The 1995 amendments apply to transactions occurring in years beginning on or after July 12, 1995. Thus, they apply to Years 2 and 3, at issue herein.

1. <u>Applicability of the 1995 Regulations -- Existence of Intercompany Transaction and "Corresponding Item"</u>

Taxpayer asserts that the intercompany transaction regulations do not apply to the rate support payments from Parent to Subsidiary during Years 2 and 3 because such payments do not constitute intercompany transactions. However, under the 1995 regulations, the definition of "intercompany transaction" is very broad: "a transaction between corporations that are members of the same consolidated group immediately after the transaction." Treas. Reg. sec. 1.1502-13(b)(1)(i). In addition, the examples in the regulations make clear that a wide variety of transactions were intended to fall within the rule. <u>See</u> Treas. Reg. sec. 1.1502-13(b)(1) (sale of property, performance of services, licensing of technology, rental of property, extension of loan, corporate distribution), and (c)(7)(ii), ex. 3 (sec. 351 contribution) and ex. 13 (manufacturer incentive payment). Further, the definitions of "intercompany item" and "corresponding item", discussed below, reinforce the broad reach of these regulations. Therefore, we conclude that the rate support payments from Parent to Subsidiary constitute "intercompany transactions."

Taxpayer also argues that the intercompany transaction regulations do not apply to the transaction because neither the discount income received by Subsidiary over the

[12] The Tax Court states, "The 1995 amendments are not before the Court; therefore, we make no conclusions as to whether these amendments are valid." <u>General Motors Corp</u>, 112 T.C. at 299, n.28.

term of a RISC nor the rate support payment itself constitutes a "corresponding item" to Subsidiary under the 1995 regulations. We note here that, because Parent is the paying party in the transaction, it is designated as the buying member, or "B", under the 1995 regulations. Therefore, Parent's expense item would constitute the corresponding item in the transaction. See Treas. Reg. sec. 1.1502-13(b)(1)(i) and (3)(i). Subsidiary's income would constitute the intercompany item or items. See Treas. Reg. sec. 1.1502-13(b)(2)(i); see also Treas. Reg. sec. 1.1502-13(c)(7)(ii), ex. 13. However, because of the similarities in the definitions of intercompany item and corresponding item, Taxpayer's misapprehension is of no consequence.

In substance, Taxpayer asserts that the discount income cannot constitute an intercompany item because Subsidiary receives it from a third party. However, the broad definitions of "intercompany item" and "corresponding item" adopted by the 1995 regulations make clear that such items may flow "directly or indirectly from an intercompany transaction." Treas. Reg. sec. 1.1502-13(b)(2)(i) and (3)(i). Therefore, the 1995 regulations contemplate a situation in which a group member may receive from a non-member party a payment containing either a corresponding item or an intercompany item.[13] Thus, we conclude that the discount income received by Subsidiary constitutes an intercompany item.

We have concluded that, under the 1995 regulations, (1) the rate support payments from Parent to Subsidiary constitute intercompany transactions; (2) Parent's rate support payments constitute corresponding items; and (3) Subsidiary's discount income receipts from the RISCs constitute intercompany items. Therefore, we next examine how application of the 1995 regulations will effect the timing of these items.

2. Proper Application of the 1995 Regulations -- Clear Reflection of Income Standard

Taxpayer argues that, even if the 1995 intercompany transaction regulations apply to the rate support transactions, application of the regulations should result in no deferral of Parent's otherwise deductible rate support payment. Taxpayer argues that current deduction is necessary to clearly reflect the income of the consolidated group.

The purpose of the 1995 intercompany transaction regulations is "to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." Treas. Reg. sec. 1.1502-

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[13] See, e.g., sec. 1.1502-13(c)(7)(ii), ex. 13; see also Treas. Reg. sec. 1.1502-13(b)(2)(iii) (an amount reflected in basis under S's separate entity method of accounting that is a substitute for income, gain, deduction, or loss from an intercompany transaction is an intercompany item.)

13(a)(1). Therefore, these regulations must be applied in such a way as to reach a timing result that clearly reflects the income of the consolidated group.

Under the 1995 regulations, the timing of the inclusion of B's corresponding item in any year generally controls the timing of the inclusion of S's intercompany item. Treas. Reg. sec. 1.1502-13(c)(2)(i) and (ii). However, the clear reflection of income principle controls the overall timing of items. That clear reflection standard is represented in the calculation of the "recomputed corresponding item", which is the hypothetical item that B would take into account "if S and B were divisions of a single corporation and the intercompany transaction were between those divisions." Treas. Reg. sec. 1.1502-13(b)(4).

The clear reflection of income standard is imposed in each year by application of the following formula: Recomputed corresponding item <u>minus</u> corresponding item <u>equals</u> intercompany item. That is, the amount of S's intercompany item taken into income in any year equals the hypothetical amount that the single-entity would take into account for that year (recomputed corresponding item) <u>minus</u> the amount of B's corresponding item. In this case, the amount of Subsidiary's intercompany item (discount income) to be taken into income in each year is equal to the group's hypothetical "single entity" item <u>minus</u> Parent's corresponding item (rate support payment).[14]

Therefore, the proper application of the 1995 intercompany transaction regulations hinges on the appropriate single-entity tax treatment of the RISC-acquisition transaction. That is, for this purpose, we assume that a hypothetical Parent-Subsidiary single-entity acquired a below-market interest rate RISC at face value rather that fair market value, in order to stimulate interest in Product and to increase sales volume. The question to be answered is whether the hypothetical single-entity's income would be clearly reflected to the extent that it currently deducted (e.g., as a marketing expense) the spread between fair market value and face value of that RISC.

3. <u>Deductibility on Hypothetical Single-Entity Basis</u>

Section 162(a) provides that a deduction is allowed for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. section 1.162-1(a) provides that selling expenses generally constitute business expenses within the meaning of section 162.

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[14] As discussed in the Facts section of this document, the current deductibility of the rate support payment by Parent (if it were filing a separate return) is not addressed by this Technical Advice Memorandum.

Section 1012 provides that the basis of property is generally the cost of such property. Treas. Reg. section 1.1012-1(a) provides that the cost is the amount paid for such property in cash or other property.

Thus, in a money-for-property transaction, cost is equal to the price paid for the property. Edwards v. Commissioner, 19 T.C. 275, 279 (1952), acq., 1953-1 C.B. 4. However, this rule does not apply where a transaction is not conducted at arm's length between two economically self-interested parties or where there are peculiar circumstances that influence the purchaser to agree to a price greater than the property's fair market value. See, e.g., Lemmen v. Commissioner, 77 T.C. 1326, 1347-48 (1981), acq., 1983-2 C.B. 1; Bixby v. Commissioner, 58 T.C. 757, 776 (1972), acq., 1975-2 C.B. 1; Regan v. Commissioner, T.C. Memo 1982-733. In such cases, the basis in purchased property may be limited to its fair market value. See, e.g., Lemmen, 77 T.C. at 1347-48; Mountain Wholesale Co. v. Commissioner, 17 T.C. 870, 875 (1951); G.U.R. Co. v. Commissioner, 41 B.T.A. 223, 226 (1940), aff'd, 117 F.2d 187 (7th Cir. 1941). The amount paid in excess of fair market value should be treated in accordance with the substance of the transaction. See Lemmen, 77 T.C. at 1350-51.

In Lemmen, the taxpayer purchased two herds of cattle, one for $40,000 and one for $20,000. At the time of purchase, the fair market value of each herd was about $7,000. Simultaneously with each purchase, the taxpayer entered into a maintenance contract under which the seller agreed to breed and provide care for the herd. The stated consideration for the maintenance contracts was worth less than the fair market value of the services to be provided under the contracts. The court found that the dealings between the parties were carried on at arm's length and that the buyer and seller were each economically self-interested. However, because the stated price for the herds was inflated, while the stated consideration for the maintenance contracts was unrealistically low, the court found that the taxpayer, in substance, purchased a package that included the herd and the maintenance contract. Because of these "peculiar circumstances," for depreciation and investment tax credit purposes, the court limited the taxpayer's basis in the cattle to the cattle's fair market value, $7,000 per herd. The court held that the amount paid in excess of the fair market value of the cattle was allocable to the maintenance contracts. See also Regan, T.C. Memo 1982-733 (same result on similar facts).

In Rev. Rul. 89-102, 1989-2 C.B. 202, a foreign corporation agreed to sell a product to a foreign government at a price in excess of the product's fair market value. As a condition of this transaction, the foreign government required the domestic corporate parent of the foreign corporation to purchase another product, also at an inflated price, from an unrelated third party. The Service ruled that the two transactions were related and limited the domestic corporation's basis in the property it purchased to the property's fair market value.

In other cases, courts have also limited a taxpayer's basis to the fair market value of acquired property where special circumstances or the relationship between the parties have caused a taxpayer to pay more than fair market value for the property. In Majestic Securities Corp. v. Commissioner, 120 F.2d 12 (8th Cir. 1941), the taxpayer purchased securities from a bank at a price in excess of fair market value. Virtually all of the taxpayer's stock was owned by stockholders of the bank or relatives of a principal stockholder of the bank. The court held that the excess amount paid for the securities was actually paid to improve the condition of the bank and was not part of the taxpayer's basis in the securities for purposes of computing gain or loss on a subsequent sale. In New Hampshire Fire Insurance Co. v. Commissioner, 2 T.C. 708 (1943), nonacq., 1944 C.B. 45, aff'd, 146 F.2d 697 (1st Cir. 1945), an insurance company repurchased its own stock from some of its agents at a price above fair market value. The insurance company paid the excess amount because of a "moral obligation to keep faith" with its agents, who had purchased the stock as an investment before its value declined. The court stated that "[p]rices in excess of market paid for personal reasons are not the correct measure of cost." N.H. Fire Ins. Co., 2 T.C. at 724. The court held that the taxpayer did not incur a deductible loss upon the subsequent resale because the excess amount was not part of the taxpayer's basis in the stock.

In Jordan v. Commissioner, 60 T.C. 872 (1973), aff'd, 514 F.2d 1209 (8th Cir. 1975), the taxpayer, along with others, organized an insurance company and received options to purchase the company's stock. Other shareholders subsequently sued the corporation and its incorporators for violating S.E.C. rules by not disclosing that stock sold to incorporators was unrestricted as to resale, while stock sold to the general public had provisions restricting subsequent sales. As a result, the taxpayer and other incorporators purchased some of the stock from other shareholders at a price in excess of fair market value at that time. The taxpayer made these purchases to protect his business reputation and future earnings, not to acquire more stock in the insurance company. The taxpayer deducted the excess amount paid for the stock. The court held that the taxpayer's basis in the stock was equal to the entire amount paid for it, and that no part of the payment was deductible. The court distinguished Majestic Securities Corp. and New Hampshire Fire Insurance Co. on the grounds that the parties in those cases were related and set a higher price to enhance the financial position of the seller. In Jordan, however, the parties were dealing at arm's length and the price did not reflect the taxpayer's desire to aid the seller.

Under the retail financing program, the hypothetical single-entity (Parent and Subsidiary) pays a price in excess of fair market value to acquire a RISC from an Unaffiliated Product Dealer. The Parent-Subsidiary single-entity would not ordinarily pay a premium to acquire a RISC that carried a below-market interest rate. Parent initiated the retail financing program to encourage retail customers to purchase Product from Unaffiliated Product Dealers. As a result, Parent hoped to increase its sales of Product. Thus, the rate support payment should not be treated as part of the basis in the RISC, because, in substance, it was not part of the cost of acquiring the RISC. Rather, it was an incentive payment that was essentially passed along to the customer in the form of below-market-rate financing. Therefore, the rate support payment is properly treated as a selling or marketing expense paid to stimulate sales of Product. As such, the rate support payment should be deductible under section 162 in the taxable year paid or incurred.

4. Conclusion – Issue 1(b)

The facts of this Technical Advice Memorandum assume that Parent (B) is entitled to currently deduct its rate support payment (corresponding item) to Subsidiary under its separate method of accounting. We have concluded above that the hypothetical single-entity would be permitted to deduct the intentional overpayment (i.e., the spread between face amount and fair market value) on acquisition of a RISC. Therefore, Subsidiary's intercompany item inclusion for the year of the rate support payment transaction computes as follows under Treas. Reg. section 1.1502-13(c)(2)(ii):

> Full amount of the spread (recomputed corresponding item) minus full amount of the spread (corresponding item) equals 0 (intercompany item).

Consequently, we conclude that, under the given facts, no acceleration by Subsidiary is required in the year of the rate support transaction to satisfy the clear reflection of income standard embedded in the purpose statement of the intercompany transaction regulations. See Treas. Reg. sec. 1.1502-13(a)(1). The intercompany transaction regulations will not cause a change in the timing of Subsidiary's income inclusion.[15]

C. CHANGE IN METHOD OF ACCOUNTING

Section 446(a) of the Internal Revenue Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

No uniform method of accounting can be prescribed for all taxpayers. Each taxpayer may adopt such forms and systems as are, in its judgment, best suited to its needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of

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[15] See Issue 2, below, for discussion of whether Parent may change, without authorization from the Commissioner, from deferral to current deduction of Parent's rate support payment.

gross income and expense are treated consistently from year to year. Treas. Reg. sec. 1.446-1(a)(2).

Section 446(b) requires that a taxpayer use a method of accounting that clearly reflects income. If a method of accounting does not clearly reflect income, the taxpayer may be required to compute taxable income using a method that, in the opinion of the Commissioner, does clearly reflect income.

Section 446(e) prohibits a taxpayer from changing the method of accounting used to compute taxable income without first securing the Commissioner's consent. The term "method of accounting" includes not only the over-all method of accounting but also the accounting treatment of any material item. Treas. Reg. sec. 1.446-1(e)(2)(ii)(a). 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 Treas. Reg. sec. 1.446-1(e)(2)(ii)(a). In most cases, a method of accounting is established by a pattern of consistent treatment of an item. Id. When a taxpayer treats a material item in the same way in determining gross income or deductions on two or more consecutively filed tax returns, such treatment represents consistent treatment of that item for purposes of Treas. Reg. section 1.446-1(e)(ii)(a) and the taxpayer has effectively adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57; see also Diebold, Inc. v. United States, 16 Cl. Ct. 193, aff'd, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990). The Commissioner's consent is required even where the method currently being used is not proper or permitted under the Code and regulations. Treas. Reg. sec. 1.446-1(e)(2)(i); see also, FPL Group, Inc. v. Commissioner, 115 T.C. 554, 561 (2000) ("a method of accounting includes 'the consistent treatment of a recurring, material item, whether that treatment be correct or incorrect.'" (quoting H.F. Campbell Co. v. Commissioner, 53 T.C. 439, 447 (1969), aff'd, 443 F.2d 965, (6th Cir. 1971))).

Treas. Reg. section 1.446-1(e)(2)(ii)(b) provides that 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).

The filing of consolidated returns is a privilege extended to affiliated groups. See section 1501. Section 1502 provides that the Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

Treas. Reg. section 1.1502-12 provides that the separate taxable income of a member is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations (subject to certain modifications found in Treas. Reg. sections 1.1502-12(a) through 12(r)).

Treas. Reg. section 1.1502-12(a) (1966) provides that transactions between members and transactions with respect to stock, bonds, or other obligations of members shall be reflected according to the provisions of Treas. Reg. sections 1.1502-13 and 1.1502-14.

Treas. Reg. section 1.1502-12(a) (1995) provides that transactions between members and transactions with respect to stock, bonds, or other obligations of members shall be reflected according to the provisions of Treas. Reg. section 1.1502-13.

Treas. Reg. section 1.1502-12(d) provides that the method of accounting under which separate taxable income is computed and the adjustments to be made because of any change in method of accounting shall be determined under Treas. Reg. section 1.1502-17.

Treas. Reg. section 1.1502-13(a)(1) (1966) provides that an intercompany transaction means a transaction during a consolidated return year between corporations which are members of the same group immediately after such transaction.

Treas. Reg. section 1.1502-13(b)(2) (1966) provides that, if, in an intercompany transaction (other than deferred intercompany transactions), one member would otherwise properly take an item of income or a deduction into account for a consolidated return year earlier than the year (whether consolidated or separate) for which another member of the group can properly take into account the corresponding item of income or deduction, then both the item of income and the deduction shall be taken into account for the later year (whether consolidated or separate).

Treas. Reg. section 1.1502-13(a)(1) (1995) acknowledges that its purpose is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

Treas. Reg. section 1.1502-13(a)(3) (1995) states that the timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member’s other methods of accounting.

Treas. Reg. section 1.1502-17(a) provides that the method of accounting to be used by each member of the group shall be determined in accordance with the provisions of section 446 as if such member had filed a separate return.

Treas. Reg. section 1.1502-17(b) (1995) provides that if a member of a group changes its method of accounting for a consolidated return year, the terms and conditions prescribed by the Commissioner under section 446(e) shall apply to the member.

For the years at issue, Subsidiary treated the rate support payments as a reduction in its basis in the RISCs and reported an equivalent amount as discount income over the term of the related RISCs. Believing that these transactions constituted intercompany transactions under Treas. Reg. section 1.1502-13, Parent deferred its deductions for the rate support payments until Subsidiary took the amounts into income.

On March , Taxpayer filed a refund claim for each of Year 1, Year 2, and Year 3. The claim for refund asserts that rate support payments made by Parent to Subsidiary are not intercompany transactions that must be accounted for pursuant to Treas. Reg. section 1.1502-13 of either the 1966 regulations or the 1995 regulations. In addition, Taxpayer asserts that the timing change for the deduction of the rate support payments is not a change in method of accounting that requires the prior approval of the Commissioner.

1. Whether Parent May Change the Time for Deducting Rate Support Payments in Year 1 Without First Securing the Commissioner's Consent[16]

Section 446(e) prohibits a taxpayer from changing an accounting method used in the computation of taxable income without first securing the Commissioner's consent. Thus, once a taxpayer has established a method of accounting, the taxpayer cannot unilaterally begin using a different method of accounting to compute its taxable income. The consent requirement applies even where the method currently in use is an impermissible method.

Timing and consistency are the hallmarks of a method of accounting. The consistent treatment of a material item establishes a method of accounting. A material item is any item that involves the proper time for including an item in income or the taking of a deduction. Thus, a taxpayer establishes a method of accounting by the application of a timing rule to a particular type of expense in two or more consecutive tax returns. See Rev. Rul. 90-38, 1990-1 C.B. 57; see also Diebold, Inc. v. United States, 16 Cl. Ct. 193, aff'd, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990).

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[16] Unless otherwise stated, for Year 1, all references are to Treas. Reg. section 1.1502-13 (1966).

Parent's separate taxable income for all years at issue was computed under Treas. Reg. section 1.1502-12 which incorporates the timing provisions of Treas. Reg. section 1.1502-13(b)(2). Treas. Reg. sec. 1.1502-12(a).[17] Under Taxpayer's reading of Treas. Reg. section 1.1502-13, Parent consistently deferred its deductions for the rate support payments made to Subsidiary so that the deductions would match Subsidiary's discount income. (The amount of each rate support payment Parent deducted in a particular year was equal to the amount of discount income that Subsidiary took into account from the RISC to which the rate support payment related.) Parent's treatment of rate support payments did not affect whether rate support payments would be deducted; it only affected when those payments would be deducted. Indeed, Taxpayer acknowledges that Parent's treatment of rate support payments only involved the timing of the deduction for rate support payments.

Taxpayer argues that Parent's consistent treatment of rate support payments did not establish a method of accounting, even though such treatment only affected the proper time for taking a deduction. Taxpayer's assertion is based on the central premise that Parent's tax accounting method for rate support payments was the accrual method. Taxpayer argues that Parent's systematic deferral of deductions for rate support payments that were otherwise allowable for a particular year under the accrual method was not an accounting method. Thus, according to Taxpayer, the claim for refund is based on the proper application of Parent's previously-established accrual method for rate support payments, not a change from a deferral method to the accrual method.

Taxpayer believes that Parent's tax accounting method was the accrual method because it "consistently deducted rate support payments in the year made on its separate corporate books." It then made adjustments for purposes of computing Taxpayer's consolidated taxable income. Those adjustments, Taxpayer argues, were not part of Parent's method of accounting, but part of the consolidated group's "method of reporting." We disagree.

Section 446(a) requires a taxpayer to compute its taxable income under the method of accounting used in keeping the taxpayer's books. For nearly a half-century, the term "books" for purposes of section 446(a) has been interpreted so as to include memorandum journal entries and accounting workpapers containing accounting adjustments necessary to convert the items of income and expense recorded in the

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[17] Under Treas. Reg. section 1.1502-12 (1966 and 1995), a member's separate taxable income is computed as if it were a separate corporation, subject to certain modifications found in Treas. Reg. sections 1.1502-12(a) through 12(r) (including adjustments required under Treas. Reg. section 1.1502-13). The group's consolidated taxable income is determined by taking into account the separate taxable income of each member of the group and certain other listed items. Treas. Reg. sec. 1.1502-11.

taxpayer's books to the tax accounting method. See Patchen v. Commissioner, 258 F.2d 544, 546 (1958). This interpretation is necessary because financial accounting and tax accounting have different criteria for income inclusion and expense deduction.[18] For example, a business entity may establish a reserve for estimated expenses for financial accounting purposes, but is not eligible to deduct those expenses for tax accounting purposes until the all-events test is satisfied. Thus, an adjustment must be made to the financial books so that the tax accrual method is properly applied. Similarly, amounts that are deductible in a certain period for financial purposes that also meet the all-events test may be capitalized into inventory or into other property for tax purposes, but not financial accounting purposes. Here again, an adjustment for tax purposes is necessary. These adjustments are part of the taxpayer's books for purposes of section 446(a), and the result of the adjustments from the books of original entry to the income tax computation is the taxpayer's method of accounting for federal income tax purposes.

In the instant case, Parent made accounting adjustments to its original bookkeeping entries so that the rate support payments that otherwise met the all-events test for accrual of deductions during the taxable year were taken into account over several years. These accounting adjustments were part of Parent's books and records for purposes of section 446. Moreover, these adjustments resulted in the computation of Parent's separate taxable income using the method of accounting that Parent used in keeping its books. Thus, Taxpayer's assertion that Parent's method of accounting was the accrual method because Parent "consistently deducted rate support payments in the year made on its separate corporate books" is incorrect insofar as section 446 is concerned. For purposes of section 446, Parent's method of accounting was to defer its deductions for the rate support payments made to Subsidiary so that the deductions would match the amount of discount income that Subsidiary took into account from the RISC to which the rate support payment related. Whether Parent's deferral of deductions for rate support payments was permissible or not, its treatment of the deductions constituted a method of accounting and, under section 446(e), cannot be changed without first securing the Commissioner's consent.

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[18] This interpretation is also necessary for the appropriate application of the consent requirement of section 446(e). On its face, section 446(e) requires the Commissioner's consent to a tax accounting method change only where the taxpayer has also changed its book accounting method. Nonetheless, since the adjusting entries are part of the book accounting method, the Commissioner's consent is also necessary in situations where a taxpayer changes its tax accounting method without changing its basic bookkeeping method. Without the Patchen rule, the accounting oversight role Congress assigned to the Commissioner in section 446(e) would be severely limited because taxpayers could change their tax accounting methods without the Commissioner's approval so long as they did not also make similar changes for book and financial accounting purposes.

In General Motors Corp. v. Commissioner, 112 T.C. 270 (1999), relied on by Taxpayer, the Service stipulated that General Motor's method of accounting was to deduct rate support payments as incurred. The Tax Court held that subsequent adjustments made to comply with Treas. Reg. section 1.1502-13 of the 1966 regulations was a "method of reporting" rather than a method of accounting for the General Motors consolidated group.[19] Here, in contrast, we believe that Parent's method of accounting for purposes of section 446 was to defer its deductions for the rate support payments so that the deductions would match the amount of discount income that Subsidiary took into account from the RISCs to which the rate support

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[19] The General Motors court made other statements in regard to the relationship between section 446 and Treas. Reg. section 1.1502-13 that Taxpayer relies on to support its position. In one passage, the court stated that since the matching rule of Treas. Reg. section 1.1502-13 is not mentioned as a permissible method in section 446(c), it is not a method of accounting. General Motors, 112 T.C. at 299. In making this statement, the court apparently overlooked the regulations under section 446(c) providing that the Commissioner may authorize a taxpayer to use a method of accounting not specifically described in Chapter 1 of the Code or the regulations thereunder if the Commissioner determines that the method of accounting clearly reflects the taxpayer's income. Treas. Reg. sec. 1.446-1(c)(2)(ii). Moreover, section 446(c) only describes permissible methods of accounting. It is well-settled that improper or impermissible methods of accounting are nonetheless methods of accounting and cannot be changed without first securing the Commissioner's consent. Treas. Reg. sec. 1.446-1(e)(2)(i); see H.F. Campbell Co. v. Commissioner, 53 T.C. 439, 447 (1969), aff'd, 443 F.2d 965, (6th Cir. 1971); accord Diebold, Inc. v. United States, 16 Cl. Ct. 193, aff'd, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990); Witte v. Commissioner, 513 F.2d 391, 394 (D.C. Cir. 1975); American Can Co. v. Commissioner, 317 F.2d 604, 606 (2d Cir. 1963), cert. denied, 375 U.S. 993 (1964); Commissioner v. O Liquidating Corp., 292 F.2d 225 (3d Cir.), cert. denied, 368 U.S. 898 (1961). Thus, the fact that a taxpayer's accounting treatment of an item is not described in section 446(c) is not determinative as to whether that treatment qualifies as a method of accounting.

In another passage, the Tax Court's opinion seems to suggest that section 446(e) is inapplicable in cases where the taxpayer does not also use the method being changed for financial accounting purposes. However, the Tax Court subsequently approved the Commissioner's rejection of an accounting method change that the taxpayer made solely for purposes of computing taxable income. See FPL Group, Inc. v. Commissioner, 115 T.C. 554 (2000). For the reasons explained in note 17, *supra*, we believe that the court's conclusion in FPL Group is the correct interpretation of section 446(e).

payments related.[20] Thus, to the extent that the General Motors court relied on the stipulation that General Motor's method was to deduct rate support payments as incurred, the holding of the case is inapplicable here. Parent's separate taxable income was not computed by taking into account the full amount of its payments to Subsidiary only to have those deductions adjusted in calculating Taxpayer's consolidated taxable income. Rather, Parent's separate taxable income computed under Treas. Reg. section 1.1502-12 was itself computed by application of the timing provisions of Treas. Reg. section 1.1502-13(b)(2) to rate support payments made to Subsidiary.

Taxpayer also relies on Henry C. Beck Co. v. Commissioner, 52 T.C. 1 (1969), aff'd per curiam, 433 F.2d 309 (5th Cir. 1970); Vernon C. Neal, Inc. v. Commissioner, 23 T.C. Memo 873 1964-145; United Contractors, Inc. v. Commissioner, 23 T.C. Memo 453 1964-68, aff'd per curiam, 344 F.2d 123 (4th Cir. 1965). None of these cases involved the deferral of deductions generally or the application of Treas. Reg. section 1.1502-13(b)(2) in particular. These cases involved regulations in effect prior to the 1966 regulations where income, gains, losses, and deductions were zeroed out (eliminated) between members of a consolidated group. Therefore, timing questions regarding the reporting of these items could never arise. However, the 1966 regulations in effect in Year 1 specifically provide for systems where the timing of income and deductions is matched between members of a consolidated group. Consequently, those cases do not address the issues presented here.

Although Taxpayer has not specifically argued that the proposed "correction" falls within the scope of Treas. Reg. section 1.446-1(e)(2)(ii)(b), which lists certain adjustments that do not constitute accounting method changes, we note that none of the provisions of that regulation applies to Taxpayer's facts. Whether Parent deferred its deductions due to its erroneous application of the timing rules of Treas. Reg. section 1.1502-13 or any other timing principle is irrelevant. That deferral was a method of accounting, not merely a reporting error. See FPL Group, Inc. v. Commissioner, 115 T.C. 554 (2000) (taxpayer capitalized and depreciated certain expenditures based on regulatory accounting requirements that might have been different from tax accounting requirements).

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[20] The Tax Court has previously held that the deferral of an otherwise accruable expense until a related party includes the amount in income is a method of accounting. Summit Sheet Metal Co. v. Commissioner, T.C. Memo. 1996-563. That method of accounting is similar to the method used by Parent in this case where Parent deferred the deduction of its rate support payments to Subsidiary so that the deductions Parent took in a given taxable year would match the amount of discount income that Subsidiary took into account in the same taxable year.

2. Whether Parent May Change the Time for Deducting Rate Support Payments Made in Year 2 and Year 3 Without First Securing the Commissioner's Consent

Parent attempted to apply the timing provisions of the 1995 intercompany transaction regulations in computing its taxable income for Year 2 and Year 3. As discussed above in our analysis of Issue 1, Parent's interpretation of those regulations was erroneous; in effect, Parent applied the timing provisions of the 1966 regulations. Parent now attempts to change its timing rule for rate support payments to conform with a correct reading of the 1995 regulations, as determined above at Issue 1(b).

Whether Parent's attempt to change its treatment of rate support payments for Year 2 and Year 3 is a change in method of accounting must be analyzed under the 1995 regulations. Although Parent did not correctly apply the timing rules of Treas. Reg. section 1.1502-13[21] to its rate support payments, Parent did apply a consistent timing rule for those intercompany transactions in computing its taxable income for two consecutive years. This consistent treatment of rate support payments satisfies the requirements for establishing a method of accounting under the general rules of section 446, which are incorporated into Treas. Reg. section 1.1502-17(b). The 1995 regulations specify that the timing rules set forth in the intercompany transaction provisions are a method of accounting to be applied by each member of a consolidated group in addition to the member's other methods of accounting. See Treas. Reg. section 1.1502-13(a)(3). Therefore, Parent's attempt to change its consistently applied timing rule for rate support payments to conform the timing of its deductions with a correct reading of the 1995 intercompany transaction regulations is, by definition, a change in method of accounting. Treas. Reg. section 1.1502-17(b) (1995) requires members of a consolidated group to follow the rules of section 446(e) by securing the Commissioner's consent before changing a method of accounting.

Taxpayer argues, however, that because Parent is entitled to change its accounting treatment of the rate support payments for Year 1,[22] Parent is permitted to "carry-through" the new treatment to all succeeding taxable years. Thus, notwithstanding the fact that Parent consistently applied a timing rule to its rate support payments in Year 2 and Year 3, Taxpayer argues that Parent is permitted to change its accounting treatment of rate support payments in those years to conform to the revised treatment of those payments in the immediately preceding taxable year. Stated differently, Taxpayer argues that though Parent's prior consistent accounting treatment

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[21] Unless otherwise stated, for Years 2 and 3, all references are to Treas. Reg. sections 1.1502-13 (1995).

[22] Taxpayer's argument assumes that Parent did not establish a method of accounting prior to Year 2 under the regulations applicable to those prior years.

of rate support payments is not a method of accounting for purposes of section 446(e) in Year 1, the treatment of those payments on the final amended return for Year 1 establishes Parent's method of accounting for purposes of applying Treas. Reg. section 1.1502-13 in Year 2 and following.

Taxpayer's position in this regard is clearly incorrect. Even if Parent had not established the deferral method of accounting for rate support payments prior to Year 2, the consistent use of that method in Year 2 and Year 3 establishes it as Parent's method of accounting for purposes of Treas. Reg. sections 1.1502-13 and 1.1502-17 (1995). Under section 446(e), a taxpayer may not change from a consistently used method of accounting, whether the method is proper or improper, without first securing the Commissioner's consent. This principle is incorporated into Treas. Reg. section 1.1502-17(b) (1995). Thus, Parent may not change its accounting method for rate support payments in Year 2 and Year 3 through the filing of an amended return by Taxpayer.

3. Conclusion – Issue 2

Parent consistently deferred deductions for its rate support payments to Subsidiary until Subsidiary took those payments into income over the term of the RISC. Parent, in determining its separate taxable income under Treas. Reg. section 1.1502-12, consistently deferred deductions for its rate support payments to Subsidiary. This treatment, regardless of Treas. Reg. section 1.1502-13's applicability, established a method of accounting for Parent. The refund claim filed on March for Year 1, Year 2, and Year 3, represents a retroactive change of accounting method for those years without following the procedures under section 446 applicable to requesting the consent of the Commissioner. Since Taxpayer did not timely file the required Form 3115 and obtain permission from the Commissioner for those years, Parent is prohibited from changing its treatment of the rate support payments to Subsidiary in Year 1, Year 2, and Year 3.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.