

Part IV -- Items of General Interest

Changes in Method of Accounting

Announcement 2002-37

PURPOSE

In 1998, the Service published Notice 98-31, 1998-1 C.B. 1165, which proposed procedures for changes in method of accounting imposed by the Service under § 446(b) of the Internal Revenue Code and § 1.446-1(b) of the Income Tax Regulations (“involuntary changes”), and for accounting method issues resolved by the Service on a nonaccounting-method-change basis. Notice 98-31 also requested comments from the public in connection with these proposed procedures. The final involuntary change procedures appear concurrently in this Bulletin as Rev. Proc. 2002-18. The purpose of this announcement is to discuss some of the most significant and prevalent issues raised in the comments to Notice 98-31, and the manner in which those issues are addressed in the final guidance.

Along with Rev. Proc. 2002-18, this Bulletin contains Rev. Proc. 2002-19, which modifies the procedures contained in Rev. Proc. 97-27 and Rev. Proc. 2002-9 for taxpayers within the scope of those revenue procedures to obtain advance consent of the Commissioner, or automatic consent, respectively, to change a method of accounting (“voluntary changes”). Together, these three

revenue procedures are intended to provide a more efficient use of Service and taxpayer resources with respect to accounting method issues and facilitate greater uniformity in the Service's resolution of accounting method issues.

CHANGES TO NOTICE 98-31

The Service received a number of comments in connection with Notice 98-31, which were considered carefully in revising and finalizing the proposed procedures in Rev. Proc. 2002-18. The following discussion describes some of the most significant comments and the manner in which the final guidance addresses them.

Commentators expressed concern that use of the term "timing issue" to describe the scope of the proposed procedures, and in particular an examining agent's discretion, inappropriately expanded the scope of the procedures to issues that affect timing but that should not be treated as changes in method of accounting, such as where the issue is an isolated occurrence or results from a change in underlying facts. The Service and Treasury Department did not intend to alter the definition of a change in method of accounting or to expand the scope of the proposed revenue procedure beyond issues concerning changes in method of accounting. To address the commentators' concerns, the final revenue procedure uses the term "accounting method issue" rather than "timing issue," clarifies the definition of an accounting method issue, and changes the reference for the definition of a change in method of accounting to § 1.446-1(e)(2).

Commentators expressed concern that the procedures set forth in Notice

98-31 would deprive examining agents of the authority to exercise discretion and professional judgment in resolving accounting method issues. Specifically, the commentators believed that the procedures would limit the existing authority of an examining agent to make findings of fact and to apply the law to those facts in determining whether an issue is an accounting method issue and whether the taxpayer's method of accounting is permissible. Rev. Proc. 2002-18 makes clear that these procedures do not limit or expand an examining agent's authority under existing delegation orders. Under Rev. Proc. 2002-18, an examining agent's ability to exercise professional judgment in accordance with existing auditing standards to make findings of fact, and to apply the law to the facts as found by the agent is preserved. Rev. Proc. 2002-18 also clarifies that although accounting method changes ordinarily will be implemented in the earliest open year under examination, and with a § 481(a) adjustment, there may be instances in which it is appropriate for an examining agent to consider deferring the year of change to a later year under examination, or to impose the change on a cut-off basis.

Similarly, some commentators believed that the procedures set forth in Notice 98-31 would limit the existing authority of Appeals and counsel for the government to resolve accounting method issues. Rev. Proc. 2002-18 clarifies that an appeals officer or counsel for the government may resolve an accounting method issue as an accounting method change (with or without compromise terms and conditions), using one of the nonaccounting-method change procedures provided in Rev. Proc. 2002-18, or using any other means deemed

appropriate under the circumstances, consistent with existing delegation orders.

The background section of the proposed revenue procedure provides that the Service ordinarily will not initiate an accounting method change if the change will place the taxpayer in a position more favorable than if the taxpayer had not been contacted for examination (taxpayer-favorable change). Some commentators thought that this statement was out of place in a document intended to provide the procedures for how the Service will resolve accounting issues that are raised on examination. The Service and Treasury Department agree that this statement does not belong in the background of the involuntary method change revenue procedure and thus have deleted it from Rev. Proc. 2002-18.

Consistent with Rev. Proc. 97-27 and Rev. Proc. 2002-9, the background section of the proposed revenue procedure provides that a change in the characterization of an item may constitute a change in method of accounting if the change has the effect of shifting income from one period to another. Some commentators objected to the inclusion of this statement, questioning whether a change in characterization of an item is properly considered a change in method of accounting and, in any event, whether such a rule belongs in the revenue procedures. Consistent with the purpose of these documents to provide procedural, rather than substantive, rules governing changes in method of accounting, the Service and the Treasury Department have not included section 2.01(3) of Notice 98-31 in Rev. Proc. 2002-18. Further, similar paragraphs have been removed from Rev. Proc. 97-27 and Rev. Proc. 2002-9 by Rev. Proc. 2002-

19. The Service and Treasury Department are considering issuing separate guidance to address the issue of characterization in the context of a guidance project regarding the definition of a change in method of accounting.

The Service and Treasury Department were considering including guidance regarding the effect of closed years following the year of change (closed intervening years) in the final revenue procedure. In response to a specific request to opine as to the effect of closed intervening years, commentators suggested that substantive guidance addressing this issue should not be set forth in the final revenue procedure. Upon further consideration, the Service and Treasury Department agree that the resolution of this legal issue should not be set forth in Rev. Proc. 2002-18 and are considering issuing separate guidance to address this issue.

Finally, some commentators objected to the fact that, under Notice 98-31, the specified amount payable in the case of accounting method issues resolved by Appeals or counsel for the government on a time-value-of-money (TVM) basis is not treated as interest under § 163, and is not deductible under any provision of the Code. The commentators argued that this limitation was effectively punitive, and made the TVM alternative less attractive. In fact, as the sample computation contained in Notice 98-31 illustrates, the computation of the specified amount should be based on a tax-effected tax rate for taxpayers that would otherwise be entitled to a deduction if the specified amount were treated as interest under the Code. The use of a tax-effected rate effectively allows a deduction for the specified amount. A sentence is included in the final revenue

procedure to clarify the use of tax-effected rates.

The Service and Treasury Department recognize that the TVM resolution has not been widely tested in practice, and that as the Service and taxpayers gain experience with this alternative, issues may arise that will require further clarifying guidance. The Service and Treasury Department anticipate that the TVM resolution will be most attractive in situations where it would be unnecessary to perform the complex interest credit calculation upon a subsequent change in method, such as when the resolution includes all years preceding a point at which a statutorily prescribed method becomes effective, a safe harbor method becomes available and is elected, or the issue of the proper method is otherwise resolved.

RELATED GUIDANCE

In addition to the proposed revenue procedure, Notice 98-31 outlined other guidance that the Service intended to publish as part of a comprehensive, and interrelated, set of procedures for resolving accounting method issues raised on audit. First, Notice 98-31 announced that the Service intended to publish guidance making the Coordinated Examination Program (CEP) early referral process provided in Rev. Proc. 96-9, 1996-1 C.B. 575, available to non-CEP taxpayers for the resolution of accounting method issues. This guidance has been published as Rev. Proc. 99-28, 1999-2 C.B. 109. By expanding the early referral procedures to include all taxpayers with respect to accounting method issues, the Service intends to provide a mechanism for expediting the resolution of those issues, which otherwise might be delayed pending the resolution of

other (non-accounting-method) issues raised in the course of the audit.

Second, the Service announced that it intended to publish guidance that would permit taxpayers under examination who otherwise cannot request a voluntary change in method of accounting under the advance consent revenue procedure (Rev. Proc. 97-27) or the automatic consent revenue procedure (Rev. Proc. 2002-9) to do so prospectively without audit protection. That guidance is contained in Rev. Proc. 2002-19. The modification is intended to provide a means for taxpayers under examination with an accounting method issue pending, as well as taxpayers before an area appeals office or a federal court with an accounting method issue under consideration, to change their method of accounting on a going forward basis while the issue is in the process of being resolved for prior taxable years. This new procedure set forth in Rev. Proc. 2002-19 does not limit or extend the existing authority of an examining agent, appeals officer, or counsel for the government to resolve accounting method issues raised on examination.

Also in connection with finalizing Notice 98-31 and the related guidance, the Service and Treasury Department have reconsidered the appropriateness of a 4-year § 481(a) adjustment period for voluntary accounting method changes that result in a negative adjustment. The Service and Treasury Department have concluded that the objectives of prompt voluntary compliance are enhanced by reducing the § 481(a) adjustment period for such changes from 4 years to 1 year. This new 1-year § 481(a) adjustment period, reflected in Rev. Proc. 2002-19, is effective for taxable years ending on or after December 31, 2001.

Third, Notice 98-31 provided that the Service intended to publish a model closing agreement for Service-initiated accounting method changes in order to provide greater uniformity in the Service's resolution of accounting method issues. Appendices A and B of Rev. Proc. 2002-18 provide model closing agreements for use in finalizing accounting method changes imposed by the Service, and for finalizing accounting method issues resolved by the Service on a nonaccounting-method-change basis, respectively. Closing agreements are encouraged, but not required, in the case of accounting method issues resolved as accounting method changes. Closing agreements are required for accounting method issues resolved on a nonaccounting-method-change basis. In response to comments, the Service is considering whether it would be appropriate to change the existing delegation orders to authorize approval of closing agreements for accounting method change issues at lower levels.

Fourth, Notice 98-31 referred to certain other anticipated guidance projects (*i.e.*, guidance that would delegate limited discretionary authority to Examination to resolve certain accounting method issues, and guidance to expand the accelerated issue resolution procedures of Rev. Proc. 94-67, 1994-2 C.B. 800, to non-CEP taxpayers to allow these taxpayers and the Service to resolve accounting method issues for taxable years beyond the years under examination, before appeals, or before a federal court). The Service is interested in receiving comments from taxpayers and practitioners on the extent to which there is a need for this guidance.

