New IRS rules encourage taxpayers using impermissible accounting methods to change sooner rather than later.

Revised Procedures for Changing Accounting Methods

By Linda Burilovich and Gary B. McCombs

What is a change in accounting method? What approvals are necessary? How are the adjustments resulting from the change treated? When should a taxpayer change a method of accounting? These and other questions are discussed as a result of new IRS rules.

The IRS, in Rev. Proc. 92-20, issued a new set of rules for changing accounting methods, replacing previous guidelines in Rev. Proc. 84-74. The purpose of the new rules is to encourage changes from impermissible accounting methods to those allowed by the IRC, regulations, and Supreme Court decisions. In reporting taxable income, no single method of accounting is required of all taxpayers. IRC Sec. 446 requires accounting methods to clearly reflect income and be used consistently. The principle of clearly reflecting income is an issue often decided upon examination of the tax return. Consistent application of a specified set of accounting principles, however, is more objectively determined. Any deviation from the method of accounting regularly used to compute taxable income may require the consent of the IRS Commissioner.

While the IRC does not offer a specific definition of a change in accounting method, the regulations note it "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 such overall plan." Treasury Reg. 1.446-1 includes the following as changes in accounting methods: a switch from cash receipts and disbursements method to an accrual method, or vice versa, a change in the method or basis used in valuing inventories, a switch from cash or accrual method to a long-term contract method, or vice versa, adoption, use or discontinuance of any specified method of computing taxable income, such as the crop method, and changes for which the IRC and regulations require the consent of the commissioner before the adoption of such change. Changes in accounting methods do not include corrections for mathematical or posting errors, computational mistakes, and non-timing adjustments, such as the correction of items deducted as business expenses that are really dividends and personal expenses. In addition, a change in the method of accounting does not include adjustments to an addition to a reserve for bad debts or to the useful life or basis of an asset. Once an item has been reported under a specific accounting method, a pattern is established. Any change in treatment of such an item requires notification and permission from the IRS. A taxpayer wishing to request consent for a change in method must file a Form 3115 within 180 days of the beginning

EXHIBIT 1
ILLUSTRATION OF RETROACTIVE VS. PROSPECTIVE APPROACH

A corporation is required to change from a Designated A method in 19X0. The change results in a positive Sec. 481(a) adjustment of $45,000. Without this adjustment, 19X0 taxable income is $5,000. The proper adjustment was not made on the corporation's 19X0 tax return and it must now choose between two options available in 19X1.

Retroactive Approach: File an amended 19X0 tax return.

Tax per 19X0 return	$ 750
Increase in tax per amended return with Sec. 481(a) adjustment	6,750
Total tax per amendment	7,500
Less: Tax paid	750
Underpayment	6,750
19X0 interest rate applied to deficiencies	X .08
Interest amount	$ 540

Prospective Approach: File a Form 3115.

Tax per 19X0 return	$ 750
Hypothetical Sec. 481(a) adjustment (taxed at 34%)	15,300
Total tax per adjustment	16,050
Less: Tax paid	750
Hypothetical underpayment	15,300
19X0 interest rate applied to deficiencies	X .08
Interest amount	$ 1,224

of the tax year in which the change will first apply. The form requires complete information regarding the old and new method as well as the adjustment to taxable income that results from the change. The request for consent must be filed regardless of whether the change is made from a prohibited method or a permissible method. A user fee is required with the submission of the request. For most taxpayers (other than employee plans and exempt organizations) the current fee is $500.

Sec. 481(a) requires adjustments necessary to prevent duplications or omissions of income or deductions when a new accounting method is applied. The adjustment may be positive (increase in taxable income) or negative (decrease in taxable income). For example, a calendar-year taxpayer currently using lower of cost or market to value inventories wishes to change to cost for the year 1993. If inventory is valued at $365,000 under lower of cost or market on December 31, 1992, and $410,000 at cost on January 1, 1993, the Sec. 481(a) adjustment is a positive $45,000. This means the taxpayer must include $45,000 in taxable income in 1993 or over a specified adjustment period.

Categories of Methods

There are four classifications (two categories and two designations) of accounting methods and specific guidelines are provided regarding the appropriate time period for spreading the Sec. 481(a) adjustment within each classification.

- ***Category A*** includes methods specifically not permitted by the code, regulations, and decisions of the U.S. Supreme Court. Examples of Category A methods would include the use of direct costing in valuing manufacturing inventories or the use of the cash method of accounting for sales and purchases when inventory is a material factor.
- ***Category B*** methods include all methods not included in Category A.
- ***Designated A*** methods are Category A methods identified as such by publication in an *Internal Revenue Bulletin*. Taxpayers are required to change from a Designated A method to a permissible method. The designating document may proscribe specific terms. As of this date, no Designated A methods have been published.
- ***Designated B*** methods are defined as Category B methods published in the Internal Revenue Bulletin as Designated B methods. There have been several of these methods identified as Designated B since 1981. Each classification is subject to a unique set of rules affecting the recognition of the Sec. 481(a) adjustment.

Examination Status

The examination status of the taxpayer will affect the options available for making changes. Those not under examination may file a request for change within 180 days of the beginning of the year of change. Under certain conditions, extensions may be granted for consents filed after 180 days but within the first nine months of the year of change.

In general, taxpayers under examination may not file requests for changes in accounting methods without the consent of the District Director. A taxpayer is considered under examination once contact has been made by the IRS to schedule an audit. Upon receipt of this notice, a 90-day window exists in which a request for change may be filed without first obtaining the approval of the District Director. The 90-day window ends earlier if the IRS obtains the taxpayer's agreement to proposed audit adjustments. This 90-day period is not available if the taxpayer is already under examination for another year or if the request is for a change from a Designated A method. A taxpayer will obtain less favorable terms if the Designated A method is changed under examination. This poses an incentive for making a timely change from impermissible methods.

A taxpayer has a 120-day window following the date an examination is completed even though a subsequent examination has begun. The 120-day window is not available when—

a. The method change is included as an item of adjustment in the closed examination.

b. The method change is an issue which the IRS has placed in suspense.

c. The taxpayer has received notice that the method is specifically cited as an issue under examination in a subsequent taxable year.

The first 30 days of any taxable year is available as a window to taxpayers who have been under examination for at least 18 consecutive months and have not received written notice from the examiner that the method to be changed is an examination issue under consideration.

Taxpayers filing for change within any of these window periods must provide a copy of the Form 3115 to the District Director. If the date of request does not fall within the windows described it will be necessary to obtain

Illustration by Steve Björkman

EXHIBIT 2
TIME PERIOD FOR SPREAD OF SEC. 481(A) ADJUSTMENT

Category of Method	Examination Status	Sec. 481 Adjustment	Adjustment Period
A	Not Under Examination 90-day window 120-day window 120-day window 30-day window	Positive	Maximum of 3 years
		Negative	1 year (year of change)
B	Not under examination 120-day window 30-day window	Positive	Maximum of 6 years
		Negative	Maximum of 6 years
B	90-day window	Positive	1 year (year of change)
		Negative	Maximum of 3 years
Designated A	Not under examination and retroactive approach or prospective approach	Positive	1 year (year of change)
		Negative	Maximum of 3 years
Designated A	Under examination No windows available	Positive	IRS determines adjustment by examination
		Negative	
Designated B	Not under examination 90-day window 120-day window	Positive	Maximum 6 years
		Negative	Maximum 6 years

the consent of the District Director. If there is no objection, the procedures followed will be the same as taxpayers not under examination.

Special Rules for Designated A Methods

Taxpayers not under examination should make a timely change from a Designated A method to obtain better terms than will be available upon examination. Once a notice of examination is given, adjustments and terms for changing from a Designated A method will be determined by the IRS. Those who do not make a timely request to change from an improper method will have two choices, file an amended return implementing the method retroactively, or file a Form 3115 to make a prospective change and pay an interest payment on the time value benefit of making the change prospectively rather than retroactively.

The retroactive approach requires an amended return to be filed for the first year the change from a Designated A method is required or the earliest open year; no further consent is necessary. Any positive Sec. 481(a) adjustment is made in the year of change and negative adjustments are spread over three years.

The prospective approach requires filing a Form 3115. Any positive Sec. 481(a) adjustment is made in the year of change and negative adjustments are subject to a three year spread. Taxpayers selecting the prospective option, however, must pay an additional amount that approximates the economic benefit of delaying the change. This benefit is based on the interest rate (set forth in Sec. 6621(a)) applicable to underpayments for the year immediately preceding the year of change. For each open tax year prior to the year of change the taxpayer must calculate the effect of the Sec. 481(a) adjustment "as if" it had been made in the earliest open year. A hypothetical underpayment is obtained by applying the highest marginal tax rate applicable to the taxpayer (e.g. 34% in 1992 for corporations) to the difference in taxable income which would have resulted if the Sec. 481(a) adjustment had been made in the appropriate year. The interest on this hypothetical underpayment is the additional amount. If this amount is negative (i.e. provides an economic benefit to the government) it is treated as zero. The taxpayer must pay any positive additional amount. The additional amount is intended to place the taxpayer in the same position "as if" an amended return had been filed. This provision is meant to eliminate any incentive for delaying the switch from an improper method of accounting to obtain economic benefit. It suggests the need for caution on the part of taxpayers in the lower tax brackets. Consider the example of a corporate taxpayer in the lowest marginal tax bracket. *Exhibit 1* illustrates the additional tax cost which will be incurred if the prospective approach is selected.

The $684 difference in cost for the two approaches occurs because the taxpayer is required to apply the maximum applicable tax rate to the adjustment when calculating the hypothetical underpayment rather than using the normal marginal rate used when filing an amended return.

Special rules also apply to Designated B methods. If the taxpayer changes within two years of the designation, the change is treated as a change from Category B methods. However, if the change is made beyond this two year period the change is treated as a change from a Category A method.

Sec. 481(a) Adjustment Spread

One of the incentives employed to encourage change from erroneous methods is the time period permitted for the spread of the Sec. 481(a) adjustment. Allowable spreads vary from one to six years depending on the category of the method, the examination status of the taxpayer, the type of Sec. 481(a) adjustment (positive or negative), and the terms set forth by the Commissioner in the agreement. *Exhibit 2* provides the standard terms set forth in Rev. Proc. 92-20 for taxpayers not under examination and those under examination who file within the acceptable window periods.

Expeditious Procedures

Under certain conditions, some taxpayers may presume to have IRS consent to proposed changes. These procedures are not available to taxpayers under examination. Rev. Proc. 92-74 allows expeditious procedures for a switch from the hybrid method to overall accrual method if inventories are a factor in measuring income and for a change from the cash method to the overall accrual method when inventories are not a factor in measuring income.

Under the expeditious procedure rules, a taxpayer may presume the Commissioner's consent to the change. A Form 3115 must still be filed within the first 270 days of the tax year of change. No user fee is required in these situations.

Automatic Changes

Some accounting method changes are mandated by law and do not require consent from the IRS. A required change from cash to accrual method of accounting is an automatic change. If made on a timely filed return (including extensions) of the first affected year, the taxpayer will file Form 3115 with the return that contains the change. If the change is not made in a timely fashion, IRS approval must be obtained under usual procedures.

The application of uniform capitalization rules to inventory also falls under the automatic change rules. If applied in the first year the taxpayer is subject to the uniform capitalization rules, the change is automatic and no IRS approval is required. If the change is not made in the appropriate year, the usual procedure for requesting consent must be followed.

The time period for spreading the Sec. 481(a) adjustment differs under the automatic change procedures. *Exhibit 3* contains a summary of the rules for recognizing the adjustment. Special rules for recognizing the adjustment for application of uniform capitalization rules are contained in Treasury Reg. 1.263A-1T(e)(1). Opportunities for accelerating the adjustment are discussed in Treasury Reg. 1.263A-1T(e)(4).

EXHIBIT 3
TIME PERIOD FOR SPREAD OF SEC. 481(A) ADJUSTMENT UNDER AUTOMATIC CHANGE PROCEDURES

AUTOMATIC CHANGE	SEC. 481(A) ADJUSTMENT	ADJUSTMENT PERIOD
Change for cash to accrual method	Positive Negative	Lessor of: 1) Number of tax years cash method was used 2) Four tax years (10 for a hospital)
Application of Sec. 263A to inventories	Positive Negative	Lesser of : 1) Number of tax years taxpayer has produced property held as inventory 2) Four tax years
Application of Sec. 263A to inventories where 75% or more of the adjustment is for 1st, 2nd, or 3rd preceding tax year period.	Positive Negative	Highest percent attributable to the 1st, 2nd, or 3rd preceding tax year period is taken into account ratably over three years. The remainder is included in the fourth tax year.

Agreements

When sufficient information regarding the proposed change is provided, an agreement must be reached with the Commissioner regarding the terms, conditions and adjustments under which the change will be effected. The IRS provides its consent to change for a particular year in a letter ruling from the national office. If there is agreement to the terms and conditions contained in the ruling, the taxpayer must sign the Consent Agreement and return it within 45 days. At the time of filing Form 3115, the taxpayer should indicate a request for a conference in the event of an unfavorable response. If this is not indicated at the time of filing, it is assumed the taxpayer does not wish to have a conference.

Sec. 481 and regulations thereunder provide guidelines regarding special adjustments required by various types of changes. Notwithstanding the guidelines discussed here, the IRS has reserved the right to impose differing terms, conditions, and procedures for considering accounting changes which might prohibit sound tax administration. For example, the situation in which a positive Sec. 481(a) adjustment is generated for the specific purpose of offsetting an expiring net operating loss carryforward may not receive treatment under the general rules provided in the table. Thus taxpayers filing for a consent under conditions that might be interpreted as tax avoidance, should be prepared for compromise in obtaining the Commissioner's consent.

The implication of the new guidelines are particularly important for those taxpayers practicing impermissible accounting methods classified as Designated A. The rules encourage timely changes from such methods and impose penalties at the time of change for both taxpayers under examination and those who are not. Tax practitioners are well advised to familiarize themselves with the options available under such circumstances. ❑

***Linda Burilovich, PhD, CPA**, and **Gary B. McCombs, MBA, CPA**, are Assistant Professors at Eastern Michigan University.*