An Unpleasant Surprise: How an Accounting Change Can Open Closed Years.

Generally, the IRS has three years to assess additional tax due following the filing of a tax return. I.R.C. § 6501(a). There are exceptions explicitly set forth in the Code; for example, a false return, a willful attempt to evade tax or the failure to file a return mean there is no limitation on the power of the IRS to assess tax. I.R.C. § 6501(c)(1)-(3). A more limited exception exists where a return contains a substantial understatement of tax on a return, in which case there is a six year limitation period. I.R.C. § 6501(e).

Less well-known is the ability of the IRS to assess tax for years that appear to be beyond the limitations period if an accounting change is involved. A recent Fifth Circuit case illustrates the impact that this can have on a taxpayer. *Mingo v. Comm'r,* 2014 U.S. App. LEXIS 23158 (9th Cir. Dec. 9, 2014).

Mrs. Mingo was former partner in the management consulting and technology practice at PriceWaterhouseCoopers LLC. When PWC decided to sell that practice, Mrs. Mingo received an interest in a subsidiary partnership and cash; the new partnership's assets included the uncollected receivables of the practice group. *Mingo,* 2014 U.S. App. LEXIS 23158, slip op. at *2. When the sale of the practice group closed in October 2002, the value of Mrs. Mingo's interest in the partnership included roughly $124,000 in receivables of the partnership. IBM, the purchaser gave Mrs. Mingo a convertible promissory note for over $800,000 in return for her partnership interest; the note could be converted into IBM stock. Absent conversion, the noted would be paid in October 2007. The Mingos elected to treat the note as an installment sale under Section 453 of the Code and did not recognize any income from the sale of the partnership receivables. *Id.,* slip op. at *3-*4. For the next several tax years, they held the note and reported the interest associated with it.

In 2007, the Mingos converted the note in a series of transactions. The IRS issued a notice of deficiency in May 2007, asserting that to the extent the note was paid on account of partnership receivables, it was improper to use the installment method to account for the note. Although Mrs. Mingo received the note in 2002, the IRS assessed $126,240 (her share of the receivables) in additional tax in the 2003 tax year because her accounting method did not clearly reflect her income. It effected the change under Section 446 of the Code. *Id.,* slip op. at *4-*5. The IRS then issued an alternative assessment for 2007, in which it argued that if installment treatment was correct, then Mrs. Mingo should have reported $126,240 of the proceeds from disposition of the note as ordinary income. *Id.,* slip op. at *5.

The tax court sustained the first assessment, and Mrs. Mingo appealed. The Fifth Circuit first sustained the IRS determination that the portion of the note associated with Mrs. Mingo's interest in partnership receivables was not eligible for installment treatment and should have been recognized as ordinary income when received.

The Court then turned to the change in accounting treatment. The parties agreed that the IRS could not change the accounting treatment for 2002, the year in which Mrs. Mingo acquired the note, because the assessment limitation period had expired. This left the question whether it could make an adjustment in 2003 to correct the treatment of the partnership receivables?

The Fifth Circuit readily concluded that the adjustment could be made. First, it noted that the IRS has broad discretion in determining that a change in accounting method is appropriate

under Section 446(b) of the Code. *Id.,* slip op. at *12. Next, it noted that Mrs. Mingo had no reason to believe that her election to treat the partnership receivables as part of an installment sale meant that the receivables would not be taxed. *Id.* Accordingly, the Court concluded that it was proper to force Mrs. Mingo to recognize the income in 2003, the year in which the change in accounting method was made, rather than waiting until 2007, when she disposed of the note. *Id.,* slip op. at *13.

The Court explained that when the IRS initiates a change in accounting method, it is then free to make adjustments under Section 481 of the Code. And under established precedent, there is essentially no limitations period applicable to the tax years that can be considered in making an adjustment due to a change in accounting method. *Id.,* slip op. at *14 (citing *Comm'r v. Welch,* 345 F.2d 939, 950 (5th Cir. 1965)).

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