ROBERTS & HOLLAND LLP

December 19, 2018

Adoption and Change of Accounting Method: *Thrasys v. Commissioner*

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Businesses have significant flexibility in adopting accounting methods for tax purposes. This flexibility relates not only to "overall" accounting methods of general application, such as the cash and accrual methods, but also to accounting for specific items of revenue and expense. However, once an accounting method is adopted, whether an overall method or one that relates only to specific items, the taxpayer generally is not permitted to change that method, except with the consent of the Internal Revenue Service (see Internal Revenue Code ("Code") Sec. 446(e) and Reg. Sec. 1.446-1(e)(2)(ii)*(a)*).

In *Thrasys, Inc. v. Commissioner* (T.C. Memo 2018-199), a recent Tax Court decision, the government sought summary judgment that the corporate taxpayer could not use the "deferral method" of accounting for one large advance payment that the taxpayer received during the year in issue. The taxpayer had permissibly adopted the deferral method several years earlier, but had then accounted for advance payments received in one interim year in a manner inconsistent with the deferral method, and had also used an inconsistent method on its tax return for the year in issue, as originally filed. The taxpayer never obtained the IRS's permission to change from the deferral method to either inconsistent method. Nevertheless, the government's position in *Thrasys* was that the taxpayer's impermissible divergences from the deferral method precluded the corporation from shifting back to the deferral method for the advance payment in the year at issue without IRS consent.

The Tax Court denied the motion for summary judgment. The decision offers guidance as to when a taxpayer will be considered to have adopted, or changed, an accounting method, which can be an issue in many contexts other than that of accounting for advance payments.

Facts in *Thrasys*

Thrasys, Inc. ("Thrasys") was, during and prior to the year at issue (2008), a C corporation engaged in a software development business, primarily for customers in the healthcare industry. It used the accrual method of accounting.

Commencing in 2005, Thrasys entered into contracts with Siemens Medical Solutions USA, Inc. ("Siemens") to develop software for Siemens. These contracts were amended several times, and additional contracts were executed with Siemens, during the years 2006 to 2008. Each time a contract or amendment was executed, Siemens made a payment that was described, in a declaration of a Thrasys executive submitted to the court (the "Declaration"), as an advance payment—that is, a payment for services or goods that, at least in part, would not be earned until a year after the year of receipt.

The advance payments received in the years 2005 through 2008 were taken into account in various ways on the income tax returns of Thrasys. Advance payments totaling $1,281,945 that were received from Siemens in 2005 were reflected in the balance sheet included in the Thrasys return for 2005 as "unearned revenue," with that amount being taken into income by Thrasys on its 2006 return.

The reporting of the initial advance payments received by Thrasys seems to have been consistent with one of the accounting methods permitted for such payments under Revenue Procedure 2004-34 (2004-1 C.B. 991). That revenue procedure generally provides that advance payments that are received in one taxable year but not earned until a later taxable year, and that are otherwise within the scope of the revenue procedure, may be taken into income either under the "full inclusion" method, under which the amount is included in income in the year received, or under the "deferral method," under which the amount is included in income in the taxable year following the year of receipt.

Advance payments were also received from Siemens in 2006 and 2007, in the amounts of $958,000 and $98,000 respectively. The 2006 advance payment was not included in the gross income of Thrasys as reported on its returns for

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2007, the year of required inclusion under the deferral method permitted by the revenue procedure, or for 2006. The Declaration described this as a mistake possibly caused by failure of communication between Thrasys and its tax return preparer. Both the 2006 and 2007 advance payments were ultimately included in the gross income reported on the 2008 return of Thrasys.

In 2008, an advance payment of $15 million was received from Siemens under an agreement which was referenced in a note in the Thrasys financial statements as the "Asset Acquisition Agreement." The note further stated that Thrasys did not deliver certain software by December 31, 2008, as required under that agreement, and considered itself to be in technical breach of the agreement at that date. By reason of the technical breach, Thrasys considered the $15 million to be potentially refundable, and the payment was therefore recorded on its books as a customer deposit liability (which would not be included in income so long as it retained its character as a deposit) and not as deferred revenue.

It was determined by the end of 2009, however, that the risk of having to refund the $15 million payment had been eliminated. Accordingly, the deposits shown on the balance sheet included in return at the beginning of 2009 were reduced by $15 million, and that amount was included in deferred revenue at the end of 2009. Coincidentally or otherwise, Thrasys elected to be taxed as an S corporation effective January 1, 2009.

The $15 million was reported on the 2010 return of Thrasys as a long-term capital gain. That return also included a Form 8275 Disclosure Statement, which is used to make disclosure of a position in a manner that may reduce the risk of imposition of an accuracy-related penalty under IRC Section 6662 if the position is ultimately determined to be incorrect.

The Form 8275 described the $15 million payment as having been received and recorded as a liability in 2008, as reported as deferred revenue on the Thrasys financial statements in 2009, and as included in gross income in 2010 under the deferral method permitted by Rev. Proc. 2004-34—even through the circumstances described on the Form 8275 strongly suggested that Thrasys was not in fact reporting the payment in the year required by the deferral method as described in the revenue procedure.

In 2012, and after the IRS had commenced an audit, Thrasys filed amended returns for 2008, 2009, and 2010, with the $15 million payment being reported on the 2009 return as long-term capital gain. The IRS did not agree with the treatment on these returns of the $15 million payment, and ultimately issued a notice of deficiency for 2008 reflecting a determination that the $15 million payment should have been reported as income in the year in which it was received.

The government further asserted, in a notice of deficiency simultaneously issued with respect to 2009, that, if the inclusion of the payment in income was properly deferred to 2009, the corporation was subject to tax with respect to the advance payment under IRC Section 1374 as a "net recognized built-in gain." That provision creates an exception to the general rule that the income of an S corporation is not subject to federal tax at the corporate level. This built-in gain tax issue for 2009, however, was not presented to the court or further discussed in the memorandum opinion addressing the motion for summary judgment.

Thrasys asserted two alternative positions in its petition for redetermination of the asserted deficiency for 2008: (1) that the $15 million payment was properly treated as a deposit in 2008 and first includible in income in 2010; and (2) that the $15 million was an advance payment that, under Rev. Proc. 2004-34, was properly deferred to 2009 as set forth in the amended returns.

A stipulation was entered into by the parties and filed with the court in which Thrasys conceded the first of its two alternative positions (treatment as a security deposit). The remaining unresolved issue before the court was whether the payment was required to be reported in 2008, or could be reported in 2009 pursuant to the deferral method permitted by Rev. Proc. 2004-34.

The Commissioner made a motion for summary judgment, asserting that, even if the $15 million payment constituted a deferred payment within the scope of the revenue procedure, Thrasys had, by 2008, changed its accounting method for payments of this type to a method other than the deferral method and was therefore precluded by Code Section 446(e) from changing back to the deferral method absent the Commissioner's consent to that further change – which consent had not been obtained.

In response, Thrasys asserted that it had properly adopted the deferral method for advance payments by 2005 and had permissibly continued to use that method through the year at issue. More specifically, Thrasys argued that neither its failure to include the 2006 advance payment in gross income in 2007 nor its treatment of the 2008 payment as a security deposit constituted the adoption of a different accounting method. Thrasys characterized its failure to include deferred revenue in income in 2007 as a one-time error. It also referred to regulations providing that the treatment of an item results "in most cases" in the adoption of an accounting method only if there exists a "pattern of consistent treatment" (Reg. Sec. 1.446-1(e)(2)(ii)*(a)*), and to case law to the effect that such a pattern is typically established through the use of a method consistently for two or more years. With respect to payments received from Siemens, it appears that only the $15 million payment received in 2008 was treated as a deposit.

Discussion

The court concluded that there was a question of material fact as to whether the circumstances established that there was a change in accounting method for advance payments from the deferral method so some other method, observing that only one advance payment from Siemens (the $15 million payment) was accounted for as a deposit in one year.

The court also noted that a change in method of accounting does not include "a change in treatment resulting from a change in material facts" (Reg. Sec. 1.446-1(e)(2)(ii)*(b)*). Thrasys asserted

that the treatment of the 2008 payment in that year as a deposit was the result of particular circumstances, involving a breach of contract and consequent risk that the payment was subject to refund, that were specific to that payment.

Even though Thrasys had since stipulated that the initial treatment of that payment as a deposit was incorrect, the court considered the circumstance that *Thrasys* and its auditor may have reasonably believed that the payment should be treated as a deposit as, at least potentially, a change in treatment required by a change in facts, rather than the adoption of a different accounting method.

The court concluded that, "viewing all facts and inferences from the facts in the light most favorable to the petitioner," as it was required to do in the context of a motion for summary judgment by the other party to the litigation, there were genuine disputes of material fact as to whether Thrasys had adopted a method of accounting different from the deferral method, and denied the government's motion for summary judgment.

Observations

Circumstances described in *Thrasys* suggest that the government may have other arguments in support of a tax deficiency owed by the corporation that may well prevail. On the specific issue confronted by the court, however, the *Thrasys* decision is a welcome reminder that the government's broad authority to correct situations involving an improper adoption or change of accounting method does not encompass treatment as a change in accounting method an error that is isolated in nature, or a change in treatment that originates from a change in relevant circumstances.

On the other hand, *Thrasys* is also a reminder that a decision to adopt a different accounting treatment for a material item may have unexpected tax consequences, the potential ramifications of which should be considered before such a decision is made, even if the decision is at least arguably not a change in accounting method requiring IRS consent. After all, *Thrasys* did no more than deny summary judgment to the IRS, and it remains possible that the harsh position asserted by the Government, holding a taxpayer to an impermissible method of accounting that the taxpayer did not even want to adopt, may yet prevail at trial.

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