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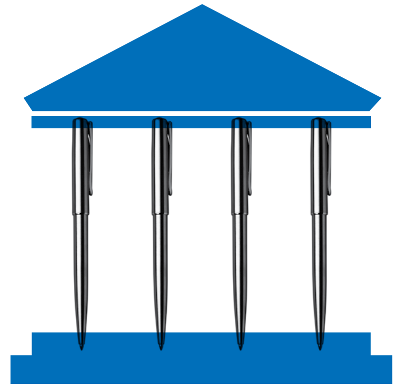

Timing or permanent?

The Tax Court faces this question in its denial of an IRS-proposed section 481(a) adjustment

In *Hyatt Hotels Corp. v. Commissioner*, T.C. Memo. 2023-122, the Tax Court determined a taxpayer's treatment of income and expenses related to its customer loyalty program did not implicate timing and, therefore, was not a method of accounting. Because the taxpayer's existing tax treatment was not a method of accounting, the Commissioner could not invoke section 481(a) to require adjustments related to closed tax years, which adjustments gave rise to the lion's share of the proposed deficiencies. This Alert discusses the court's opinion in *Hyatt* as it relates to the method of accounting issue, and the implications of the court's holding.

Facts

In 1987, Hyatt (taxpayer) began operating a customer reward program (Program) through which customers could earn points redeemable for free stays at Hyatt-branded properties (Hotels). The Program called for the Hotels to pay into a fund (Fund) when customers earned points, and the taxpayer, in turn, paid the Hotels a compensation payment from the Fund when points were redeemed. Employees of the taxpayer directed certain of the Fund balances to be invested or to pay administrative and advertising expenses related to the Program. For US federal income tax purposes, the taxpayer neither included any of the Program revenues in its gross income, nor claimed deductions for Program expenses paid out of the Fund.

Procedural Posture and Issues for Decision

On audit, the Commissioner determined the taxpayer's treatment was an improper method of accounting and proposed a section 481(a) adjustment to take into account omissions from income dating back to inception of the Program. The taxpayer, relying upon the longstanding conduit principle, maintained that its treatment was proper because it was not the true owner of the Fund for US federal income tax purposes. Alternatively, the taxpayer argued that the Commissioner overreached by characterizing the taxpayer's treatment as a method of accounting, in connection with the Commissioner's effort to sweep-in net revenues for closed tax years, as a section 481(a) adjustment.

With respect to the "open" tax years, the Tax Court addressed the taxpayer's trust fund (or conduit) doctrine[1] arguments and determined that the Program revenues constituted gross income to the taxpayer given its control and discretion over, and economic benefit from, the Program revenues, and upheld the modest proposed deficiencies for the open tax years. But the Tax Court further ruled

1 *Seven-Up Co. v. Comm'r*, 14 T.C. 965 (1950) (involving a tailored application of the claim of right doctrine).

that the taxpayer's treatment of the Program revenue and expenses was not a method of accounting and denied the Commissioner's efforts to assess a deficiency with respect to several hundred million dollars of net revenues for the "closed" tax years. We focus our discussion in this Alert on the method of accounting issue, with respect to which the Tax Court held for the taxpayer, determining its treatment of the Program revenues and expenses was not a method of accounting subject to the provisions of section 481(a).

Methods of Accounting

Under section 481(a), a change in a taxpayer's method of accounting calls for adjustments necessary to prevent the omission or duplication of income or expense. Notably, the Commissioner's authority to impose an adjustment under section 481(a) is not subject to the prescribed limitations (i.e., the statute of limitations) on the Commissioner's assessment authority under section 6501(a). Thus, the Commissioner's proposed section 481(a) adjustment in *Hyatt* hinged on the determination that the taxpayer's treatment of Program revenues and expenses constituted a method of accounting, such that, upon the Commissioner's proposed change, a section 481(a) adjustment afforded the Commissioner the opportunity to tax net revenues from closed tax years. If the taxpayer's treatment of the Program revenue and expenses was not a method of accounting, section 481(a) would not apply, and the Commissioner would be barred from imposing an adjustment to include net revenues from closed tax years.

Neither the Code nor the regulations define "method of accounting." Section 481(a) applies both to an overall change in method of accounting and to changes in the treatment of a material item.[2] Section 446(e) and the regulations thereunder provide further guidance as to what constitutes a change in method of accounting. A method of accounting is generally understood to implicate timing (i.e., the acceleration or postponement of income or expense). A "material item" is any item that involves the proper time for inclusion of the item in income or the taking of a deduction. The adjustment of an item that does not involve the proper time for including the item in income or taking a deduction does not constitute a change in method of accounting.[3]

The courts have developed the "lifetime income test" as a tool for determining whether treatment of a particular item constitutes a method of accounting.[4] The Tax Court in Hyatt describes the test as encompassing two prongs: (i) whether the taxpayer's existing treatment would permanently avoid the reporting of income over the taxpayer's lifetime, or whether it would merely postpone such reporting, and (ii) whether a change in the taxpayer's treatment of a material item would result in no more or less income to the taxpayer over the course of its lifetime. An item that impacts the timing of reporting income or deductions, but not "how much" or "whether," is a material item. If the taxpayer's treatment is a material item, courts then ask whether a change in the treatment would result in a distortion of the taxpayer's lifetime income. If the change would not alter the taxpayer's lifetime income, the change implicates timing and constitutes a change in method of accounting.

While the broad authority under section 481(a) to impose adjustments that reach back to closed tax years "does not frustrate the policy that men should be able, after a certain time, to be confident that past wrongs are set at rest,"[5] that authority arises only in connection with a change in method of accounting. It follows that any treatment that results in the permanent inclusion or omission of an amount is not a method of accounting, and does not confer upon the Commissioner the authority to impose a section 481(a) adjustment.

The Commissioner argued that the change in treatment would not affect the aggregate amount of the taxpayer's lifetime taxable income when considering both income and deduction components, and therefore implicated questions of timing. The court, however, noted the Commissioner's interpretation of the lifetime income test disregarded the threshold step in the analysis—the requisite finding that the taxpayer's existing treatment constitutes a material item.

The court in *Hyatt* agreed with the taxpayer's argument that its treatment of the Program revenue and expenses was not a method of accounting because it permanently excluded the net amount from the taxpayer's returns. Because timing issues were not implicated, the taxpayer's treatment was not a material item and did not constitute a method of accounting. The Tax Court noted that the taxpayer's consistent

2 Treas. Reg. § 1.481-1(a)(1).
3 Treas. Reg. § 1.446-1(e)(2)(ii)(a) and (b).
4 See, e.g., *Primo Pants Co. v. Comm'r*, 78 T.C. 705 (1982); *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984).
5 *Peoples Bank & Tr. Co. v. Comm'r*, 415 F.2d 1341, 1344 (7th Cir. 1969), aff'g 50 T.C. 750 (1968).

exclusion of Program revenues and expenses did not involve timing as long as the Program continued in perpetuity. Further, the court found the "Day of Armageddon" principle of the lifetime income test—whereby a termination of a fund or entity that would result in the inclusion of income under the existing treatment suggests that treatment implicates timing—did not apply. The court found there was credible testimony and documentation that any remaining Fund balance would have been refunded to participating Hotels in the event of termination of the Program.

Eversheds Sutherland Observation

The Tax Court's opinion demonstrates that there are instances when treatment of an item of income or expense does not constitute a method of accounting even under the broadly construed "Day of Armageddon" principle of the lifetime income test. Accordingly, a perceived underreporting of income cannot necessarily be rectified by imposing a section 481(a) adjustment. In other words, the court, citing *Peoples Bank & Tr. Co.*, upheld the policy underpinning the statute of limitations that taxpayers "should be able, after a certain time, to be confident that past wrongs are set at rest."