

Tax Accounting

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This month's column is the second installment of a two-part discussion of the new guidance package released in May concerning the adoption and change of accounting periods (taxable years). Last month's column discussed changes affecting the taxable years particular types of taxpayers can use and the regulatory "business purpose" standard. This month's column discusses the provisions of the new automatic consent procedures (Revenue Procedures 2002-37 and 2002-38) and the general procedure governing discretionary changes (Revenue Procedure 2002-39). Proposed changes that fall within the scope of one of the automatic consent procedures must be made under that procedure.¹ In such cases, the "application" is really a notification procedure. If the proposed change is not eligible for automatic consent, then the taxpayer must apply for discretionary consent under Revenue Procedure 2002-39.

The discussion that follows first addresses the scope of each procedure and then the general terms and conditions prescribed for making a change and the mechanics of application.

Revenue Procedure 2002-37

Revenue Procedure 2002-37 combines and updates the long-standing automatic consent "safe harbor" in the regulations under section 442 and the separate procedures in Revenue Procedure 2000-11. Revenue Procedure 2002-37 generally applies to corporations, except for subchapter S corporations and personal service corporations (which are covered by Revenue Procedure 2002-38).² Presumably, Revenue Procedure 2002-37 also excludes corporations that are presently C corporations but are electing subchapter S status for the "short period" caused by the change, since these are also covered by Revenue Procedure 2002-38.³

Corporations that propose to elect subchapter S status for the taxable year *following* the short period may use Revenue Procedure 2002-37, but only to change to a year that would be permitted to a subchapter S corporation.⁴ Similarly, foreign corporations

subject to section 898, which limits the taxable years of "controlled foreign corporations" (CFCs) and "foreign personal holding companies" (FPHCs), may use Revenue Procedure 2002-37, but only to change to the taxable year required by section 898, or to or from a "52-53 week" year referencing the same month-end.⁵

Revenue Procedure 2002-37 is not available to most tax-exempt organizations, which are covered by another automatic consent procedure,⁶ or for most changes by certain specialized types of corporations such as foreign sales corporations (FSCs), interest charge domestic international sales corporations (IC-DISCs), possessions corporations,⁷ cooperatives,⁸ and miscellaneous entities subject to statutory restrictions on taxable years.⁹ Such entities must generally follow the procedures for discretionary consent.

The scope of Revenue Procedure 2002-37 is set by the interplay of its paragraphs 4.01 (entitled "applicability") and 4.02 (entitled "inapplicability"). Four general types of changes are permitted:

1. Changes by corporations generally, with exclusions in particular circumstances;
2. Changes to a natural business year, to which some of the usual exclusions do not apply;
3. Changes to and from "52-53 week" years, which are generally freely permitted except for certain specialized taxpayers; and
4. Changes by controlled foreign corporations and foreign personal holding companies that want to revoke their "one-month deferral" elections and adopt the year ordinarily required under section 898.

General Corporate Changes

Corporations (apart from subchapter S corporations, personal service corporations, and certain specialized entities) are generally granted automatic consent to change taxable years, subject to two basic limitations:

1. *Previous Changes in Taxable Years.* A taxpayer is not entitled to automatic consent if it has changed taxable years within the preceding four years, disregarding (i) changes to adopt a "required taxable year" or an "ownership taxable year"; (ii) changes to conform to the consolidated group rules; and (iii) changes to and from "52-53 week" years. However, a corporation that was recently acquired, or whose majority shareholder's taxable

year recently changed, may conform to its shareholder's year so as to file consolidated financial statements, regardless of previous changes.¹⁰

2. *Interests in Passthrough Entities.* A taxpayer may also not use the "automatic consent" procedure if it owns an interest in passthrough entities, unless (i) the passthrough entities are also changing taxable years; (ii) the taxable year that the taxpayer proposes to adopt would result in no more deferral than its present taxable year; or (iii) the taxpayer's holdings are *de minimis*. Similar rules apply to taxpayers that own interests in FSCs or IC-DISCs.¹¹

Changes to Natural Business Years

Taxpayers can use Revenue Procedure 2002-37 to adopt a "natural business year" regardless of the usual restrictions on taxpayers holding interests in passthrough entities, FSCs, or IC-DISCs. However, for this purpose the year to which the taxpayer proposes to change must qualify as a "natural business year" under the objective "25 percent test" and the taxpayer must have the necessary 47 months of results to apply that test. Taxpayers seeking to change to one of the other types of "natural business years"¹² must apply for discretionary consent under Revenue Procedure 2002-39 if they do not qualify for automatic consent under the general rules for corporate changes outlined above.

"52-53 Week" Years

Taxpayers can use Revenue Procedure 2002-37 to change between a calendar and fiscal year and a "52-53 week" year referencing the same month-end, regardless of the usual exclusions for taxpayers that have recently changed periods or own interests in passthrough entities, FSCs, or IC-DISCs. These types of changes can also be made without regard to the usual restrictions applicable to corporations that plan to elect S status after the short period, controlled foreign corporations and foreign personal holding companies, and cooperatives.

Revoking Elections Under Section 898

Section 898 generally requires CFCs and FPHCs to use the "majority U.S. shareholder year," if there is one, or else the year that produces "least aggregate deferral" to its U.S. owners, determined under principles similar to the rules governing partnerships.¹³ CFCs (but not FPHCs, unless they are also CFCs) may elect to adopt a taxable year one month earlier than the "majority U.S. shareholder year."

CFCs and FPHCs can generally use Revenue Procedure 2002-37 — subject to the normal exclusions — to adopt the taxable year required under section 898. This might happen, for example, when the corporation first became subject to section 898, or upon a change in its owners (or their taxable years).

However, in the specific situation where the corporation is revoking a previous "one-month deferral" election, the procedure grants automatic consent without regard to the usual exclusions.

Impact of Changes

The old regulatory "safe harbor" was hard to meet, because it required the taxpayer to have gone *ten* years without *any* change in taxable year, including minor changes that would be ignored under the new rules, such as changes to or from "52-53 week" years or to conform taxable years within a consolidated group. However, taxpayers that qualified under the "safe harbor" could obtain a "fresh start" without meeting some of the conditions imposed by Revenue Procedure 2000-11. This flexibility no longer exists. If a corporate taxpayer has substantial interests in passthrough entities, for example, there is a good chance that it will wind up having to request discretionary consent under Revenue Procedure 2002-39.

Revenue Procedure 2002-38

The other automatic consent procedure included in the new guidance package is Revenue Procedure 2002-38, which generally applies to partnerships, subchapter S corporations, "electing S corporations" (corporations that newly elect S status for the short period following the change), and personal service corporations (PSCs). What all these entities have in common is that, as discussed in last month's column, they are required to use a statutorily specified default year ("required taxable year") unless they can establish a business purpose for using another year.¹⁴ Like all taxpayers, they are also subject to section 442's general requirement that a taxpayer demonstrate a business purpose for any change in taxable periods.

The interplay between these two sets of rules means that taxpayers have to apply for IRS permission (and demonstrate "business purpose") in three basic situations:

1. When initially adopting a taxable year other than the statutorily required taxable year or a taxable year allowed because of an election under section 444;
2. When they want to retain a taxable year that is not, or is no longer, their "required taxable year" because of a change in status or circumstances (e.g., a change in ownership);
3. When changing taxable years, even to a "required taxable year."

General Rules

Revenue Procedure 2002-38 provides generally that the taxpayer can establish a business purpose for changing to, or remaining on, a taxable year if

that year is any of the following:

- The “required taxable year” under section 441(i), 706, or 1378, as the case may be;
- An “ownership based taxable year”; or
- A “natural business year.”

An “ownership-based taxable year” is defined similarly to a “majority interest taxable year,” the first in section 706’s pecking order of default taxable years for partnerships. Revenue Procedure 2002-38’s permitting automatic changes to such years has implications in two situations:

1. In the relatively unusual case where a majority interest in a subchapter S corporation or PSC is held by taxpayers using the same fiscal year, the entity may adopt the same year.
2. Partnerships may change to conform to a new “majority interest taxable year” without waiting for expiration of section 706’s three-year waiting period.

As under Revenue Procedure 2002-37, the “natural business year” has to be determined under the “25 percent test” in order for taxpayers to be granted automatic consent. Taxpayers seeking to change to one of the other types of “natural business years” have to use Revenue Procedure 2002-39.¹⁵

Deadlines, Terms, and Conditions

General Filing Requirements

Requests for discretionary consent to changes of taxable year must be filed between the last day of the “short period” created by the change, and the unextended due date for the short-period return. A user fee is required.¹⁶ Requests for automatic consent on the usual form (Form 1128) must be filed by the extended due date for the short-period return. The deadline for requests filed on the Form 2553 (used to elect subchapter S status) is the same as for the related election. No user fee is required for automatic changes.¹⁷ The return for the short period must be timely filed and, where applicable, the taxpayer must comply with the requirement to “annualize” income in computing tax rates¹⁸ and the special rules applicable to “52-53 week” years.¹⁹

Taxpayers with Pending Proceedings

A taxpayer with a statutorily required taxable year (including a partnership, subchapter S corporation, or PSC) may not change taxable years under either the automatic consent or the general procedure if...

- The taxpayer is under examination, unless it has permission from the “appropriate director” (which is supposed to be given unless the director concludes that the taxpayer’s taxable year would “ordinarily” be the subject of an adjustment in the examination years)²⁰;

- The taxpayer is before an area office (IRS Appeals) or a federal court and its taxable year is an “issue under consideration” in that proceeding²¹; or
- In the case of a partnership or subchapter S corporation, its partner or shareholder is under examination, at Appeals, or in court, and the entity’s taxable year is an “issue under consideration” in that proceeding.²²

Taxpayers under examination have to attach the director’s consent to the application. Taxpayers before Appeals or in court have to include a statement from an “appropriate person” that to the best of the taxpayer’s knowledge, the taxpayer’s annual accounting period is not an “issue under consideration.”²³

Book Conformity

Taxpayers must generally keep books and records and prepare financial reports (except for records maintained under foreign law) on the basis of the new taxable year, unless that year is a “required year” or an “ownership taxable year.”²⁴ This represents a deliberate change from the rule under the old regulatory “safe harbor.”²⁵ Less clear, however, is why the conformity requirement under Revenue Procedure 2002-37 differs from that in the other procedures by only exempting changes to a “required year.”²⁶ This may represent an oversight, since most taxpayers eligible for Revenue Procedure 2002-37 will not have an “ownership taxable year.” However, as mentioned above, certain corporations that intend to elect S status may use that procedure to adopt an ownership taxable year,²⁷ and intentionally or not, such taxpayers would appear to be subject to a different rule.

Losses and Credits

Net operating losses, capital losses, and credits generated during the short period generally may not be carried back but must be carried forward instead. An exception permits losses to be carried back if either...

- The loss amounts to \$50,000 or less; or
- The loss is generated during a “short period” of at least nine months, and is less than the loss that would have been generated during a normal twelve-month year if the taxpayer had not changed taxable years.²⁸

Later Required Changes of Taxable Year

Entities with required taxable years (partnerships, subchapter S corporations, and PSCs) may be required to change taxable years again when the underlying facts change. The rules are a bit fuzzy around the edges.

A subchapter S corporation using an “ownership taxable year” must change again “if its ownership taxable year changes.” Taxpayers may not always have an “ownership taxable year,” and the procedures do not explain whether the quoted phrase means the corpora-

tion must change if its present year no longer qualifies as an “ownership taxable year,” or only if some other taxable year does.²⁹

Partnerships, subchapter S corporations, and PSCs that use a “natural business year” may also have to change taxable years when their natural business year changes. Variations of this rule are found in all three procedures. Revenue Procedures 2002-38 and 2002-39 both provide that a taxpayer that has adopted a “natural business year” must change again if its year no longer qualifies as a “permitted year.”³⁰ Both procedures define a “permitted year” to include the taxpayer’s “required year” and its “ownership taxable year” as well as its “natural business year.”³¹ However, as discussed above, “natural business year” is defined more narrowly in Revenue Procedure 2002-38 than in Revenue Procedure 2002-39, and it is not wholly clear whether the differences in definition were intended to

carry over to the references to “permitted years.” Moreover, the corresponding condition in Revenue Procedure 2002-37 requires “electing S corporations” (corporations that plan to elect S status after the “short period”) that adopt a natural business year to change when “that annual accounting period no longer qualifies as a *natural business year*.”³² This may represent another oversight.

Protection from IRS-Imposed Changes

If a taxpayer has properly changed taxable years in compliance with all terms and conditions, the IRS will not disturb its previous use of another taxable year unless the National Office revokes its consent because of the omission or misstatement of a material fact, and later changes will generally be imposed only prospectively except as they may reflect a change in the law or the underlying facts.³³

1. See Rev. Proc. 2002-39, § 3.02(1), 2002-22 I.R.B. 1046, 1049.

2. Rev. Proc. 2002-37, § 4, 2002-22 I.R.B. 1030, 1032-34.

3. See Rev. Proc. 2002-38, §§ 4.01, 5.02, 2002-22 I.R.B. 1037, 1040-41.

4. Rev. Proc. 2002-37, § 4.02(6), 2002-22 I.R.B. 1030, 1033.

5. *Id.*, § 4.02(8), 2002-22 I.R.B. 1030, 1033.

6. See Rev. Proc. 85-58, 1985-2 C.B. 740.

7. See I.R.C. § 936.

8. See I.R.C. § 1381 *et seq.*

9. Rev. Proc. 2002-37, § 4.02(4), (9)-(12), 2002-22 I.R.B. 1030, 1033-34.

10. *Id.*, § 4.02(1), 2002-22 I.R.B. 1030, 1032.

11. *Id.*, § 4.02(2), 2002-22 I.R.B. 1030, 1033.

12. See Rev. Proc. 2002-39, § 5.03, 2002-22 I.R.B. 1046, 1051.

13. I.R.C. § 898(c); Prop. Reg. § 1.898-3, INTL-0848-89 (Jan. 5, 1993). Certain administrative exceptions exist. See Notice 95-13, 1995-1 C.B. 296.

14. I.R.C. §§ 441(i), 706(b), 1378.

15. Rev. Proc. 2002-38, § 5.05, 2002-22 I.R.B. 1037, 1041-42.

16. Rev. Proc. 2002-39, § 6.02, 2002-22 I.R.B. 1046, 1055-56.

17. Rev. Proc. 2002-37, § 7.02, 2002-22 I.R.B. 1030, 1036; Rev. Proc. 2002-38, § 7.02, 2002-22 I.R.B. 1037, 1044.

18. See I.R.C. § 443(b).

19. See Reg. § 1.441-2.

20. Rev. Proc. 2002-38, §§ 4.02(1), 7.03(1), 2002-22 I.R.B. 1037, 1041, 1044; Rev. Proc. 2002-39, §§ 3.02(2), 6.06(1), 2002-22 I.R.B. 1046, 1049, 1056.

21. Rev. Proc. 2002-38, § 4.02(2)-(3), 2002-22 I.R.B. 1037, 1041; Rev. Proc. 2002-39, § 3.02(3)-(4), 2002-22 I.R.B. 1046, 1049.

22. Rev. Proc. 2002-38, § 4.02(4), 2002-22 I.R.B. 1037, 1041; Rev. Proc. 2002-39, § 4.02(4), 2002-22 I.R.B. 1046, 1049.

23. Rev. Proc. 2002-38, § 7.03, 2002-22 I.R.B. 1037, 1044; Rev. Proc. 2002-39, § 6.06, 2002-22 I.R.B. 1046, 1056.

24. Rev. Proc. 2002-38, § 6.04, 2002-22 I.R.B. 1037, 1043; Rev. Proc. 2002-39, § 5.04(3), 2002-39 I.R.B. 1046, 1053.

25. See T.D. 8996, “Summary of Comments and Explanation of Revisions” [Summary & Explanation] part ILC, 2002-24 I.R.B. at 1130.

26. Rev. Proc. 2002-37, § 6.04, 2002-22 I.R.B. 1030, 1035.

27. See Rev. Proc. 2002-37, §§ 4.02(6), 5.04, 6.06, 2002-22 I.R.B. 1030, 1033-35.

28. Rev. Proc. 2002-37, §§ 6.08-.09, 2002-22 I.R.B. 1030, 1035-36; Rev. Proc. 2002-38, §§ 6.08-.09, 2002-22 I.R.B. 1037, 1043; Rev. Proc. 2002-39, §§ 5.04(6)-(7), 2002-22 I.R.B. 1046, 1052-53.

29. Rev. Proc. 2002-37, § 6.06, 2002-22 I.R.B. 1030, 1035; Rev. Proc. 2002-38, § 6.06, 2002-22 I.R.B. 1037, 1043.

30. Rev. Proc. 2002-38, § 6.05, 2002-22 I.R.B. 1037, 1043; Rev. Proc. 2002-39, § 5.04(4), 2002-22 I.R.B. 1046, 1052.

31. Rev. Proc. 2002-38, § 5.04, 2002-22 I.R.B. 1037, 1041; Rev. Proc. 2002-39, § 4.05, 2002-22 I.R.B. 1046, 1049.

32. Rev. Proc. 2002-37, § 6.05, 2002-22 I.R.B. 1030, 1035.

33. Rev. Proc. 2002-38, § 8, 2002-22 I.R.B. 1037, 1044-45; Rev. Proc. 2002-39, § 8, 2002-22 I.R.B. 1046, 1057-58.