O'Shaughnessy v. Comm'r

2001 U.S. Dist. LEXIS 22738; 2002-1 U.S. Tax Cas. (CCH) P50,235; 89 A.F.T.R.2d (RIA) 658

September 29, 2001, Decided

OPINION

MEMORANDUM OPINION AND ORDER ON PETITIONER'S MOTIONS FOR PARTIAL SUMMARY JUDGMENT

Petitioner Roger O'Shaughnessy, as tax matters person for Cardinal IG Company ("Cardinal"), a flat glass manufacturer in Menomonie, Wisconsin, brings this petition against the Internal Revenue Service ("IRS") asserting nine issues arising from administrative adjustments the IRS made with respect to Cardinal tax years 1994 and 1995.

Cardinal has moved for partial summary judgment for resolution of two of the issues raised in its petition. In its first motion, Cardinal seeks a determination that the 168 tons of tin that Cardinal originally installed in [*2] its manufacturing plant is subject to "exhaustion, wear and tear" and is therefore "depreciable property" for tax purposes. In its second motion, Cardinal requests for a determination that the IRS's reallocation of Menomonie plant assets is not a change of accounting method and therefore, the IRS cannot impose a *§ 481(a)* income adjustment upon Cardinal for 1994. [1] For the reasons that follow, the Court grants Cardinal's motion regarding the depreciability of tin issue but denies its motion as to the method of accounting issue.

1 Cardinal also moved for a determination that a $ 1.5 million payment to Pilkington Brothers as consideration for a release of liability was properly deducted as a current operating expense. According to a joint status report received by the Court on August 9, 2001, the parties have settled this issue along with six other issues raised in the case. Therefore, the only issues which remain are the two issues now before the Court.

BACKGROUND

I. Depreciability of Tin

Cardinal [*3] engages in the business of manufacturing flat glass at its plant in Menomonie, Wisconsin. To manufacture flat glass, Cardinal uses the "float" manufacturing process. This process involves melting limestone, sand, soda ash and other glass material components to form liquefied molten glass. The molten glass then proceeds into a "tin bath" structure that holds up to 200 tons of liquefied, molten tin. The molten glass "floats" upon and is also conveyed across the surface of the molten tin which then absorbs sufficient heat from the glass to enable it to begin forming a cohesive and continuous sheet or "ribbon" of glass. From there, the glass ribbon enters the plant's "annealing lehr" where the glass continues to cool and harden. Cardinal then cuts the glass into lengths for shipment to its other plants for further processing and assembly into insulated glass units that Cardinal sells to window manufacturers.

When Cardinal began operations at the Menomonie plant in 1992, Cardinal melted 168 tons of tin and placed it in the tin bath portion of the plant. The molten tin is an integral part of the manufacturing process serving numerous important functions, including fabricating the sheet [*4] glass, removing heat from the continuous sheet of glass and transporting the glass from the melter to the annealing lehr.

Molten tin is a highly-reactive metal that combines with oxygen, sulfur, iron and the glass in the tin bath. As a result of these combinations and reactions, tin oxide and tin sulfide impurities continuously form on the surface of the molten tin. To prevent the impurities from damaging the glass, Cardinal must physically remove the tin oxide and tin sulfide compounds, known in the glass industry as "dross." Removal of these compounds causes the tin to lose volume. To address the lost volume and tin purity losses, Cardinal has added roughly 62 tons of new molten tin to the bath since installing the original volume in 1992. In addition to tin losses resulting from the formation and removal of tin oxide and tin sulfide compounds, other quantity losses occur through evaporation, migration and contamination of the molten tin.

In order to successfully carry out the manufacturing process, it is crucial that Cardinal maintain a sufficient depth, volume and purity level. If enough tin is removed from the bath through these chemical reactions described above and the volume [*5] and depth of the tin within the bath fall too low, the tin would become functionally and physically useless to Cardinal.

On its federal income tax returns for 1992 through 1995, Cardinal treated the original volume of tin as depreciable property. It therefore claimed depreciation expense deductions in accordance with the Modified Accelerated Cost Recovery System ("MACRS") method of depreciation accounting that Cardinal had adopted for depreciable assets at the plant. As such, Cardinal has consistently depreciated the cost of the entire original volume of tin as seven-year property in accordance with the IRS's determination in*Revenue Procedure 87-56* relating to the depreciable period applicable to property used in the flat glass manufacturing process.*Rev. Proc. 87-56, 1987-2 C.B. 674*. Cardinal also deducted as a repair and maintenance expense the cost of the new tin that Cardinal added to the bath during 1994 and 1995.

Following its examination of Cardinal's 1994 and 1995 tax returns, the IRS allowed the repair and maintenance expense deductions, but disallowed the depreciation expense deductions for the cost of the 168 tons of tin. The IRS based this determination [*6] on a 1975 Revenue Ruling which concluded that the original tin used in the float glass process is not depreciable property because the addition of new tin "essentially" restores the used tin to its original volume and condition. Cardinal challenges the IRS's disallowance of the depreciation expense deductions for the original 168 tons of tin.

II. Change in Method of Accounting

Cardinal also challenges the IRS's determination that its reallocation of certain assets from one asset grouping to another within Cardinal's existing accounting system constitutes a change in method of accounting, thus triggering a one-time adjustment under *§ 481 of the Internal Revenue Code*. In 1992, Cardinal purchased the Menomonie plant from an affiliate of AFG Industries, Inc., ("AFG") for approximately $ 66 million. At the request of AFG, the accounting firm of Deloitte & Touche performed a cost segregation study that allocated the $ 66 million among the various plant assets in accordance with the MACRS method of tax depreciation accounting. In its study, Deloitte & Touche allocated the total purchase price for the plant to the various plant assets; allocated those assets [*7] and their assigned costs to various asset groupings based upon each asset's particular functional type; and then assigned the applicable

MACRS "cost recovery period" to each asset grouping. By applying the cost recovery period applicable to each asset grouping to the total cost assigned to that grouping, the plant owner could compute the allowable depreciation expense under MACRS.

Cardinal adopted the MACRS method of depreciation accounting when it acquired the plant from AFG and accordingly applied that method to the asset allocation cost figures as determined in the Deloitte & Touche study on its income tax returns for 1992 through 1995. Upon examination of Cardinal's 1994 and 1995 returns, the IRS disagreed with some of Deloitte & Touche's asset allocations and reallocated those particular assets from one Deloitte & Touche asset grouping to another. As a result of this reallocation, the IRS reduced the allowable Menomonie plant depreciation expense for fiscal years 1994 and 1995.

The IRS characterized its asset reallocation as a change of Cardinal's method of accounting, which, in turn, triggers a *§ 481(a)* accounting adjustment for 1994. Cardinal claims that the IRS erred in [*8] this determination. According to Cardinal, the IRS's reallocation of assets from one asset group to another is not a change of Cardinal's method of accounting within the meaning of *§ 446(e)* of the Code. Cardinal emphasizes that the IRS used the same asset groups and MACRS cost recovery periods to compute the allowable depreciation expense and applied the same definitional accounting rules as Cardinal's computation. Thus, because the IRS has not changed Cardinal's method of accounting, Cardinal argues the IRS cannot impose upon Cardinal a *§ 481(a)* accounting adjustment for 1994.

ANALYSIS

I. Standard of Review

Rule 56(c) of the Federal Rules of Civil Procedure provides that summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." *Fed. R. Civ. P. 56*. Only disputes over facts that might affect the outcome of the suit under the governing substantive law will properly preclude the entry of summary judgment. *See Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986)*. [*9] Summary judgment is not appropriate if the dispute about a material fact is genuine, that is, if the evidence is such that a reasonable jury could return a verdict for the nonmoving party. *See id.* Summary judgment is to be granted only where the evidence is such that no reasonable jury could return a verdict for the nonmoving party. *See id.*

II. Depreciability of Original Volume of Tin

The central question before the Court is whether the original 168 tons of tin that Cardinal installed in the tin bath structure at its Menomonie plant in 1992 is depreciable or non-depreciable property. The answer to this question affects the timing of Cardinal's cost recovery for this unit of property. Under the Internal Revenue Code ("the Code"), if a capital asset is depreciable within the meaning of *§ 167*, a taxpayer can recover the cost by way of depreciation expense deductions. *Section 167(a)(1)* provides, in relevant part, that "there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion wear and tear (including a reasonable allowance for obsolescence)--of property used in a trade or business." If the property is non-depreciable, however, cost [*10] recovery is limited to the taxpayer's right to offset against the proceeds of "sale or other disposition of the property the excess of the amount realized [on sale or disposition] over the adjusted basis." *I.R.C. § 1001(a)*. In other words, no current-year deduction or amortization is allowable with respect to the cost of non-depreciable property. [2]

2 Boris Bittker and Lawrence Lokken explain the differences between depreciable and non-depreciable property as follows:

> If a business outlay is classified as a capital expenditure, it cannot be deducted when paid or incurred, but instead must either be depreciated over its useful life or, in the case of land and other assets that are not exhausted by use, be held in abeyance until the property is sold or abandoned, at which time its cost can be offset against the amount realized in computing gain or loss on the sale or deducted as an abandonment loss.

Federal Taxation of Income, Estates and Gifts P 20.4.10.

Cardinal [*11] argues that it properly treated the original 168 tons of tin as a depreciable capital asset in taxable years 1994 and 1995. Cardinal explains that from the time the original volume of tin is poured into the tin bath structure and Cardinal begins using it in the manufacturing process, the tin undergoes continuous and inexorable volumetric and purity losses as a result of tin oxide and tin sulfide formation, tin evaporation, iron contamination and tin absorption into the glass being manufactured. These physical and purity losses, Cardinal argues, establishes as a matter of law that the original volume of tin is subject to "exhaustion wear and tear" within the meaning of *§ 167* and is thus depreciable property under the Code.

The IRS contends that Cardinal errs in characterizing the original quantity of tin as a single indivisible unit of property that is subject to "exhaustion, wear and tear or obsolescence." According to the IRS, a fundamental legal error in Cardinal's analysis is its failure to segregate the tin which remains in the bath from the tin which is consumed by the manufacturing process. Under this analysis, the IRS argues that the original quantity of tin is not depreciable [*12] because the mere reduction in the volume of tin from the manufacturing process amounts to neither exhaustion, nor wear or tear, nor obsolescence of the tin which remains in the bath.

The IRS finds supports for its position in a 1975 Tax Revenue Ruling in which the IRS concluded that "molten tin used in the float process manufacture of flat glass is not depreciable property."*Rev. Rul. 75-491*, *1975-2* C.B.19. In that ruling, the IRS determined that although "[a] certain amount of tin is lost as a result of [the float process] operation," the molten tin is not depreciable because the addition of new tin "essentially restores" the used tin to its original volume and condition. *Id.* Rather, only the tin that Cardinal adds to replenish the lost volume is deductible as an operating expense. Specifically, the IRS stated:

> The tin is a fungible commodity a portion of which is consumed and used in operation during the taxable year. The portion that remains has not diminished in value by reason of its use. When a quantity of tin is added to bring the level of tin to the level that existed at the beginning of the year, the property is essentially the same that existed [*13] at the beginning of the year. Accordingly, in the instant case, the initial installation of tin is property that is not subject to depreciation.
>
> The amount of tin that is added during the year to keep the molten tin at an optimum level is equal to the amount of tin used and consumed during the year in the production of the glass. The costs of the tin consumed is deductible under section 162 of the Code and regulations thereunder as an expense of operation.

Id.

Cardinal responds that the IRS's allowance of a current business deduction expense for the additional 62 tons of tin that it has added over an eight-year period does not cure the cost recovery errors and inequities of the IRS's position for the original volume of tin. Cardinal emphasizes that as of June 2000, it has placed a total of 230 tons (168 plus 62) in the tin bath, but the IRS will have only allowed Cardinal to recover for income tax purposes the cost of the 62 tons of newly-added tin. The original volume of tin, however, must be carried on Cardinal's books until it sells or abandons it, even though by the time it does so, the entire original volume of tin has undergone significant wear and tear and [*14] over sufficient time been completely exhausted through the volume and purity losses.

Depreciation expense deductions, Cardinal notes, only apply to the original volume of tin, while repair and maintenance expense deductions relate solely to the new tin additions. Consequently, Cardinal maintains that its repair expense deductions for the cost of the new tin that Cardinal has added to the bath no more negates its right to depreciate the cost of the original tin than a transport company's deduction of truck repair expenses precludes it from depreciating the purchase price of the truck.

To determine whether the original volume of tin "is property of a character subject to the allowance for depreciation," *I.R.C. § 168(c)*, the sole question the Court must answer is whether the property in question, that is, the original volume of tin, suffers exhaustion, wear and tear, or obsolescence within the meaning of *§ 167*. *Liddle v. Commissioner, 65 F.3d 329, 334-35 (3d Cir. 1995)* (to demonstrate that property is "recovery property" under 168(c)(1), "[plaintiffs] must only show that the [violin] bass was subject to exhaustion wear and tear"); *Simon v. Commissioner, 68 F.3d 41, 47 (2d Cir. 1995)* [*15] ("The test is whether property will suffer exhaustion, wear and tear, or obsolescence in its use by a business."). Upon consideration of the parties' briefs and especially counsels' arguments, the Court concludes that it does.

Recent caselaw interpreting the "exhaustion, wear and tear" standard under *§ 167* confirms that the standard is an undemanding one. *Simon v. Commissioner, 68 F.3d 41 (2d Cir. 1995)*; *Liddle v. Commissioner, 65 F.3d 329 (3d Cir. 1995)*. In both cases, only minor, even imperceptible physical changes in or impact upon the particular item of property during its usage was sufficient to qualify the property in question as depreciable. In *Simon*, the taxpayers were professional violinists who regularly used antique museum-quality bows in their profession. *68 F.3d at 43*. Both the tax court and the Second Circuit determined that the violin bows suffered wear and tear when used by plaintiffs even though 1) the bows would literally last for decades; 2) the taxpayers could not establish any specified or limited useful life for the bows and 3) the bows were actually increasing in value while the plaintiffs owned them. [3] *Id. at 43-46*. In [*16] concluding that the bows were subject to "exhaustion, wear and tear" and thus depreciable, the Second Circuit stated:

> Playing with a bow adversely affects the bow's condition; when a musician plays with a bow, the bow vibrates up, down, sideways, and at different angles. In addition, perspiration from a player's hand enters the wood of a bow and ultimately destroys the bow's utility for playing. Cracks and heavy-handed bearing down while playing certain pieces of music also create wear and tear to a bow . . .

Simon, 103 T.C. 247, 251-52. Likewise, in *Liddle,* the taxpayer was a professional musician who used an antique bass viol as his principal instrument. *65 F.3d at 330*. The Third Circuit concluded that:

> The rigors of Liddle's profession soon took their toll upon the bass and it began reflecting the normal wear and tear of daily use, including nicks, cracks, and accumulations of resin . . . At trial, an expert testified for Liddle that every bass loses mass from use and from oxidation and ultimately loses its tone.

Id. at 331.

> 3 It is noteworthy that the court in *Simon* concluded that the violin bows were depreciable even though they were appreciating in value. This finding differs from the tax revenue ruling which concluded that the molten tin was not depreciable, in part, because the tin which remained in the bath had not diminished in value. *Simon* thus demonstrates that "exhausation, wear and wear," not value, is the crucial consideration.

[*17] In this case, the original volume of tin, which the Court believes is best characterized as an indivisible unit of property for purposes of this question, is subject to and continues to suffer volumetric and purity losses throughout its use in the manufacturing process. The addition of new tin is merely a stop gap measure in the process. It does not negate the fact that the original volume of tin has lost volume and purity and will continue to do so throughout the time it is used in the bath, even after the new quantities of tin are added. On this record and in light of *Liddle* and *Simon,* the Court concludes that the original volume of tin undergoes "exhaustion wear and tear" within the meaning of *§ 167* and thus qualifies as depreciable property under the Code.

The Court recognizes that its conclusion runs contrary to the 1975 Revenue Ruling. Revenue rulings, however, while of some persuasive authority, are not controlling. *Oetting v. United States, 712 F.2d 358, 362 (8th Cir. 1983)* (revenue rulings are persuasive, not controlling authority); *True Oil Co. v. Commissioner, 170 F.3d 1294, 1304 (10th Cir. 1999)* ("Revenue rulings issued by the [*18] Commissioner do not have the same force and effect as treasury regulations and are not binding on this court."); *Storm Plastics, Inc. v. United States, 770 F.2d 148, 154 (10th Cir. 1985)* ("Revenue rulings do not have the force and effect of law, but rather are offered for the guidance of taxpayers, IRS officials, and other concerned"); *Schwieger v. Iowa Beef Processors, Inc., 816 F.2d 1217, 1219 (8th Cir. 1987)* ("This court has previously held that 'revenue rulings are not binding upon the courts and are of little aid in interpreting statutes. Any conflict between a revenue ruling and a statute must of course be resolved in favor of the statute.'") (quoting *Mercantile Bank & Trust Co. v. United States, 441 F.2d 364, 368 (8th Cir. 1971))*.

Moreover, the 1975 Revenue Ruling predates significant changes Congress implemented to the depreciation rules in the 1980s. Prior to 1981, income tax depreciation accounting rules required a taxpayer to estimate the anticipated "useful life" of a particular item of tangible personal property, and additionally, to estimate a "salvage value" of that item at the time the taxpayer would eventually retire [*19] the property from use in its business. Under this system, in which depreciation deductions were designed to match as closely as possible operating costs with income, the taxpayer could depreciate the difference between the cost of the property and its estimated salvage value over the number of years equal to the estimated "useful life" of the property. Accordingly, if a taxpayer purchased a machine for $ 35,000, the estimated "useful life" of which was 15 years and the estimated salvage value of which was $ 5,000, the taxpayer could depreciate the net amount of $ 30,000 over 15 years.

This system, however, had serious limitations. In particular, the system provided no tax-related incentive for taxpayers to invest in new capital assets given its slavish attempt to spread depreciation expense deduction over the actual life of the asset and then only to the extent that the cost of the asset exceeded its estimated salvage value at the end of its useful life. *Liddle, 65 F.3d at 333-34* (the pre-ACRS system "did not provide the investment stimulus that was felt to be essential for economic expansion.").

In 1981, in an effort to spur economic growth, Congress passed the [*20] Economic Recovery Tax Act of 1981 ("ERTA"). In passing this statute, Congress adopted the Accelerated Cost Recovery System ("ACRS"), which abandoned the system described above in favor of a simplified, more predictable and most importantly, accelerated cost recovery system. Under ACRS and as modified in 1986 under MACRS, the entire cost of depreciable property, unreduced by any salvage value, is recoverable through depreciation expense deductions over a fixed statutorily predetermined number of years. Not only are the cost recovery periods under ACRS far shorter than the old useful life applications, but additionally, the allowable amount of depreciation deductions are far larger in the earlier years of the depreciation period than in later years. By providing for shorter cost recovery periods and by "front-end" loading the total allowable depreciation expenses, Congress created strong financial incentives for capital investment through the promise of tax reductions. Thus, although neither ACRS nor MACRS altered the threshold requirement that a capital asset be subject to "exhaustion, wear and tear or obsolescence" to be depreciable, the purposes and policies behind Congress' actions [*21] factor into the Court's analysis.

Finally, while the IRS's position at the motion hearing that the molten tin is best characterized as materials and supplies, portions of which are consumed and replenished throughout the manufacturing process, is not an implausible one, the IRS in its 1975 Ruling did not treat the original volume of tin as such. The IRS's conclusion that "molten tin used in the float process manufacture of flat glass is not depreciable property" reveals that the IRS believed that we are dealing here with capital asset recovery. In fact, had the IRS determined that the original volume of tin qualified as a business expense deduction under § 162, Cardinal would have recovered the entire cost in 1992. Thus, for all the foregoing reasons, the Court grants Cardinal's motion for partial summary judgment on this issue.

III. Change in Method of Accounting

Section 446(a) of the Code sets forth the general rule that requires a taxpayer to adopt one or more "methods of accounting" for reporting that taxpayer's items of income and expense. *I.R.C. § 446(a)* ("Taxable income shall be computed under the method of accounting on the basis of which [*22] the taxpayer regularly computes his income in keeping his books."). Whatever method of tax accounting the taxpayer adopts, the tax law requires that the taxpayer use that method consistently to insure that over the course of time the taxpayer's taxable income will be accurately and clearly reflected. *Treas. Reg. § 1.446-1(a)(2)*.

Before a taxpayer changes its method of accounting, it must first secure the permission of the Commissioner of the Internal Revenue Service. *I.R.C. § 446(e)*; *Treas. Reg. § 1.446-1(e)*. If the IRS consents to a requested change or if it involuntarily imposes a method change upon the taxpayer, the Code requires that the taxpayer also include in its income for the year in which the change first occurs the amount of the "adjustment" determined under *§ 481(a)*. Under this section, the amount of the income adjustment is equal to the amount of any additional taxable income that would have been reported in all prior tax years had the new method, rather than the old method of accounting, been used in those prior years. In this way, *§ 481(a)* requires that the taxpayer pick up and report any [*23] taxable income that would otherwise be forever omitted solely as a result of the taxpayer changing from one method to some other method. Conversely, if the taxpayer or the IRS have not changed the taxpayer's method of accounting, then no *§ 481(a)* adjustment is necessary.

The issue before the Court is whether the IRS imposed a change in Cardinal's method of accounting when it reallocated some of Cardinal's assets in 1994. A change in accounting method is defined under the treasury regulations to include "a change in the overall plan of accounting for gross income or deductions" as well as "a change in the treatment of any material item used in such overall plan." *Treas. Reg. § 1.466-1(e)(2)(ii)(a).* A material item is considered to be "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." *Id.* On the other hand, a change in the method of accounting does not include "correction of mathematical or posting errors . . . adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction . . . an adjustment in the useful [*24] life of a depreciable asset . . . or a change in treatment resulting from a change in underlying facts." *Id. § 1.446-1(e)(2)(ii)(b).*

Cardinal argues that by reallocating certain assets, the IRS did not change Cardinal's overall method of accounting. Rather, the IRS merely corrected errors of allocation of items to asset groups. The IRS claims that its reallocation of various assets into different asset groupings with different cost recovery periods under MACRS system affected the proper timing of deductions and thus amounted to a change in the method of accounting. Relying on *H.E. Butt Grocery Co. v. USA, 108 F. Supp. 2d 709, 713 (W.D. Tcx. 2000)* and *Kurzet v. Commissioner, 222 F.3d 830, 842 (10th Cir. 2000)* as support, the IRS emphasizes that a change of a material item is a change in the method of accounting, thus requiring an adjustment under *§ 481* of the Code.

It is clear that by reallocating certain assets, the IRS did not change Cardinal's overall method of accounting. Cardinal's reliance on *H.E. Butt* to support its argument that its overall method of accounting, MACRS, remains the same despite the IRS's changes is correct. [*25] *108 F. Supp. 2d at 713* ("The IRS cannot really argue that by reclassifying some of its assets HEB has changed its overall method of accounting."); *Brookshire Brothers Holding Inc v. Commissioner, 2001 Tax Ct. Memo LEXIS 177, 2001 T.C. Memo 150* (June 22, 2001) (explaining that petitioner's reclassification of its gas stations from nonresidential real property with 31.5 to 39 year recovery period to 15-year property "altered neither its overall plan of accounting for income and deductions on an accrual basis nor its basic system of accounting for depreciation using MACRS").

Nonetheless, the question remains whether the IRS's changes in the treatment of various assets is a change in the treatment of a material item. Two cases relied on by the IRS persuades the Court to answer this question in the affirmative. *H.E. Butt, 108 F. Supp. 2d at 713*; *Kurzet, 222 F.3d 830*. In *H.E. Butt,* a case strikingly similar to the case at bar, the taxpayer had placed new stores in service over a period of several years. *108 F. Supp. 2d at 713*. In reporting its depreciation expense deductions for the store assets, it allocated differing types of components [*26] into various asset classes. *Id.* It then applied the applicable MACRS cost recovery period to each asset class. *Id.* After it had filed its returns using this allocation of assets for a number of years, the taxpayer determined through a cost segregation study that it had allocated certain store components to the wrong assets classes. [4] *Id.* The taxpayer thus sought to recover the additional depreciation deductions it would have taken had the items originally been properly classified. *Id.*

4 For example, the taxpayer discovered that "some fixtures and equipment (with a 5-year recovery period and a 200 percent declining balance method of depreciation) and some site

materials (with a 15-year recovery period and a 150 percent declining balance method of depreciation) were erroneously classified as non-residential real property (with either a 31.5 or 39-year recovery period and with a straight line method of depreciation). *Id. at 713*.

Although the district court agreed with petitioner [*27] that his reclassification of certain assets into other asset groupings was not a change in his overall method of accounting, it concluded that his changes involved the "timing of deductions" and was thus a change in the treatment of a material item. *Id. at 713*; *Treas. Reg. § 1.466.1(e)(2)(ii)(a)* (defining change in method of accounting as including not only the overall method of accounting, **but also** the accounting treatment of any item) (emphasis added). Specifically, the court found that a change of fixtures from a 39-year period of recovery to a 5-year period of recovery "seeks to shorten the time over which the deductions are taken and to increase the percentage of the cost it may recover in a year." *Id. at 713*. As such, the court concluded that such change is a change in the treatment of a material item and thus comprises a change in the method of accounting within the meaning of *§ 446(e)*.

The Tenth Circuit reached the same result in *Kurzet v. Commissioner, 222 F.3d 830 (10th Cir. 2000)*. There, the taxpayer sought to change the recovery period for its reservoir under MACRS from 31.5 year property [*28] to 15 year property. *Id. at 844*. The court concluded that under the plain language of § 1.446(e)(2)(ii)(a), "a change in the recovery period is a change in the method of accounting because it affects the time at which a deduction is taken." *Id.*

Similar reallocations of assets occurred in this case. For instance, the IRS reallocated property originally classified as 15-year property to property with a 31.5-year class life. For others, the IRS reallocated property originally classified as five and seven-year property to the 31.5 year classification. As the IRS emphasizes, these changes affected the depreciation methods, recovery periods and conventions for those amounts, thus constituting a change in accounting method. In light of *E.B. Butt* and *Kurzet*, the Court agrees. Accordingly, Cardinal's motion for partial summary judgment that the IRS's reallocation of assets was not a change in Cardinal's method of accounting is denied. [5]

5 While these motions were pending, Cardinal submitted a recent decision from the United States Tax Court, *Brookshire Brothers Holding Inc v. Commissioner, T.C. Memo 2001-150, 2001 Tax Ct. Memo LEXIS 177, 81 T.C.M. (CCH) 1799 (2001)*. *Brookshire* also involves a taxpayer's reclassification of the period of recovery for certain property and whether such change constitutes a change in the method of accounting under *§ 446(e)*. In *Brookshire*, the taxpayer sought to reclassify the depreciation cost of its gas station properties from a 31.5 or 39-year period on a straight-line basis to a 15-year term on a declining balance basis.*T.C. Memo 2001-150*, [WL] at *5. As in *E.B. Butt* and *Kurzet*, the tax court concluded that such reclassification "involves the timing of deductions . . . and would thus appear at first blush to be a 'material' difference signaling a change in accounting method."*T.C. Memo 2001-150*, [WL] at *16-17. Although the court went on to find that the taxpayer's change fell within the "useful life" exception found in *§ 1.446-1(e)(2)(ii)(b)* of the regulations and thus did not constitute an unauthorized change in petitioner's method of accounting, *id.* at * 19-21, Cardinal has not raised this argument here. It only argues that the IRS's changes were akin to a "correction of mathematical or posting errors" under *§ 1.446-1(e)(2)(ii)(b)*. In any event, the Court notes that the courts in both *E.B. Butt* and *Kurzet* expressly rejected the argument that the tax court in *Brookshire* found persuasive. *E.B. Butt at 714* (declining to expand the useful life exception to current situation on the basis that under the MACRS system, useful life has been replaced by class

> life, and the relationship between class life and depreciation method is much more intertwined and has a much more dramatic effect than useful life changes under the previous system); *Kurzet, 222 F.3d at 844-45* (rejecting taxpayer's argument "that 'recovery period' under MACRS should be treated in a like manner to its predecessor, the 'useful life.'").

[*29] **ORDER**

Based upon the foregoing, the submissions of the parties, the arguments of counsel and the entire file and proceedings herein, **IT IS HEREBY ORDERED** that:

1. Petitioner's motion for partial summary judgment regarding amount of tin installed in 1992 at its Menomonie plant [Docket No. 20] is **GRANTED**.

2. Petitioner's motion for partial summary judgment regarding change of accounting method issues [Docket No. 30] is **DENIED**.

DATED: Sept. 29, 2001

at Minneapolis, Minnesota.

JOHN R. TUNHEIM
United States District Judge