H. F. Campbell Company (formerly H. F. Campbell Construction Company), Petitioner v. Commissioner of Internal Revenue, Respondent, 53 T. C. 439 (1969)

A taxpayer must obtain IRS consent before changing its accounting method, and a change initiated by the taxpayer triggers adjustments under Section 481 for pre-1954 tax years.

Summary

H. F. Campbell Co. , which used a completed-contract method of accounting for its construction contracts, changed its criteria for determining contract completion in 1962, reducing from four to two criteria. The IRS argued this constituted a change in accounting method requiring their consent under Section 446(e), and since the change was initiated by the taxpayer, adjustments under Section 481 were necessary for pre-1954 years. The Tax Court agreed, holding that the change in criteria was indeed a change in accounting method, initiated by the taxpayer, necessitating adjustments to prevent income duplication or omission.

Facts

H. F. Campbell Co. used a completed-contract method to report income from long-term construction contracts, employing four criteria to determine when contracts were completed: physical completion, customer acceptance, recordation of all costs, and computation of the final bill. In 1962, during an audit, the company decided to use only the first two criteria, influenced by a revenue agent’s preliminary findings on certain contracts. The company reported its 1962 income using the reduced criteria without obtaining IRS consent.

Procedural History

The IRS audited Campbell’s 1960 and 1961 returns, proposing adjustments for five contracts they believed should have been reported in 1961. Campbell contested these findings, and in 1962, used only two of its four criteria for determining contract completion. The IRS issued a notice of deficiency for 1962, asserting Campbell had changed its accounting method without consent. Campbell appealed to the Tax Court, which upheld the IRS’s position.

Issue(s)

1. Whether the reduction in the number of criteria used to determine contract completion in 1962 constituted a change in Campbell’s method of accounting.
2. Whether this change was initiated by Campbell.
3. Whether adjustments under Section 481 were necessary solely by reason of the change to prevent amounts from being duplicated or omitted.

Holding

1. Yes, because the change from four to two criteria represented a different method of accounting under Section 481(a)(1).
2. Yes, because Campbell voluntarily changed its method without IRS direction or consent.
3. Yes, because the change necessitated adjustments to prevent income duplication or omission, as required by Section 481.

Court's Reasoning

The court found that Campbell's method of accounting was defined by the consistent application of four criteria from 1954 to 1961. The change to only two criteria in 1962 constituted a change in method under Section 481(a). The court rejected Campbell's argument that the revenue agent's informal comments during the audit process constituted a change "required" by the IRS, emphasizing that only formal IRS action could initiate a change. The court also noted that Section 446(e) requires IRS consent for any change in accounting method, and since Campbell did not obtain such consent, the change was deemed voluntary. The necessity for adjustments under Section 481 was affirmed to prevent income from being taxed twice or omitted due to the change.

Practical Implications

This decision reinforces the importance of obtaining IRS consent before changing accounting methods. Taxpayers must be cautious not to misinterpret informal IRS comments during audits as permission to change methods. The case also illustrates the broad discretion the IRS has in determining whether a method clearly reflects income. For legal practitioners, this case serves as a reminder to advise clients on the formalities and potential consequences of changing accounting methods, including the application of Section 481 adjustments. Businesses in similar situations should review their accounting practices carefully and seek professional advice before making changes, especially during audits. Subsequent cases have continued to apply these principles, emphasizing the need for formal IRS consent and the potential for adjustments when changes are taxpayer-initiated.

