Keeping the books, and keeping the books the IRS way, are two different things!

A CHANGE IN A METHOD OF ACCOUNTING includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any “material item” used in that overall plan.

IN GENERAL • A taxpayer may not change its method of accounting without first obtaining the permission of the Commissioner. In some cases, however, the taxpayer is given advance approval. Along with completing the application (Form 3115) for a change in method of accounting, a taxpayer must calculate the adjustments to income as described in Code section 481. (All section references are to the Code unless otherwise indicated.)

Rev. Proc. 97-27, 1997-1 C.B 680, sets forth the rules under which a taxpayer may act relative to an accounting change. Adherence to Rev. Proc. 97-27 is important, and often can prevent significant adverse ad-
justments to a taxpayer’s timing of a deduction or item of income. Rev. Proc. 97-27 makes it clear that there are different rules for taxpayers who voluntarily change their method of accounting and for taxpayers who are under examination. Rev. Proc. 2002-18, 2002-1 C.B. 678, provides guidance as to IRS-initiated accounting method changes.

Notwithstanding the strict rules regarding changes in methods of accounting, a taxpayer may avoid the application of these rules if the change is merely a change in fact; in which case, a taxpayer’s change may not rise to a level of being a change in method of accounting for which permission of the IRS is needed.

What Constitutes A Change In Accounting Method?

Once a taxpayer has adopted a method of accounting, a “change in method of accounting” occurs when a taxpayer changes its determination of when an item of income or expense is recognized. The IRS must consent to the change and can attach conditions to it. §446(e).

Unfortunately, the Internal Revenue Code does not define the phrase “change in method of accounting” but the regulations (Treas. Reg. §1.446-1(c)(2)(ii)(a)) provide some guidance. Under them, a change in method of accounting includes:

- A change in an overall plan or system of identifying or valuing items in inventory;
- A change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory;
- A change from the cash receipts and disbursement method to the accrual method, or vice versa;
- A change involving the method or basis used in the valuation of inventories (see §§ 471 and 472, and the regulations hereunder);
- A change from the cash or accrual method to a long-term contract method, or vice versa (Treas. Reg. §§1.446-1(c)(2)(ii)(a) and 1.460-4);
- Certain changes in computing depreciation or amortization;
- A change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; and
- A change for which the Code and regulations specifically require the consent of the Commissioner.

The rulings of the IRS provide some additional guidance. Under the IRS rulings, a change in method of accounting includes:

- A change in computing the cost of LIFO inventory by including the cost of freight-in (Rev. Rul. 80-190, 1980-2 C.B 161);
- A change from the use of estimates to the use of actual expenditures in accounting for insurance expenses (Rev. Rul. 81-93, 1981-1 C.B 322);
- A change where deductions were based on contributions made to pension plans on account of hours of service performed after the end of the taxable year, but before the due date for the tax return (TAM 200110031);
- A change in the method of handling deposits (Rev. Rul. 60-243, 1960-2 C.B. 160);
- A change in the accrual of commission income on securities from the “settlement date” to the “trade date” (Rev. Rul. 74-372, 1974-2 C.B. 147); and

Under Rev. Proc. 97-27, the treatment of an asset from not depreciable or not amortizable to depreciable or amortizable or vice versa is a change of accounting. (Rev. Proc. 97-27, 1997-1 C.B. 680, 681, providing in part, a change of accounting occurs when the change “permanently changes the amount of the taxpayer’s lifetime income. If the practice does not permanently affect the taxpayer’s lifetime income, but does or could change the tax-


What Is Not A Change Of Accounting?

Under the regulations, the following do not constitute a change of accounting:

- An adjustment of any item of income or deduction that does not involve the proper time for including the item in income or the taking of a deduction (Treas. Reg. §1.446-1(c)(2)(ii)(b));
- An adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset (see PLR 9222017, where the use of a different estimation method to determine the fair market value of foreclosure property did not rise to the level of an accounting method because the estimation method only went to the amount rather than the timing in which an item of income or deduction is taken into account);
- Correction of mathematical or posting errors (see TAM 9421003, where the National Office advised that the taxpayer did not merely make a posting error when it switched from deducting all of its software development costs to capitalizing at least two-thirds of them; rather, the taxpayer’s consistent treatment of such costs for five years resulted in an accounting method change);
- Errors in the computation of tax liability;
- The recharacterization of an item of income or expense, such as from deductible to non-deductible (Treas. Reg. §1.446-1(c)(2)(ii)(b)); and

Courts have been liberal in finding that a change was the result of an “error” as opposed to an accounting change. In Evans v. Commissioner, 55 T.C.M. (CCH) 902 (1988), the Tax Court found the prior reporting of bonuses by a cash basis taxpayer, in the year authorized rather than in the year received, did not establish an accrual method of accounting but was only the misapplication of the cash method. See also, North Carolina Granite Corp. v. Commissioner, 43 T.C. 149 (1964), where the taxpayer used an erroneous method for its depletion deduction in arriving at taxable income. The Tax Court said that the fact that the taxpayer may have repeated its mistake for a number of years does not transform the mistake into a method of accounting.

“Material Items”

A change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a “change in method of accounting.”

What is a “material item”? The current regulations provide that a material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. §1.446-1(c)(2)(ii)(a). See, e.g., Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500 (1989), where the court concluded that a change from an erroneous perpetual inventory system to a physical inventory system amounted to a change in method of accounting because there would be a change in the time when items of income and expense were reported. On the other hand, in Korn Industries, Inc. v. U.S., 532 F.2d 1352 (Ct. Cl. 1976), the court found no change in accounting method where the taxpayer re-included in its beginning inventories three “cost elements” that for a period of four years had been inadvertently excluded and therefore expensed. The court, in siding with the taxpayer, called this a correction of a mathematical or posting error rather than a change of accounting. In Rev. Rul. 77-134, 1977-1 C.B. 132, the IRS said it would not follow Korn Industries, Inc.

Before the current regulations were issued in 1970, the courts determined materiality as “absolute” or “relative.” Absolute materiality refers to the size of the adjustment. In Dorr-Oliver, Inc., v.
Commissioner, 40 T.C. 50 (1963), an adjustment of $25,000 was held to be material. The court considered whether a change in accounting for accrued vacation time was a “substantial change of a material item.” The court observed, “$25,000 is seldom insubstantial.”

Absolute materiality has its flaws, and therefore, many courts have turned to relative materiality to decide the issue. Unfortunately, some courts look at the adjustment relative to the gross amount of the item, some look at taxable income, and some look at gross income. When the amount of the deduction is compared to the total deductions for the items, materiality is generally found. When the amounts at issue have been held to be material, See, e.g., Leonhart v. Commissioner, 27 T.C.M. (CCH) 443 (1968), aff’d per curiam, 414 F.2d 749 (4th Cir. 1969).

Adoption Of A Method Of Accounting

Rev. Rul. 90-38, 1990-1 C.B. 57, states that a taxpayer has not adopted a method of accounting by virtue of having applied an improper treatment once. However, if the taxpayer applies an improper treatment twice, then he has adopted a method of accounting. (In Rev. Rul. 72-491, 1972-2 C.B. 104, the IRS ruled that a taxpayer erroneously using an accelerated method of depreciation for “used” property may file an amended return using a proper method, provided that the taxpayer has not filed the tax return for the succeeding tax year.) In making this ruling, the IRS relied on two propositions:

(1) The holding in Diebold, Inc. v. U.S., 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990), where the court held that the treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of Treas. Reg. §1.1446-1(c)(2)(ii)(a) (the regulation provides: “in most instances a method of accounting is not established for an item without...consistent treatment”); and

(2) Treas. Reg. §1.1446-1(c)(2)(ii), which indicates that the consistent, but erroneous, treatment of material items constitutes a method of accounting.

The IRS further explained that Rev. Rul. 90-38 is intended to prevent a taxpayer from retroactively changing from an erroneous to a permissable method of accounting, without IRS consent, by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired. This principle was also applied in TAM 9421003, in which the National Office advised that the taxpayer changed its method of accounting when it capitalized most of its software development costs consistently for five years after properly and consistently deducting those costs for 16 years. This change was improper, the National Office stated, because the taxpayer did not obtain the IRS’s consent. Citing Rev. Rul. 90-38 and Diebold, the National Office explained that the taxpayer could not use amended returns to retroactively change its accounting method of capitalizing the software development costs to deducting such costs without the IRS’s consent. (In TAM 9439002, the IRS ruled that a retroactive change in an erroneous accounting method required the consent of the Commissioner, even if the period for amending the return for the first year in which the erroneous method was used had not expired.)

Change In Underlying Facts

In general, a change in tax reporting will be found to be a change in underlying facts and not a change in method of accounting when the taxpayer continues to apply its existing method of accounting to a change in business practice, a change in economic or legal relationships, or an otherwise after-the-fact situation.

Often a problem arises in distinguishing a change in method of accounting from a change in underlying facts. The issue is whether the facts
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changed, so as to justify different treatment under a single, consistent method of accounting, or whether the change in treatment represented a decision to treat the same “item” in a different way, i.e., a change in method of accounting.

A change in a method of accounting involves changing a reporting result by the application of a different rule to the same facts, rather than the application of the same rule to different facts. As one court explained:

Fundamentally, the item itself must be basically the same as an item previously accounted for with the present method of accounting differing from the prior treatment. Unless the transactions are basically the same, the accounting treatment would not be “change” of accounting but only a “new” accounting method for a different transaction.

*Federated Department Stores v. Commissioner*, 51 T.C. 500, 513-14 (1968), nonacq., 1971-2 C.B. 4, aff’d, 426 F.2d 417 (6th Cir. 1970). See also, e.g., *Alabama Coca-Cola Bottling Co. v. Commissioner*, 28 T.C.M. (CCH) 635, 657 (1969), where the taxpayer switched from expensing to capitalizing the costs of certain signs. The court noted that the taxpayer had previously used a different, less durable type of sign, and stated in *dicta* that if the earlier signs had a useful life of less than one year, capitalizing the new signs would not be a change in method of accounting; on the other hand, if the earlier signs had a useful life in excess of one year, then there would be a change in method.

In each example above, it is clear that the taxpayer has applied its existing method of reporting to a changed fact situation. The different tax consequences arose from a different legal obligation and economic condition, respectively, not from a change in method of reporting.

**Example 2**

From 1968 through 1970, a taxpayer had fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Timing, Not Categorization, Counts

Similarly, adjustments of any item of income or deduction that do not involve the proper time for inclusion of an item or the taking of a deduction are not considered changes in accounting method. For example, corrections of items that are deducted as interest or salary but which, in fact, are payments of dividends, and of items that are deducted as business expenses but which are in fact personal expenses, are not changes in methods of accounting. Treas. Reg. 1.446-1(e)(2)(ii)(b). When the character of an item in a particular year is at issue rather than the year in which the item is to be reported,
a change in character does not amount to a change in method of accounting and is not subject to the requirement governing such changes. In *Saline Sewer Co. v. Commissioner*, 63 T.C.M. (CCH) 2832 (1992), the court held that a recharacterization in which amounts that should have been treated as income were treated as non-taxable contributions to capital did not result in a change of accounting method. Therefore, the IRS could not use section 481 to tax a catch-up adjustment. As a result, some of the proposed adjustments were barred by the statute of limitations. In PLR 9222017, the use of a different estimation method to determine fair market value of foreclosure property did not rise to a method of accounting because an estimation method only goes to the amount rather than the timing in which an item of income or deduction is taken into account.

**Change Of Facts Illusory?**

On the other hand, the IRS occasionally argues that a purported change in underlying facts is actually illusory and does not justify a change in treatment. For example, in Rev. Rul. 60-243, 1960-2 C.B. 160, a taxpayer, a soft drink manufacturer, proposed to remove from its invoices the clause in which it retained title to the bottles, and change its accounting to reflect a sale of the bottles together with the soft drink. The IRS ruled that, as a practical matter, the taxpayer was relying on the “practical certainty” that it would continue to reacquire most of the bottles it sold, and therefore there was no real change in business practice. The IRS’s position appeared to be based on the reasoning that there was in substance no sale, and that the change had no practical effect. It did not help the taxpayer’s case that the price at which it sold the bottles was far below cost.

Courts may be inhospitable to this approach when there is evidence that the terms have been manipulated for no business purpose other than the deferral of income. See, e.g., *Hallmark Cards v. Commissioner*, 90 T.C. 26, 34 n.6 (1988) (taxpayer shipped seasonal material before the end of the year but title did not pass until January 1; court noted that taxpayer’s business purpose was unquestioned, distinguishing the case where “a taxpayer has deliberately manipulated the terms of sale so as to prevent income from accruing that it would otherwise become entitled to prior to the end of its taxable year”).

**Planning Suggestions**

- Because of the difference between a change in the underlying facts and a change in method of accounting, a taxpayer should examine its business operations, e.g. billing practices, to delay recognition of income. In *Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), a delay in year end billing was held not to be a change in accounting method.

- A taxpayer should carefully review the impact of a section 481 adjustment before changing its method of accounting. It might be beneficial to continue to use the current method of accounting for a period of time.

- If the taxpayer is employing an incorrect method of accounting, file Form 3115 early to avoid being disqualified by IRS contact.

**Taxpayer-Initiated Changes**

If a taxpayer proposes to change its method of accounting, three conditions apply. First, the taxpayer must obtain the prior consent of the Commissioner. Second, the change is subject to the requirements of section 481, which permits adjustments to be made to ensure that changes do not result in the double inclusion of items of income or expense or an omission of such items. Third, the making of the change and any subsequent review are not subject to the applicable statutory periods of limitation; the section 481 adjustment would include amounts attributable to years on which the applicable statutory period has otherwise run. See §§481,
1311-1314, and Graff Chevrolet Co. v. Campbell, 343 F.2d. 568 (5th Cir. 1965).

Two Or More Trades Or Businesses

Different methods of accounting may be used for each trade or business of a taxpayer. Treas. Reg. §§1.446-1(d)(1) and 1.446-1(d)(2). In considering whether to grant an accounting method change for one of the trades or businesses of a taxpayer, the IRS will consider whether the change will result in the creation or shifting of profits or losses between the trades or businesses, and whether the proposed method will clearly reflect the taxpayer’s income as required by section 446 and the regulations thereunder.

A taxpayer requesting a change in method of accounting for one of its trades or businesses must identify all other trades or businesses by name and the method of accounting used by each trade or business for the particular item that is the subject of the requested change in accounting method.

If a taxpayer operates two or more distinct trades or businesses and has kept separable books and records (and employed different methods of accounting for the businesses), Form 3115 and a separate user fee is required for each separate trade or business if the taxpayer desires to change the methods of accounting of the separate trades or businesses.

Consolidated Groups

Separate methods of accounting may be used by each member of a consolidated group, subject to section 446 and the regulations thereunder. Treas. Reg. §1.1502-17(a). In considering whether to grant accounting method changes to group members, the IRS will consider the effects of the changes on the income of the group. A common parent requesting a change in method of accounting on behalf of a member of the consolidated group must submit any information necessary to permit the IRS to evaluate the effect of the requested change on the income of the consolidated group. Except as provided in section 8.13(2) of Rev. Proc. 97-27, Form 3115 and a separate user fee must be submitted for each member of the group for which a change in accounting method is requested pursuant to Rev. Proc. 97-27.

A common parent may request an identical accounting method change on a single Form 3115 on behalf of more than one member of a consolidated group at a reduced user fee. See §§15.07(1) and (3) of Rev. Proc. 2009-1, 2009-1 I.R.B.1 (or any successor) for the information required to be submitted with Form 3115. To qualify, the taxpayers in the consolidated group must be members of the same affiliated group under section 1504(a) who join in the filing of a consolidated tax return, and they must be requesting to change from the identical present method of accounting to the identical proposed method of accounting. All aspects of the requested accounting method change, including the present and proposed methods, the underlying facts, and the authority for the request, must be identical, except for the section 481(a) adjustment.

Audit Protection For Taxable Years Before Year Of Change

One of the most important changes made by Rev. Proc. 97-27 was to provide audit protection. When a taxpayer timely files Form 3115, the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year before the year of change, unless the change was not made or was made improperly, such as when:

- The taxpayer withdraws or does not perfect its request;
- The National Office denies the request;
- The taxpayer declines to implement the change in method of accounting pursuant to the terms and conditions of Rev. Proc. 97-27 and the “Consent Agreement” it requires of the taxpayer;
The taxpayer implements the change but does not comply with the terms and conditions contained in the Consent Agreement and Rev. Proc. 97-27; or

The National Office modifies or revokes the ruling retroactively because there has been a misstatement or an omission of material facts.

**District Director’s Review**

The district director must apply a ruling obtained under Rev. Proc. 97-27 in determining the taxpayer’s liability unless the district director recommends that the ruling should be modified or revoked. The district director will ascertain if:

- The representations on which the ruling was based reflect an accurate statement of the material facts;
- The amount of the section 481(a) adjustment was properly determined;
- The change in method of accounting was implemented as proposed in accordance with the terms and conditions of the Consent Agreement and Rev. Proc. 97-27;
- There has been any change in the material facts on which the ruling was based during the period the method of accounting was used; and
- There has been any change in the applicable law during the period the method of accounting was used.

If the district director recommends that the ruling (other than the amount of the section 481(a) adjustment) should be modified or revoked, the district director will forward the matter to the National Office for consideration before any further action is taken. Such a referral to the National Office will be treated as a request for technical advice, and the provisions of Rev. Proc. 97-2 (or any successor) will be followed.

**COMMISSIONER’S CONSENT**

In general, a taxpayer may not change its method of accounting for tax purposes without the prior consent of the Commissioner. If a taxpayer changes its method without first obtaining the Commissioner’s approval, the Commissioner may require the taxpayer to change back to the original method of accounting, or if the year is closed because the statutory period of limitation has run, to the earliest year still open. The Commissioner may also require that section 481 adjustments be made to insure that all items of income are properly reflected.

There are, however, a number of circumstances where the Commissioner’s consent is either not required or is deemed to have been received if the taxpayer meets certain conditions. Over the years, the IRS issued many rulings dealing with isolated issues involving change of accounting methods. The IRS has since combined its rulings into one comprehensive pronouncement, the most recent of which is Rev. Proc. 2008-52, 2008-2 C.B. 587. This revenue procedure provides the methods by which a taxpayer may obtain automatic consent to change its method of accounting.

The requirement for advance IRS consent applies to proper and improper methods of accounting currently in use. If the taxpayer is using an improper accounting method, prior permission still must be received before the taxpayer can change to a new method. Some courts, however, have taken issue with this position of the Commissioner and have argued that prior IRS approval is not required from a change to a correct method from an incorrect method. For example, in Douthit v. United States, 299 F.Supp. 397 (W.D. Tenn. 1969), rev’d per curiam, 432 F.2d 83 (6th Cir. 1970), the court held that the requirement of prior approval is not applicable to a change in accounting method that is required by applicable law. Since, in this case, the taxpayer was required by a change in law to change its method of accounting, prior consent was not required. See also, Woodward Iron Co. v. United States, 254 F.Supp.
835 (N.D. Ala. 1966), aff’d, 396 F.2d. 552 (5th Cir. 1968).

**Procedures For Obtaining Consent**

The IRS published procedures under section 446(e) of the Code and Treas. Reg. §1.446-1(e) for obtaining the Commissioner’s consent to change a method of accounting. The procedures can be found in Rev. Proc. 97-27, 1997-1 C.B. 680. Rev. Proc. 97-27 modified and superseded Rev. Proc. 92-20, 1992-1 C.B. 685. Rev. Proc. 97-27 has been modified by Rev. Proc. 2002-19, 2002-1 C.B. 696, which provides procedures for obtaining advance consent for a change of accounting method. And see Rev. Proc. 2002-9, 2002-1 C.B. 327, which provides new procedures for obtaining automatic consent to change an accounting method. Under Rev. Proc. 2002-19, a change in method of accounting will be allowed prospectively, without audit protection, if the method to be changed is an issue pending for a tax year under examination or an issue under consideration by either an appeals office or a federal court. Also, under the revised procedures, if a change in accounting method results in a taxpayer-favorable adjustment (negative section 481(a) adjustment), the entire amount must be taken into account in the year of change. In addition, Rev. Proc. 2002-19 makes additional conforming and clarifying changes.

Rev. Rul. 97-27’s approach is to provide incentives to encourage prompt voluntary compliance with proper tax accounting principles. Under its approach, a taxpayer generally receives more favorable terms and conditions if the taxpayer files its request for a change in accounting method before the IRS contacts the taxpayer for examination. A taxpayer is not under examination if the taxpayer has not been contacted in any manner by the IRS for the purpose of scheduling any type of examination of any of the taxpayer’s Federal income tax returns. A taxpayer that is contacted for examination and required to change its method of accounting by the IRS generally receives less favorable terms and conditions and may also be subject to penalties.

The Commissioner’s permission to change a taxpayer’s method of accounting for a specific year will be set forth in a ruling letter from the National Office that identifies the item or items being changed, the net section 481(a) adjustment (if any), and the terms and conditions under which the change is to be effected for the year specified in the ruling letter.

**Changes Effected By Rev. Proc. 97-27**

Some of the changes made by Rev. Proc. 97-27 are listed below.

- The Category A, Category B, Designated A, and Designated B classifications were eliminated.
- The 90-day window at the beginning of an examination was eliminated.
- The 30-day window for taxpayers under continuous examination was expanded to 90 days and the definition of “under examination” was clarified.
- The consent requirement for taxpayers before an appeals office or a federal court was replaced with a notification procedure.
- The various section 481(a) adjustment periods were replaced with a single four-year section 481(a) adjustment period for both positive and negative adjustments.
- Several of the terms and conditions relating to the section 481(a) adjustment were eliminated.

**Terms And Conditions**

A change in method of accounting filed under Rev. Proc 97-27, if granted, must be made pursuant to the terms and conditions provided in Rev Proc. 97-27. Notwithstanding this general rule, the IRS may determine that, based on the unique facts of a particular case and in the interest of sound tax administration, terms and conditions that differ
from those provided in Rev. Proc. 97-27 are more appropriate.

**Noncompliance With Provisions**

If a taxpayer changes its method of accounting without authorization or without complying with all the provisions of Rev. Proc. 97-27, the taxpayer has initiated a change in method of accounting without obtaining the consent of the Commissioner required by section 446(e). Upon examination, a taxpayer that has initiated an unauthorized change in method of accounting may be required to effect the change in an earlier or later taxable year and may be denied the benefit of spreading the section 481(a) adjustment over the number of taxable years otherwise prescribed by Rev. Proc. 97-27.

**Section 446(f) Sanctions**

If a taxpayer is using an improper method of accounting and does not request permission to change to a proper method of accounting, the failure to seek the Commissioner’s consent will invoke section 446(f). Section 446(f) was added to the Code by the Tax Reform Act of 1984 and authorizes the Commissioner to impose penalties and additions to tax with respect to a taxpayer who does not file a request to change from one method of accounting to another. In TAM 9253004, the National Office advised that a taxpayer’s request to change from an improper use of the cash method to an overall accrual method was eligible to be considered even though the taxpayer failed to disclose information about its erroneous treatment of purchases for which a claim for refund was subsequently filed. The National Office distinguished *Cochran Hatchery v. Commissioner*, 39 T.C.M. (CCH) 210 (1979), which involved a request for change from a proper method, on the ground that the IRS has less discretion to deny permission from an improper method to a proper method.

Essentially, section 446(f) places a strong burden on taxpayers to perform a detailed review of their accounting practice to identify errors and to file Form 3115 when necessary. This provision requires that if a taxpayer fails to file a request to change its method of accounting, the absence of the Commissioner’s consent to the change shall not be taken into account to prevent the imposition of a penalty.

**Effect Of Consent; Subsequent Modifications**

A taxpayer that changes its method of accounting pursuant to Rev. Proc. 97-27 may be required to change or modify that method of accounting for the following reasons:

- The enactment of legislation;
- A decision of the United States Supreme Court;
- The issuance of temporary or final regulations;
- The issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;
- The issuance of written notice to the taxpayer that the change in method of accounting was granted in error or is not in accord with the current views of the IRS; or
- A change in the material facts on which the consent was based.

Except in rare or unusual circumstances, if a taxpayer who changes its method of accounting under Rev. Proc. 97-27 is subsequently required to change or modify that method of accounting, the required change or modification will not be applied retroactively, provided:

- The taxpayer complied with all the applicable provisions of the Consent Agreement and Rev. Proc. 97-27;
- There has been no misstatement or omission of material facts;
- There has been no change in the material facts on which the consent was based;
• There has been no change in the applicable law; and
• The taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer’s detriment.

Automatic Consent


- The use of the cash and disbursements method of accounting by certain small taxpayers;
- Trade or business expenses (Code Section 162);
- Depreciation or amortization (Code Section 167, 168, or 197);
- Capital expenditures (Code Section 263);
- Uniform capitalization including UNICAP changes by producers of real or tangible personal property (See also Rev. Proc. 2002-19, 2002-1 C.B. 696);
- Methods of accounting (Code Section 446);
- Obligations issued at discount (Code Section 454);
- Prepaid subscription income (Code Section 455);
- Taxable year of deduction (Code Section 461);
- Inventories (Code Section 471);
- Last-in, first-out (LIFO) inventories (Code Section 472);
- Bank reserves for bad debts (Code Section 585);
- Original issue discount (Code Section 1273); and
- Short-term obligations (Code Section 1281).

TAXPAYER APPLICATIONS FOR CHANGE (FORM 3115) • Except as otherwise provided to secure the Commissioner’s consent to a taxpayer’s change in method of accounting (Treas. Reg. §1.446-1(c)(3)(i)), the taxpayer must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. Note: Form 3115 is “filed” on the date it is mailed, i.e., the date of the U.S. postmark (§7502) or delivered to and received by the IRS. If the filing deadline falls on a Saturday, Sunday, or legal holiday, the filing deadline is extended to the next working day. See Notice 97-26, 1997-1 C.B. 413.

To the extent applicable, the taxpayer must furnish all information requested on Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer’s computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require any other information that may be necessary to determine whether the proposed change should be permitted.

Permission to change a taxpayer’s method of accounting will not be granted unless the taxpayer agrees to the Commissioner’s prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first out inventory method. For any Form 3115 filed on or after May 15, 1997, see Treas. Reg. §1.446-1T(c)(3)(i)(B).

Protective Applications

When an examining agent has questioned (or might question) a taxpayer’s method of accounting, notwithstanding the belief by the taxpayer that its method of accounting is acceptable, it is good
practice to file a protective application for change. In such case, any ensuing penalty might be lessened. Similarly, if it were likely that the taxpayer’s method, if challenged, would be found to be unacceptable, a protective election would be in order.

It would also be appropriate to file protective elections if the taxpayer expected to change a manner in which it was handling an item that may or may not amount to an accounting change.

**Time For Filing**

As a practical matter, while the taxpayer is given the whole year to file an application to change an accounting method, the earlier the application is filed, the sooner it will be reviewed; moreover, any subsequent contact for examination will not prevent the taxpayer from receiving more favorable treatment for a voluntary change. A delay may result in the taxpayer being contacted for examination, which will prevent the taxpayer from availing himself of the relief under Rev. Proc. 97-27.

Sometimes, an application may take several months or longer before being reviewed; this may result in the taxpayer requesting an extension of time to file the tax return. If the approval of a request for a change of method of accounting has not been received before year end, the taxpayer should prepare the return on the assumption that the change will not be granted.

**Late Filing**

A taxpayer who fails to file Form 3115 during the year of change will not be granted an extension of time to file under §§301.9100-1 through 301.9100-3 of the Procedure and Administration Regulations, except in unusual and compelling circumstances.

**Where To File**

A taxpayer, other than an exempt organization, applying for a change in accounting method must complete and file a current Form 3115, together with the appropriate user fee, with the Commissioner of Internal Revenue, Attention: CC:DOM:CORP:T, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044. An exempt organization must complete and file a current Form 3115, together with the appropriate user fee, with the Assistant Commissioner (Employee Plans and Exempt Organizations) Attention: E:EO, P.O. Box 120, Benjamin Franklin Station, Washington, DC 20044

**User Fee**

A taxpayer is required to pay a user fee when requesting a change in accounting method under Rev. Proc. 97-27. Rev. Proc. 2009-1, 2009-1 I.R.B. 1 (or any successor) contains the schedule of fees and provides guidance for administering the user fee requirements.

**Signature Requirements**

Form 3115 must be signed by or on behalf of the taxpayer requesting the change by an individual with authority to bind the taxpayer in such matters. (See the signature requirements set forth in the General Instructions attached to a current Form 3115 regarding those who are to sign.) A corporate officer, for example, must sign on behalf of a corporation; a general partner, on behalf of a state law partnership; a member-manager, on behalf of a limited liability company; a trustee, on behalf of a trust; an individual taxpayer, on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, a Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent.

If an agent is authorized to represent the taxpayer before the IRS, receive the original or a copy of the correspondence concerning the request, or perform any other act(s) regarding the Form 3115 filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to Form 3115. A taxpayer’s representative without a
power of attorney will not be given any information regarding Form 3115.

**Facts And Circumstances Considered**
In processing an application for a change in method of accounting, the IRS will consider all the facts and circumstances, including:

- If the method of accounting requested is consistent with the Code, regulations, revenue rulings, revenue procedures, and decisions of the Supreme Court of the United States;
- If the use of the method of accounting requested will clearly reflect income;
- If the present method of accounting clearly reflects income;
- The need for consistency in the accounting area;
- The taxpayer’s reason(s) for the change;
- The tax effect of the section 481(a) adjustment;
- If the taxpayer’s books and records and financial statements will conform to the proposed method of accounting;
- If the taxpayer previously requested to change its method of accounting for the same item but did not make the change; and
- The need for consistency in the accounting area. In practice, the IRS rarely turns down a request for a change that is supported by adequate business reasons, provided the taxpayer agrees to (1) the appropriate spread of any resulting adjustment necessitated by the change, and (2) any additional conditions the IRS deems appropriate to clearly reflect, or to prevent a distortion of, the taxpayer’s income. In addition to ethical considerations, taxpayers and their representatives should be aware that disastrous tax consequences may stem from failing to disclose all material facts in an application for a change of accounting method. If the IRS consents to the change but later discovers that the taxpayer failed to disclose all material facts in its application, the IRS may retroactively revoke its consent to the change.

**Incomplete Applications**
If the IRS receives a Form 3115 that is not properly completed in accordance with the instructions on the form and the provisions of Rev. Proc. 97-27, or if supplemental information is needed, the IRS will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be allowed 21 days from the date of the notification to furnish the necessary information. The IRS reserves the right to impose shorter reply periods if subsequent requests for additional information are made. If the required information is not submitted to the IRS within the reply period, the submitted Form 3115 will not be processed. An additional period, not to exceed 15 days, to furnish information may be granted to a taxpayer. The request for an extension of time must be made in writing and submitted within the 21-day period. If the extension request is denied, there is no right of appeal.

**Conference Requests**
A taxpayer must complete the appropriate line on Form 3115 to request a conference as of right, if an adverse response is contemplated by the IRS. If the taxpayer does not complete the appropriate line on Form 3115 or request a conference later in a written communication, the IRS will presume that the taxpayer does not desire a conference. If requested, a conference will be arranged in the National Office before the IRS’s formal reply to the taxpayer’s Form 3115. For taxpayers other than exempt organizations, see §10 of Rev. Proc. 2009-1 (or any successor). For exempt organizations, see §12 of Rev. Proc. 2009-4, 2009-1 I.R.B. 118.

**IRS Discretion To Process Application**
The IRS reserves the right to decline to process any Form 3115 in which it would not be in the best
interest of sound tax administration to permit the requested change. In this regard, the IRS will consider whether the change in method of accounting would clearly and directly frustrate compliance efforts of the IRS in administering the income tax laws.

Taxpayers Under Examination

A taxpayer under examination may not file Form 3115 to request a change in accounting method except under the “90-day window,” the “120-day window,” (see below) or with the district director’s consent. A taxpayer that files a Form 3115 beyond the time periods provided in the 90-day and 120-day windows will not be granted an extension of time to file under Treas. Reg. §301.9100, except in unusual and compelling circumstances. In *Capitol Federal Savings & Loan Association v. Commissioner*, 96 T.C. 204 (1991), the IRS notified the taxpayer in a letter that the taxpayer’s return for certain years had been selected for examination. The letter also requested certain information and stated that such information might demonstrate that an examination of the taxpayer’s return was not warranted. The Tax Court held that the taxpayer was “under examination” by virtue of having received the letter, notwithstanding that the IRS was of the view that an examination might not be warranted. In TAM 9316002, the National Office advised that a telephone conversation between a taxpayer, a parent corporation, and the IRS, in which the IRS informed the taxpayer that a consolidated return had been selected for examination constituted contact for purposes of scheduling an examination under Rev. Proc. 84-74

90-Day Window Period

A taxpayer may file Form 3115 to request a change in accounting method during the first 90 days of any taxable year (“90-day window”) if the taxpayer has been under examination for at least 12 consecutive months, as of the first day of the taxable year. This 90-day window is not available if the method of accounting the taxpayer is requesting to change is an issue the examining agent has placed in suspense at the time Form 3115 is filed or is an issue under consideration at the time Form 3115 is filed.

A taxpayer requesting a change under a 90-day window must provide a copy of Form 3115 to the examining agent at the same time it files the original Form 3115 with the National Office. Form 3115 must contain the name and telephone number of the examining agent. The taxpayer must attach to Form 3115 a separate statement signed by the taxpayer certifying that, to the best of the taxpayer’s knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent.

120-Day Window Period

A taxpayer may file Form 3115 to request a change in accounting method during the 120-day period following the date an examination ends (“120-day window”) regardless of whether a subsequent examination has commenced. This 120-day window is not available if the method of accounting the taxpayer is requesting to change is an issue the examining agent has placed in suspense at the time Form 3115 is filed or is an issue under consideration at the time Form 3115 is filed. A taxpayer requesting a change under a 120-day window must provide a copy of Form 3115 to the examining agent for any examination that is in process at the same time it files the original Form 3115 with the National Office. Form 3115 must contain the name and telephone number of the examining agent. The taxpayer must attach to Form 3115 a separate statement signed by the taxpayer certifying that, to the best of the taxpayer’s knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent.
District Director’s Consent

A taxpayer under examination may request to change an accounting method if the district director consents to the filing of the request. The district director will consent to the filing of Form 3115 unless, in the opinion of the district director, the method of accounting to be changed would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination.

The district director, for example, will consent to the filing of Form 3115 to change from a clearly permissible method of accounting. The district director will also consent to the filing of Form 3115 to change from an impermissible method of accounting where the impermissible method was adopted after the years under examination. The question of whether the method of accounting from which the taxpayer is changing is permissible or was adopted after the years under examination may be referred to the National Office, as a request for technical advice under the provisions of Rev. Proc. 97-27.

A taxpayer requesting the district director’s consent must attach to Form 3115 a statement from the district director consenting to the taxpayer’s filing of Form 3115. The taxpayer must provide a copy of Form 3115 to the district director at the same time it files the original form with the National Office. Form 3115 must contain the name and telephone number of the examining agent.

Taxpayer Before An Appeals Office

A taxpayer that is before an appeals office with respect to any income tax issue may request a change in accounting method if the accounting method to be changed is not an issue under consideration by the appeals office. The taxpayer must provide a copy of Form 3115 to the appeals officer at the same time it files the original Form 3115 with the National Office. Form 3115 must contain the name and telephone number of the appeals officer.

Taxpayer Before A Federal Court

A taxpayer that is before a federal court with respect to any income tax issue may request a change in accounting method if the accounting method to be changed is not an issue under consideration by the federal court. The taxpayer must attach to Form 3115 a separate statement signed by the taxpayer certifying that, to the best of the taxpayer’s knowledge, the same method of accounting is not an issue under consideration by the federal court. The taxpayer must provide a copy of Form 3115 to the counsel for the government at the same time it files the original Form 3115 with the National Office. Form 3115 must contain the name and telephone number of the counsel for the government.

Terms And Conditions Of Change

For a taxpayer under examination, filing Form 3115 during the 90-day or 120-day window, filing with the consent of the district director, or before an appeals office or a federal court, the terms and conditions are the same as those provided for taxpayers not under examination.

Prior Applications

If a taxpayer has changed its method of accounting for the same item within the four taxable years preceding the year of change (under either an automatic change procedure or a procedure requiring advance consent), a copy of the application for the previous change, the signed Consent Agreement if applicable, and any other correspondence from the IRS must be attached to the Form 3115 filed for the subsequent taxable year. An explanation must be furnished stating why the taxpayer is again requesting to change its method of accounting for the same item. The IRS will consider the
explanation in determining whether the subsequent request for a change will be granted.

**LIFO Inventory Method Change**

If a taxpayer previously received permission from the Commissioner to change from the LIFO inventory method, the Commissioner will not consent to the taxpayer’s readoption of the LIFO inventory method for five taxable years (beginning with the taxable year the taxpayer changed from the LIFO inventory method) in the absence of a showing of unusual and compelling circumstances.

**Changes Not Made**

If a prior Form 3115 (filed under either an automatic change procedure or a procedure requiring advance consent) was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made, and the taxpayer files another application to change the same item for a year of change within four taxable years of the prior application, a copy of the earlier application (that is, the first Form 3115), together with any correspondence from the IRS, must be attached to the Form 3115 filed for the subsequent taxable year. An explanation must be furnished stating why the earlier application was withdrawn or not perfected, or why the change was not made. The IRS will consider the explanation in determining whether the subsequent request for a change will be granted.

**CONSENT AGREEMENTS** • Unless otherwise specifically provided, the Commissioner’s permission to change a taxpayer’s method of accounting for a specific taxable year will be set forth in a ruling letter (original and one copy) from the National Office. The letter identifies the item or items being changed, the section 481(a) adjustment (if any), and the terms and conditions under which the change is to be effected for the taxable year specified in the ruling letter. See Treas. Reg. §§1.446-1(c)(3) and 1.481-4.

If the taxpayer agrees to the terms and conditions contained in the ruling letter, the taxpayer must sign and date the agreement copy of the ruling letter in the appropriate space. The signed copy of the ruling letter will constitute an agreement (Consent Agreement) within the meaning of section 481(c) and as required by Treas. Reg. §1.481-4(b). The Consent Agreement must be returned to the address provided in the agreement within 45 days of the date of its issuance. If the taxpayer does not return the signed Consent Agreement within 45 days of the date of its issuance, the ruling letter granting permission for the change will be null and void.

A copy of the Consent Agreement must be attached to the taxpayer’s income tax return for the year of change. If a taxpayer signs and returns the Consent Agreement, the taxpayer must implement the change in accounting method in accordance with the terms and conditions provided in the Consent Agreement. See Treas. Reg. §1.481-4(b).

**Signature Requirements**

The Consent Agreement must be signed by or on behalf of the taxpayer making the request. If the taxpayer does not return the signed Consent Agreement within 45 days of the date of its issuance, the ruling letter granting permission for the change will be null and void.

An individual signing the Consent Agreement on behalf of the taxpayer must have the authority to bind the taxpayer in such matters. In general, the agreement may not be signed by the taxpayer’s representative.

**Rejection By Taxpayer**

If the taxpayer decides not to effect the change in accordance with the terms and conditions of the ruling letter, the taxpayer must so indicate by re-
turning the unsigned copy of the ruling letter to the National Office, addressed as follows, with an explanation of why the accounting method change will not be effected: Commissioner of Internal Revenue Attention: (Individual whose name and symbols appear at the top of the Consent Agreement), P.O. Box 14095, Benjamin Franklin Station, Washington, DC 20044.

If the taxpayer disagrees with the terms and conditions of the ruling letter, the taxpayer must express the disagreement together with an explanation of the reasons within the 45-day period set forth above. The IRS will consider the reason for disagreement and notify the taxpayer whether the original ruling will be modified. If the ruling is not modified, the taxpayer will be notified and given 15 days from the date of the notification either to accept the original ruling, by signing and returning the Consent Agreement, or to reject the change, by returning the ruling and the Consent Agreement unsigned.

**YEARS OF CHANGE** • The year of change is the first taxable year the new method is to be applied, even if no affected items are taken into account for that year. The year of change is also the first taxable year for complying with all the terms and conditions set forth in the Consent Agreement.

**SECTION 481 ADJUSTMENT** • Section 481(a) requires adjustments to be made in connection with changes in accounting methods in order to prevent an omission of income or a double deduction. Without section 481, a change in method of accounting would permit various items of income and expense to escape taxation.

If a particular change in method of reporting does not amount to a change in method of accounting, section 481 is inapplicable. Therefore, it is important to determine whether there has been a change in method of accounting.

**Historical Background**

Section 481 was enacted as part of the 1954 Code. Before then (as under present law), a taxpayer could not voluntarily change a method of accounting without the prior approval of the Commissioner. However, before the enactment of section 481, there was no provision requiring adjustments to prevent omission or duplication of items of income or expense. As a result, when a change in method of accounting was requested by a taxpayer, the Commissioner would generally condition his approval on the taxpayer’s agreeing to take into account, in the year of the change, the entire amount of any adjustment. See *Perelman v. Commissioner*, 41 T.C.234 (1963).

When a change was required on audit, the taxpayer was not compelled to agree to an adjustment to avoid omission or duplication of items or expense and the Commissioner did not have the authority to require the adjustment. The Commissioner could only require adjustments for changes initiated by the taxpayer. As a result, taxpayers were reluctant to initiate a change in method of accounting. The IRS, as well, would not require a change because of the revenue that would be lost. Because of this situation, Congress enacted section 481.

**Application Of Adjustment**

Section 481(c) and Treas. Reg. §1.481-4 provide that the adjustment required by section 481(a) may be taken into account in determining taxable income in the manner, and subject to the conditions, agreed to by the IRS and the taxpayer. Absent this special rule, the net section 481(a) adjustment (if any) is taken into account completely in the year of change, subject to section 481(b), which limits the amount of tax where the net section 481(a) adjustment is substantial. Treas. Reg. §1.446-1(c)(3)(i) authorizes the IRS to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer
to obtain consent to change a method of accounting in accordance with section 446(e) of the Code.

**Duplication Example**

Before 2008, X Corp., a calendar year, accrual-method C corporation, deducted year-end employee bonuses in the year accrued even when paid after March 15th of the following year. In 2008, X Corp. changed its method of accounting with regard to the deduction of the bonuses when it began deducting the employee bonuses in the year paid to the employees.

On December 31, 2007, X Corp. deducted $120,000 of salary expense (under the old method), which was deducted again in 2008 (under the new method). In order to eliminate this duplication, X Corp. must include a $120,000 section 481(a) adjustment in income in 2008.

**Omission Example**

X Corp., a calendar-year C corporation, changed from a cash method taxpayer to an accrual method taxpayer in 2008. In its 2007 tax return (filed under the cash method), it did not report its accrued income nor did it deduct its accrued expenses. Because X Corp. is on the accrual method in 2008, it will not include in income the collection of its accrued income or deduct the payment of its accrued expenses after December 31, 2007, which it would have done had it remained on the cash method.

X Corp. must construct an accrual method balance sheet as of December 31, 2007; review the components of each account to determine which items would have been included in income or deducted as of December 31, 2007, under the accrual method; and calculate the net effect, which is the amount of the section 481(a) adjustment.

**SECTION 481(a) ADJUSTMENT PERIOD**

- The section 481(a) adjustment period is the applicable number of taxable years for taking into account the section 481(a) adjustment. The adjustment is taken into account ratably over the number of taxable years in the adjustment period. In general, the section 481(a) adjustment period for positive and negative adjustments is four taxable years. The first taxable year in the adjustment period is the year of change.

**Short Period As A Separate Taxable Year**

If the year of change or any taxable year during the section 481(a) adjustment period is a short taxable year, the section 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year. See Rev. Rul. 78-165, 1978-1 C.B. 276. Consider the following two hypotheticals, for example.

**Example 1**

A calendar-year taxpayer received permission to change an accounting method beginning with the 2007 calendar year. The section 481(a) adjustment is $30,000 and the adjustment period is four taxable years. The taxpayer subsequently received permission to change its annual accounting period to September 30, effective for the taxable year ending September 30, 2008. The short period from January 1, 2008 to September 30, 2008 is considered a taxable year for section 481(a) adjustment purposes. The section 481(a) adjustment should be included as follows:

<table>
<thead>
<tr>
<th>Yr. No.</th>
<th>Taxable Year</th>
<th>481(a) Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1/1/07 – 12/31/07</td>
<td>7,500</td>
</tr>
<tr>
<td>2</td>
<td>1/1/08 – 9/30/08</td>
<td>7,500</td>
</tr>
<tr>
<td>3</td>
<td>10/1/08 – 9/30/09</td>
<td>7,500</td>
</tr>
<tr>
<td>4</td>
<td>10/1/09 – 9/30/10</td>
<td>7,500</td>
</tr>
<tr>
<td></td>
<td>Total: 30,000</td>
<td></td>
</tr>
</tbody>
</table>
**Example 2**

Corporation X, a calendar-year taxpayer, received permission to change an accounting method beginning with the 2007 calendar year. The section 481(a) adjustment is $30,000 and the adjustment period is four taxable years. On July 1, 2006, Corporation Z acquires Corporation X in a transaction to which section 381(a) applies. Corporation Z is a calendar-year taxpayer that uses the same method of accounting to which Corporation X changed in 2007.

The Section 481(a) adjustment should be included as follows:

<table>
<thead>
<tr>
<th>Corp.</th>
<th>Yr. No.</th>
<th>Taxable Year</th>
<th>481(a) Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>1</td>
<td>1/1/06 – 12/31/06</td>
<td>7,500</td>
</tr>
<tr>
<td>X</td>
<td>2</td>
<td>1/1/07 – 12/31/07</td>
<td>7,500</td>
</tr>
<tr>
<td>X</td>
<td>3</td>
<td>1/1/08 – 6/30/08</td>
<td>7,500</td>
</tr>
<tr>
<td>Y</td>
<td>4</td>
<td>1/1/09 – 12/31/09</td>
<td>7,500</td>
</tr>
</tbody>
</table>

Total: 30,000

**Shortened Or Accelerated Adjustment Periods**

The four-year section 481(a) adjustment period shall be shortened or accelerated for certain entities or in certain situations, as discussed below.

**De Minimis Rule Election**

A taxpayer may elect to use a one-year adjustment period in lieu of the section 481(a) adjustment period if the entire section 481(a) adjustment is less than $25,000 (either positive or negative). The taxpayer must complete the appropriate line on Form 3115 to elect this de minimis rule.

**Cooperatives**

A cooperative within the meaning of section 1381(a) must generally take the entire amount of a section 481(a) adjustment into account in computing taxable income for the year of change.

**Ceasing To Engage In A Trade Or Business**

A taxpayer that ceases to engage in a trade or business or terminates its existence must take into account the remaining balance of any section 481(a) adjustment relating to the trade or business in computing taxable income in the taxable year of the business’s or trade’s cessation or termination. A taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer.

**S Corporation Election/Cessation**

In general, no acceleration of a section 481(a) adjustment is required when a C corporation elects to be treated as an S corporation or an S corporation terminates its S election and is then treated as a C corporation.

**IRS-INITIATED CHANGES** • In Rev. Proc. 2002-18, 2002-1 C.B. 678, the IRS issued guidance on the involuntary change of accounting methods under section 446(b) and Treas. Reg. §1.446-1(b). The revenue procedure applies to any accounting method change imposed by the Service, and to any accounting method issue resolved by the Service on a non-accounting-method-change basis.

Rev. Proc. 2002-18 clarifies the definition of an accounting method issue, and changes the reference for the definition of a change in method of accounting to Treas. Reg. §1.446-1(c)(2). The revenue procedure also clarifies that its procedures do not limit or expand an examining agent’s authority under existing delegation orders. Rev. Proc. 2002-18 provides that although accounting method changes will ordinarily be implemented in the earliest open year under examination, with a section 481(a) adjustment, there may be instances when it is appropriate for an examining agent to consider deferring the year of change to a later year under examination. The revenue procedure further clarifies that an appeals officer or counsel for the gov-
The government may resolve an accounting method issue as an accounting method change using one of the non-accounting method change procedures provided. Rev. Proc. 2002-18 also includes a sentence clarifying the use of tax-effected rates.

**Change In Sub-Method**

The IRS may change a taxpayer’s method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within its method of accounting. For example, an examining agent may propose to terminate the taxpayer’s use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its method of valuing increments in the current year.

**Prior Year Changes**

The IRS may make adjustments to a taxpayer’s returns for the same item for taxable years before the requested year of change to reflect a prior-year IRS-initiated change.

**Criminal Investigations/Proceedings**

The IRS may change a taxpayer’s method of accounting for the same item for taxable years before the requested year of change if there is any pending or future criminal investigation or proceeding concerning:

1. Directly or indirectly, any issue relating to the taxpayer’s federal tax liability for any taxable year before the year of change; or
2. The possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year before the year of change.

**Examining Agent’s Discretion**

Using professional judgment in accordance with auditing standards, an examining agent can make findings of fact and apply the IRS’s position on issues of law to determine whether an issue is an accounting method issue and whether the taxpayer’s method of accounting is permissible.

**Treatment Of Accounting Method Issues**

An examining agent who determines that a taxpayer’s method of accounting is impermissible, or that a taxpayer changed its method of accounting without obtaining the consent of the Commissioner, may propose an adjustment with respect to that method only by changing the taxpayer’s method of accounting.

**Selection Of New Method Of Accounting**

An examining agent changing a taxpayer’s method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and cannot be a method contrived to reflect the hazards of litigation.

**Year Of Change**

An examining agent changing a taxpayer’s method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible.

However, in appropriate circumstances, an examining agent may defer the year of change to a later taxable year. For example, an examining agent may defer the year of change if the examining agent determines that:

- The taxpayer’s books and records do not contain sufficient information to compute a section 481(a) adjustment for the taxable year in which the change would otherwise be imposed and the adjustment cannot be reasonably estimated;
- The taxpayer’s existing method of accounting does not have a material effect for the taxable year in which the change would otherwise be imposed; or
• There are taxable years for which the statute of limitations has expired following the taxable year in which the change would otherwise be imposed.

An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change.

Section 481(a) Adjustment

An examining agent changing a taxpayer’s method of accounting ordinarily will impose a section 481(a) adjustment, subject to a computation of tax under section 481(b) if applicable. The section 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change.

Rev. Proc. 2002-18 provides details regarding disagreement with the proposed changes, changes made on appeal or by government counsel. Procedural requirements for compliance are also described in the ruling.

Audit Protection

In general, a taxpayer that executes a closing agreement finalizing an IRS-imposed accounting change will not be required to change or modify the new method for any taxable year for which a federal income tax return has been filed as of the date of the closing agreement, provided that:
• The taxpayer has complied with all the applicable provisions of the closing agreement;
• There has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact;
• There has been no change in the material facts on which the closing agreement was based; and
• There has been no change in the applicable law on which the closing agreement was based.

Example

A taxpayer-corporation deducted costs that the IRS determined should have been capitalized to real property placed in service in 2000. The taxpayer incurred and deducted $1 million of the costs in 1996, $2 million in each of 1997 and 1998, and $5 million in each of 1999 and 2000. The taxpayer was examined for the 1997 and 1998 taxable years (1997 is the earliest open year).

The examining agent determines that the treatment of the costs is an accounting method issue, and that the taxpayer’s deduction of the costs is an impermissible method of accounting. The examining agent therefore proposes an adjustment.

Under section 5 of Rev. Proc. 2002-18, the examining agent is required to properly apply the law to the facts and change the taxpayer’s accounting method to the capitalization method of accounting for the costs. The examining agent imposes the change in 1997, the earliest open taxable year. The examining agent will provide the notice required by section 7.01 of Rev. Proc. 2002-18. The examining agent imposes a section 481(a) adjustment of $1 million (representing the $1 million of the costs deducted in 1996), the entire amount of which will be taken into account in computing taxable income in 1997. The examining agent also disallows the deductions of $2 million in each of 1997 and 1998. The taxpayer’s basis in the property as of the beginning of 1998 is increased by $5 million (representing the $1 million section 481(a) adjustment and the disallowance of the $2 million of deductions in each of 1997 and 1998). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the IRS changes the method on subsequent examination.

Automatic Consent Procedures

As we have seen, an accounting method cannot be
changed without the consent of the Commissioner as discussed above. In Rev. Proc 2002-9, the IRS has published and updates from time to time procedures for obtaining automatic consent. 2002-1 C.B. 327. Under Rev. Proc. 2002-9, a taxpayer may apply for any one of 26 automatic changes. Some of the principal features of the Rev. Proc. are that the accounting changes can be made with the filing of the taxpayer’s tax return or in some cases by way of an amended tax return. Under Rev. Proc. 97-27, for each change of accounting the taxpayer must submit a separate 3115 and pay a user fee. Under Rev. Proc. 2002-9, a taxpayer can combine two or more changes of accounting in one application and no user fee is required. Some of the accounting changes that are eligible for automatic consent include:

- Depreciation;
- Changes to/from uniform capitalization;
- Methods of accounting;
- Taxable year of inclusion;
- Taxable year of deduction;
- Inventories; and
- LIFO.

Because Rev. Proc. 2008-52 is frequently updated, one should look for these changes in subsequent IRS pronouncements.