



Section of Taxation

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February 27, 2007

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments on Procedures for Requesting Accounting Method Changes

Dear Commissioner Everson:

Enclosed are comments addressing the procedures that apply to taxpayers who request to change a method of accounting. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

- cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
- Lewis J. Fernandez, Associate Chief Counsel (Income Tax & Accounting) Internal Revenue Service
- Eric Solomon, Assistant Secretary (Tax Policy) Department of the Treasury
- Michael Desmond, Tax Legislative Counsel, Department of the Treasury
- Donald Rocen, Deputy Chief Counsel, Internal Revenue Service
- Clarissa C. Potter, Deputy Chief Counsel (Technical), Internal Revenue Service
- Lon Smith, Associate Chief Counsel (Financial Institutions & Products)
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- Sharon Kay, Tax Specialist, Department of the Treasury
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COMMENTS ON PROCEDURES FOR REQUESTING ACCOUNTING METHOD CHANGES

These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Comments were prepared by members of the Section of Taxation's Committee on Tax Accounting. Principal responsibility was exercised by Jody Brewster. Significant contributions were made by Carol Conjura, Ellen McElroy, and Jan Skelton. The Comments were reviewed by Helen Hubbard, Council Director for the Tax Section's Committee on Tax Accounting. The Comments were further reviewed by Jack Donovan of the Tax Section's Committee on Government Submissions.

Although some of the members of the Tax Section who participated in preparing these Comments have clients who would be affected by the procedures addressed by these Comments or have advised clients on the application of such procedures, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 27, 2007

EXECUTIVE SUMMARY

Taxpayers desiring to change a method of accounting must first obtain the consent of the Internal Revenue Service (the “Service”). The Tax Section of the American Bar Association (the “Tax Section”) has a number of concerns about the current procedures that apply to taxpayers making such requests and the Service’s practice in reviewing and granting or denying such requests.

The Tax Section sets forth a proposal for revising the current accounting method change procedures to address the concerns. Under the proposal, all taxpayer requests for changes in methods of accounting would be made under the automatic consent procedures currently in effect for many requests today, except as otherwise specifically provided by the Service. The Service would retain authority to identify in published guidance specific method changes that could be made only under the advance consent procedures. Taxpayers changing a method of accounting under the automatic procedures would receive audit protection for their old method, but would not receive a ruling for their proposed method. Taxpayers who desire certainty regarding their proposed method or the application of their proposed method to certain fact patterns would be permitted to request a private letter ruling addressing those issues. In addition, taxpayers would have the option to request advance consent to make a method change under an “accelerated track” procedure.

COMMENTS

I. BACKGROUND

Section 446(e) of the Internal Revenue Code¹ requires that taxpayers desiring to change a method of accounting must obtain the consent of the Secretary. Authority to grant or deny requests to change an accounting method has been delegated to the Service. The procedures for obtaining consent to make a voluntary change of accounting method generally are set forth in Treasury regulations and revenue procedures issued by the Service. The procedures create incentives for a taxpayer using an impermissible accounting method to initiate a method change request before being contacted by the Service for examination.

Voluntary changes in methods of accounting generally are required to be made on a prospective basis, without regard to whether the change is from a permissible or impermissible method of accounting. The taxpayer making a change generally must take into account an adjustment under section 481(a) to avoid the duplication or omission of income or deductions. A voluntary accounting method change generally gives the requesting taxpayer “audit protection” for prior years and the ability to spread a section 481(a) adjustment over four years, beginning with the year of change, when the adjustment results in an increase in taxable income. These benefits provide strong incentives to taxpayers to change from impermissible accounting methods and should continue to be available to taxpayers.

The Service has provided automatic consent procedures for many accounting method changes. The criteria for qualifying for automatic consent, the terms and conditions of the automatic consent, and the procedural rules for making a method change with automatic consent are set forth in Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified.² Generally, automatic consent for an accounting method change is obtained by sending a completed, signed copy of Form 3115, *Application for Change in Accounting Method*, to the national office of the Office of Chief Counsel of the Service (“National Office”), attaching the original Form 3115 to a timely filed income tax return, and otherwise complying with the required terms and conditions. If a taxpayer’s change in accounting method is described in the automatic consent revenue procedure, the taxpayer generally must make the change under the automatic consent procedures, and the taxpayer generally may not request the accounting method change under the advance consent procedures.

If the accounting method change being requested is not governed by the automatic consent procedures, the taxpayer generally must request advance consent of the National Office to make the accounting method change. The procedures for requesting advance

¹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

² Rev. Proc. 2002-9 has been modified, clarified or amplified by numerous subsequent Service pronouncements, including Announcement 2002-17, 2002-1 C.B. 56, Rev. Proc. 2002-19, 2001-1 C.B. 696, and Rev. Proc. 2002-54, 2002-2 C.B. 432.

consent generally are set forth in Rev. Proc. 97-27, 1997-1 C.B. 680, 1997-33 I.R.B. 18, as modified and clarified.³ The procedures for requesting advance consent to make a method change are similar to the procedures for requesting a private letter ruling (see Rev. Proc. 2007-1, 2007 I.R.B. 1). As with an automatic consent method change, an application requesting advance consent to change an accounting method is made by completing and filing a Form 3115 with the National Office. A user fee generally is required in the case of a request for advance consent. The user fee for an accounting method change currently is \$2,500 (as compared to the user fee of \$10,000 for a private letter ruling).⁴ After receiving a Form 3115 requesting advance consent, the National Office generally studies the request and often asks for additional information. If the National Office reaches a favorable decision, a consent letter will be issued to the taxpayer. The consent letter issued by the National Office constitutes a “ruling” with the effect that, except in rare or unusual circumstances, if a taxpayer is subsequently required to change from its new method of accounting, the required change generally will not be applied retroactively.⁵

If a taxpayer desiring to make an accounting method change is under examination, special rules and limitations apply. Generally, a taxpayer under examination may not file a Form 3115 unless one of the following exceptions applies: (i) the taxpayer is in one of two window periods, (ii) permission to file the Form 3115 is received from the revenue agent, (iii) the issue is “pending” (*i.e.*, the Service has given the taxpayer written notification indicating that an adjustment is being made or will be proposed with respect to the taxpayer’s method of accounting) in which case, any change is made without audit protection, or (iv) the accounting method was first used in a year that is subsequent to the years under examination. Special rules also apply if a taxpayer’s method of accounting for an item is an issue under consideration for the taxable years, before an appeals office, or before a federal court.

II. CONCERNS WITH CURRENT PROCEDURES FOR REQUESTING METHOD CHANGES

The Tax Section has several concerns with the current procedures for requesting an accounting method change, most notably the following:

- **Significant Delays in Processing of Requests For Advance Consent –**

The National Office generally has a significant backlog of advance consent requests, which causes the processing of the requests to take many months, and in some cases, years. Taxpayers have experienced the following:

³ Rev. Proc. 97-27 has been modified, clarified or amplified by numerous subsequent Service pronouncements, including Rev. Proc. 2002-19, 2002-13 I.R.B. 69, and Rev. Proc. 2002-54, 2002-2 C.B. 432.

⁴ Rev. Proc. 2007-1, 2007-1 I.R.B. 1, Appendix A.

⁵ Rev. Proc. 97-27, § 10.02.

- A taxpayer does not have consent to make the request at the time the taxpayer files its return for the year of change notwithstanding having made the request as early as possible (taxpayers are often required to amend their returns);
- A taxpayer's request to change from a method has been granted before a taxpayer's earlier request to change to that same method;
- An examination of the year of change has closed prior to receiving consent to make the change; and
- The statute of limitations for the requested year of change has closed prior to receiving consent to make the change.

• **National Office's Extensive Review Anticipating How the Taxpayer May Apply the Proposed Method** – Although the delays in processing of requests for advance consent method changes appear to be caused by a number of factors, the principle factor appears to be that, in the case of many requests for advance consent, the National Office often goes far beyond determining that the proposed method of accounting is a permissible method of accounting. It is our experience that proposed methods described in Forms 3115 generally are not controversial, and that controversies between taxpayers and the Service typically arise, if at all, out of a taxpayer's detailed application of its new method to the taxpayer's specific facts. In the case of many requests for advance consent, the National Office spends considerable time examining how the taxpayer anticipates it will apply its proposed method to different fact patterns. We believe that the fact that a consent letter issued by the National Office constitutes a "ruling" and might be viewed by some as the National Office's express approval of the taxpayer's application of the method is the primary reason why the National Office understandably spends so much time and effort trying to anticipate how the proposed method will be applied. We also believe it is an inefficient use of the National Office's resources to spend time anticipating how the taxpayer will apply the new method. The task of determining whether the taxpayer's detailed application of the new method to the taxpayer's specific facts is permissible should be left to the examination function, in the same way that revenue agents determine whether factual representations made by a taxpayer are accurate and that the taxpayer correctly computed its section 481(a) adjustment.

• **Notwithstanding the National Office's Extensive Review, Consent Letters Generally Do Not Address Details of the Proposed Method or Application of the Method to Different Fact Patterns** – After considerable time and effort spent by the National Office examining details of the proposed method and the taxpayer's anticipated application of the proposed method, the consent letters ultimately issued rarely include any discussion of the details or the facts to which the method is anticipated to apply. This generally is true even in cases in which taxpayers have specifically requested assurance as to the National Office's understanding of the details or the application of the proposed method to described fact patterns. With increasing frequency, the National Office is issuing generic consent letters (*i.e.*, letters granting consent to change to the proposed method but specifically including a caveat that the

National Office is not ruling on whether the proposed method or the taxpayer's application of the proposed method is permissible).

- **Inconsistency In Processing Requests For Advance Consent** – The National Office often is inconsistent in its approach to processing requests for advance consent – with regard to both the amount of time spent in processing the requests and the amount and specificity of the factual analysis undertaken. This inconsistency in approach has caused confusion and frustration among taxpayers, with the result that many taxpayers simply prefer to avoid the advance consent procedures altogether.

- **Difficulty in Determining Whether a Method Change Requires Advance Consent or Automatic Consent** – The automatic consent procedures are the “exclusive” procedures for making an accounting method change for any change described in those procedures. The two track system of automatic consent and advance consent method changes puts pressure on taxpayers to determine correctly whether their change is required to be made under the automatic consent procedures or instead under the advance consent procedures. This determination can be difficult because the rules for automatic consent changes are lengthy, not contained in a single document, and the requirements for different changes are inconsistent. Some revenue agents, after determining that some aspect of an old method is impermissible, have taken the position that the taxpayer was not eligible to make a method change under the automatic consent procedures because the old method was not exactly the method described in the automatic consent procedures. The rationale provided by agents is that, before such a taxpayer could make the method change under the automatic consent procedures, the taxpayer first would have to correct the impermissible aspect of the old method under the advance consent procedures. This exposes taxpayers to an examination adjustment notwithstanding the taxpayer's affirmative attempt to correct an arguably impermissible method of accounting. The uncertainty of whether a method change is required to be made under the automatic consent or the advance consent procedures has caused some taxpayers to file advance consent requests in an attempt to get some assurance that their method change will not be challenged later as not qualifying under the automatic consent procedures.

- **Disregard by Revenue Agents of Consent Letters Issued by the National Office** – Even in cases in which taxpayers have consent letters issued in response to method change requests made under the advance consent procedures, revenue agents have challenged the taxpayer's ability to use the new method on a variety of grounds and conditions that were neither contemplated nor enumerated in the consent letter. In some cases, revenue agents who have disagreed with the taxpayer's application of its new method to particular facts have attempted to disallow the new method in its entirety on the basis that the consent letter does not specifically address these facts or that the taxpayer did not disclose to the National Office when seeking advance consent material facts regarding application of the new method in a particular way.

- **Disallowance of Use of New Method (Rather than Adjustments to Perceived Deficiencies of the New Method)** – In an increasing number of both automatic and advance consent cases, a revenue agent that challenges some aspect of the application of a taxpayer’s new method of accounting will disallow the entire new method on the basis that the taxpayer’s application of the new method to particular facts is impermissible and thus constitutes an impermissible method of accounting. In other words, rather than making adjustments with regard to the application of the new method to the taxpayer’s facts, in many cases, revenue agents are forcing taxpayer’s back to their old, sometimes-impermissible method of accounting or to another permissible method of accounting selected by the agent.

III. PROPOSAL FOR REVISING PROCEDURES FOR REQUESTING METHOD CHANGES

The Tax Section proposes the following:

- **All changes in methods of accounting made by taxpayers would be made under the automatic consent procedures unless (i) the Service has specifically provided in published guidance that the change can only be made under the advance consent procedures or (ii) the taxpayer chooses to request advance consent to make the change.**
- **The automatic consent procedures would not provide a “ruling” as to the proposed method. If the proposed method described in the taxpayer’s Form 3115 is a permissible method, a revenue agent would be permitted to make adjustments to properly apply that permissible method to the taxpayer’s facts, but the agent would not be permitted to require that the taxpayer change back to the old method or to a different method selected by the agent.**
- **A taxpayer desiring advance consent to make a method change or seeking certainty as to the permissibility of its proposed method would be permitted to request advance consent under an “accelerated track” advance consent procedure. Under this procedure, the taxpayer would be required to describe the proposed method, but would not be required to provide detailed information regarding the application of the proposed method to specific facts or provide computational examples. Under this procedure, the National Office would issue a consent letter enabling the taxpayer to change to the proposed method of accounting. A revenue agent would be permitted to make adjustments to properly apply the new method described in the consent agreement to the taxpayer’s facts. The agent would not be permitted to require that the taxpayer change back to the old method or to a different method selected by the agent unless the National Office, in the context of a request for technical advice, determines that the taxpayer’s new method was not a permissible method, in which case the provisions of section 7805(b) would determine the timing of a change from the new method.**

- **A taxpayer seeking certainty as to the permissibility of the proposed method and the proper application of the proposed method to particular facts would be permitted to request a private letter ruling from the National Office addressing those issues. The taxpayer would be afforded all protections typically afforded taxpayers who receive a private letter ruling.**
- **Thus, a taxpayer that changes a method of accounting in accordance with any of the method change procedures would get audit protection for the old method.**

The effect of the Tax Section's proposal would be to reverse the current presumption that the advance consent procedures apply unless otherwise provided. Given that proposed accounting methods described in Forms 3115 generally are not controversial, we believe that, if the National Office's focus is on the permissibility of the proposed method (rather than the detailed application of the proposed method), most or all method change requests could appropriately be made through the automatic consent procedures.

Under the Tax Section's proposal, the different method change procedures would not be mutually exclusive. For example, a taxpayer could make a method change under the automatic consent procedures, and at the same time, request a private letter ruling addressing the permissibility of the proposed method and its proper application to particular fact patterns. We suggest that a taxpayer who desires both advance consent and a private letter ruling be permitted to file the Form 3115 as part of the private letter ruling request and, in addition to ruling as to the permissibility of the proposed method and the application of that method to particular facts, the private letter ruling also would expressly consent to the taxpayer's change to the proposed method.

The Tax Section's proposal would provide substantial benefits to taxpayers.

- First, to the extent accounting method changes could be made under the automatic consent procedures, taxpayers would be able to implement the changes in a timely manner without having to pay a fee or await action by the National Office.
- Second, if all or almost all method changes could be made under the same consent procedures, taxpayers would not be faced with the possibility of adverse consequences as a result of making an incorrect choice regarding which procedures properly apply.
- Third, a taxpayer desiring certainty regarding the permissibility of its proposed method of accounting could request advance consent to use the proposed method.
- Fourth, a taxpayer desiring certainty regarding the permissibility of its proposed method and the application of the proposed method to particular facts could request a private letter ruling from the National Office addressing those issues and expressly consenting to the taxpayer's use of the method.

The Tax Section's proposal also would provide the Service with substantial benefits and, at the same time, protect the Service's interests in a number of ways.

- First, under the proposal, the Service would retain authority to identify specific method changes that could only be made under the advance consent procedures. For example, the Service could choose to exercise that authority to require use of the advance consent procedures to change a method of accounting for an item if the taxpayer previously had changed its method of accounting for the same item within a specified number of years. The Service also could choose to exercise that authority to require use of the advance consent procedures to make certain method changes that are of concern to the National Office.
- Second, the Forms 3115 would continue to provide disclosure to both the National Office and the taxpayer's examination team of the fact that the taxpayer is making or has made an accounting method change.
- Third, the National Office could review the Forms 3115, consistent with the National Office's current practice of reviewing Forms 3115 filed under the existing automatic consent procedures, and could follow up with taxpayers and even deny the changes where warranted or refer the issue to the taxpayer's examination team.
- Fourth, revenue agents could examine whether the new method and the taxpayer's application of the new method were permissible.
- Fifth, if the taxpayer's new method is subsequently determined to be impermissible, the Service would be able to require a change to a permissible method.
- Sixth, if the taxpayer's application of the new method is subsequently determined to be flawed, the Service would be able to impose audit adjustments.
- Seventh, the Service would retain the ability to reinstitute the advance consent procedures if experience demonstrates that making all or most method changes under the automatic consent procedures results in significant issues.
- Finally, the Tax Section's proposal will leave the National Office with time to devote to providing more guidance of general applicability to taxpayers and examining agents regarding accounting methods and their application to particular facts.

IV. CONCLUSION

We believe that our proposal strikes an appropriate balance between the need for taxpayers to obtain the consent of the Service to make an accounting method change and the need for administrable procedures. The proposal addresses many of the concerns with the accounting method change procedures that exist today. Finally, the proposal provides taxpayers with a number of procedural choices impacting timing, cost and desired certainty, while at the same, benefiting the Service and protecting the Service's interests.