Capital One Fin. Corp. v. Commissioner, 130 T. C. 147 (2008)

In a significant ruling on tax accounting methods, the U. S. Tax Court in Capital One Financial Corp. v. Commissioner upheld the IRS's position that Capital One could not retroactively change its method of accounting for late-fee income from the current-inclusion method to one that treats such income as increasing original issue discount (OID). The court determined that this change required the Commissioner's consent under Section 446(e), which Capital One failed to obtain, impacting how credit card companies must handle similar income in future tax filings.

Parties

Capital One Financial Corporation and its subsidiaries, Capital One Bank (COB) and Capital One, F. S. B. (FSB), were the petitioners. The Commissioner of Internal Revenue was the respondent.

Facts

Capital One, a financial holding company, earned income through its subsidiaries COB and FSB from various fees related to their Visa and MasterCard credit card operations, including late fees charged to cardholders for delinquent payments. From 1995 through 1997, COB and FSB included late fees in income when charged to cardholders under the all events test. In 1997, Congress enacted the Taxpayer Relief Act, which introduced Section 1272(a)(6)(C)(iii) allowing credit card receivables to be treated as creating or increasing OID. In 1998, COB sought to change its method of accounting to comply with this new provision but continued to recognize late-fee income under the current-inclusion method for 1998 and 1999.

Procedural History

Following a notice of deficiency from the IRS for the tax years 1997-1999, Capital One filed a petition with the U. S. Tax Court. Capital One subsequently sought to amend their petition to retroactively treat late-fee income as OID for 1998 and 1999. Both parties moved for partial summary judgment on the late fees issue, with Capital One arguing that the change did not require consent under Section 446(e), and the Commissioner asserting it did.

Issue(s)

Whether Capital One could retroactively change its method of accounting for late-fee income from the current-inclusion method to a method that treats such income as increasing OID under Section 1272(a)(6)(C)(iii) without the Commissioner's consent under Section 446(e)?

Rule(s) of Law

Section 446(e) of the Internal Revenue Code requires a taxpayer to secure the

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Commissioner’s consent before changing its method of accounting. A change in accounting method includes a change in the treatment of any material item used in the taxpayer’s overall plan of accounting. Section 1272(a)(6)(C)(iii) allows certain credit card receivables to be treated as creating or increasing OID, but does not explicitly exempt taxpayers from the consent requirement of Section 446(e).

Holding

The Tax Court held that Capital One could not retroactively change its method of accounting for late-fee income without the Commissioner’s consent. The court found that late-fee income is a material item under Section 446(e), and thus, any change in its treatment required consent, which Capital One did not obtain.

Reasoning

The court reasoned that late-fee income, being a significant component of Capital One’s income, constituted a material item. The change from recognizing late-fee income under the current-inclusion method to treating it as increasing OID involved a timing difference in income recognition, thus falling within the scope of a change in accounting method requiring consent under Section 446(e). The court also noted that Capital One’s request to change its method of accounting in 1998 was ambiguous and did not specifically mention late fees, and thus, consent was not obtained for this change. Furthermore, the court addressed Capital One’s argument that the change was merely a correction of an error, concluding that it was a change in method of accounting and not merely a correction.

Disposition

The court denied Capital One’s motion for partial summary judgment and granted the Commissioner’s motion, ruling that Capital One could not retroactively change its method of accounting for late-fee income for 1998 and 1999 without the Commissioner’s consent.

Significance/Impact

This decision underscores the importance of obtaining the Commissioner’s consent under Section 446(e) for changes in accounting methods, particularly for material items such as late-fee income. It impacts how financial institutions, especially credit card issuers, must approach changes in accounting methods for income recognition, emphasizing the need for clear and specific requests for consent to avoid retroactive disallowance of such changes. The ruling also clarifies the application of Section 1272(a)(6)(C)(iii) in the context of credit card receivables, setting a precedent for future cases involving similar issues.

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