What Taxpayers Always Want to Know About Accounting Method Changes

By Stanley Barsky*

Stanley Barsky summarizes the issues that taxpayers should consider in determining whether and how to change a method of accounting.

Introduction

Taxpayers don’t always use correct tax accounting methods, and taxpayers also don’t always use the most advantageous tax accounting methods. These failures are often attributable to complexities of the tax accounting rules. When a taxpayer discovers that a particular method of accounting is erroneous and/or is not the most advantageous method of accounting, the taxpayer will inevitably ask its advisors whether it can or must change the current method and, if so, how.

Background

What Is a Method of Accounting?
The term “method of accounting” refers to the manner in which a taxpayer determines the time for including an item or items in income or the time for deducting an item or items. The term can refer to overall method of accounting of the taxpayer, e.g., the accrual method, or the treatment of an item. A taxpayer that has two or more separate and distinct trades or businesses may use a different method of accounting for each trade or business. If a method of accounting satisfies the clear reflection of income requirement, it is correct. Otherwise, it is incorrect. In some cases, more than one method of accounting for a particular item can satisfy the clear reflection of income requirement.

How Is a Method of Accounting Adopted?
A taxpayer can adopt a correct method of accounting for an item by treating the item properly in the first return that reflects the item. It is also possible for a taxpayer to adopt an incorrect method of accounting, either deliberately or inadvertently. Adoption of an incorrect method of accounting for an item by treating the item improperly usually requires the treatment of the item in the same way on two or more consecutively filed tax returns.

A taxpayer that is the acquiring corporation in a transaction to which Code Sec. 381 applies (“Code Sec. 381 transaction”) must determine its method of accounting under the Treasury regulations promulgated under Code Sec. 381.

What Is a Change in Method of Accounting?
A change in method of accounting is a change in the time for including an item or items in income or the time for deducting an item or items.
General Requirements for Changing a Method of Accounting

Taxpayers who want to change a method of accounting must comply with the requirements listed in below. If a taxpayer does not comply with some or all of the requirements, the IRS may be able to impose an involuntary change, i.e., change the taxpayer’s method of accounting to a correct method selected by the IRS.10

Consent

Taxpayers generally must secure the IRS’s consent to the change.11 This requirement applies even if the old method is incorrect.12 The procedural rules for requesting the IRS’s consent are discussed in below.

Clear Reflection of Income

The proposed method of accounting must clearly reflect income.13 “Clear reflection of income” is not a simple concept with a precise definition. A method is generally acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year and is consistent with the Code and Treasury regulations.14

No Retroactive Change

Taxpayers are generally not allowed to change a method of accounting retroactively by amending a prior tax return, even if the prior year is still open.15 However, the IRS can consent to a retroactive change if there are “unusual and compelling circumstances.”16 It has been suggested that a bankruptcy court, as a court of equity, could compel the IRS to consent to a request for a retroactive change.17

Code Sec. 481(a) Adjustment and the Cut-off Basis

When a taxpayer changes an accounting method, the taxpayer should calculate its income for the year of change on the new method as if the taxpayer had always been on the new method. This may result in duplication or omission of items.18 For example, if a taxpayer changes from the cash method to the accrual method and, at the time of the change, has an outstanding $100 account receivable, the $100 would be omitted because it hadn’t been realized under the old method at the time of change and would not be realized in the future under the new method. For this reason, a taxpayer must either take a Code Sec. 481(a) adjustment into account to prevent the omission of the item or, alternatively, effect the change on a cut-off basis.19

Code Sec. 481(a) adjustment. If a taxpayer takes a Code Sec. 481(a) adjustment into account, the adjustment amount should be equal to the amount that would be duplicated or omitted from the taxpayer’s income as a result of the accounting method change.20 If the duplication or omission of items reduces the taxpayer’s income, the Code Sec. 481(a) adjustment increases the taxpayer’s income (called a “positive” adjustment). If the duplication or omission of items increases the taxpayer’s income, the Code Sec. 481(a) adjustment reduces the taxpayer’s income (called a “negative” adjustment). For example, if the change would cause taxpayer to omit a $100 receivable from income, the Code Sec. 481(a) adjustment would be a positive $100 adjustment, i.e., an amount that the taxpayer must take into income.

Cut-off basis. If the change is effected on a cut-off basis, items arising in years prior to the year of change are taken into account under the old method, whether they are realized under the old method before or after the year of change. Once taken into account, the items are not taken into account under the new method even if they are realized in the year of change or thereafter under the new method.21 Because no amounts are duplicated or omitted when a change in method of accounting is effected on a cut-off basis, no Code Sec. 481(a) adjustment is necessary. For example, if the change from cash to accrual method would otherwise cause taxpayer to omit a $100 receivable from income, under the cut-off basis the taxpayer would account for the receivable under the old method, i.e., the cash method, and include the receivable in income when it actually (or constructively) receives the $100 even though it was earned when the taxpayer was on the cash method (old method) and received when the taxpayer was on the new method (accrual

Taxpayers don’t always use correct tax accounting methods, and taxpayers also don’t always use the most advantageous tax accounting methods.
method). This would obviate the need for a Code Sec. 481(a) adjustment because the receivable would not be omitted from the taxpayer’s income. (As a strictly legal matter, the cut-off basis may contravene Code Sec. 481. However, it is clear that the IRS does not think so. The IRS believes that even when the taxpayer is not seeking consent to a change, the IRS has the authority to compel the taxpayer to use the cut-off basis.)

Procedural Rules for Securing the IRS’s Consent

It is important for taxpayers to comply with the procedural rules for securing the IRS’s consent. While the rules are very technical, the IRS’s denial of consent can be challenged only on the ground that the denial was an abuse of discretion, which is a difficult burden for taxpayers to meet. There are two sets of procedural rules for securing the IRS’s consent, one for changes that qualify for automatic consent, and one for changes that don’t.

Automatic Consent

Certain accounting method changes qualify for automatic consent. If a taxpayer complies with the requirements for securing automatic consent, the IRS’s consent is deemed received as soon as the taxpayer files the application for consent.

General rules. A taxpayer that wants to apply for automatic consent is required to complete and file Form 3115. The taxpayer must attach its application for consent to a timely filed (including any extension) original federal income tax return for the year of change. If the proposed change qualifies for automatic consent, the taxpayer may qualify for “audit protection,” which means that the IRS will not require the taxpayer to change its method of accounting for the same item for an earlier taxable year.

Exceptions. Changes do not always qualify for automatic consent, and taxpayers do not always qualify for audit protection.

Change when taxpayer is under examination.

A taxpayer’s ability to request consent to an automatic change is limited if the taxpayer is under examination. Specifically, the taxpayer can request consent only (i) if the accounting method that the taxpayer is changing is not an “issue under consideration” in the audit, in which case the taxpayer must request the consent within certain time limits; (ii) without audit protection, if the accounting method to be changed is an “issue pending” for any tax year under examination; (iii) with the director’s consent, unless the director is of the opinion that the method of accounting to be changed would ordinarily be included as an item of adjustment in the years for which the taxpayer is under examination; or (iv) without audit protection, if the IRS guidance so provides.

Change when taxpayer is before an appeals office or federal court. A taxpayer that is before an appeals office or federal court can apply for automatic consent, but the audit protection provisions will not apply if the accounting method to be changed is an issue “under consideration” by the appeals office or federal court.

Other exceptions and special rules. A taxpayer may be prevented from changing a method of accounting for other reasons, e.g., if the taxpayer changed its method of accounting for the same item within the previous five years. A taxpayer may lose the right to audit protection, e.g., if the taxpayer fails to implement the change.

Nonautomatic Consent

The rules for changes that are not subject to automatic consent are similar to the rules for changes that are subject to automatic consent. However, a taxpayer that proposes to effect a change that is not subject to automatic consent (i) has no assurance that the IRS will grant consent, and (ii) generally must request the IRS’s consent before the end of the year of change, and must receive the consent before filing under the new method, i.e., before the due date for filing the taxpayer’s federal tax return for the year of change.

Accounting Method Changes for Partnerships

In the case of a partnership, the partnership is the taxpayer that adopts a method of accounting, and requests the IRS’s consent to any accounting method change.

The IRS’s power to change the taxpayer’s method of accounting. If a taxpayer is using an incorrect method, the IRS can change the incorrect method to a correct method. If a taxpayer is using a correct method, the IRS cannot change the correct method to another correct method that more clearly reflects income, unless the taxpayer changed to that method without the IRS’s consent. If the IRS imposes an involuntary accounting method change, the taxpayer may be subject to a taxpayer-detrimental Code Sec. 481(a) adjustment.
spread period, the IRS may impose the change for the earliest open year in which the taxpayer used the incorrect method of accounting, and the IRS may be able to select the accounting method that is least favorable to the taxpayer. In addition, the IRS may impose any otherwise applicable penalties if it changes the taxpayer’s method of accounting.

Issues That Taxpayers Should Consider When Changing a Method of Accounting

Taxpayers often have questions about their obligation to change from an incorrect method of accounting, or from a correct method of accounting to which they changed without the IRS’s consent. A taxpayer that learns that it could be obligated to change a method of accounting may be reluctant to effect the change, especially if (i) the current method of accounting is taxpayer-favorable, and/or (ii) the taxpayer is under audit and would be required to alert the IRS audit team to the proposed change.

Benefits of Changing from an Incorrect Method or from a Correct Method to Which the Taxpayer Changed Without Consent

A taxpayer that uses an incorrect method of accounting, or a correct method of accounting to which the taxpayer changed without the IRS’s consent, should consider requesting a change to a correct method before the IRS raises the issue. This may allow the taxpayer to (i) qualify for audit protection; (ii) qualify for taxpayer-favorable Code Sec. 481(a) adjustment spread period; (iii) select the most taxpayer-favorable correct method; and/or (iv) avoid penalties. The latter point could prove to be a major factor for taxpayers who are reluctant to effect the change because their audit position requires them to disclose the issue to the IRS audit team.

Obligation to Change a Method of Accounting

Obligation to Change from an Incorrect Method

Some authorities suggest that a taxpayer is not obligated to change from an incorrect method of accounting. However, a taxpayer that knowingly uses an incorrect method of accounting (regardless of whether the taxpayer knew that the method was incorrect when the taxpayer adopted or changed to that method) is more exposed to penalties than a taxpayer that uses an incorrect method unwittingly. Accordingly, if a taxpayer learns that it has been using an incorrect method, the taxpayer should seriously consider requesting consent to change from the incorrect method before deliberately filing a tax return that reflects the incorrect method.

Obligation to Change from a Correct Method to Which a Taxpayer Changed Without Consent

It is unclear whether a taxpayer is obligated to change from a correct method to which the taxpayer changed without consent. Depending on the facts, the taxpayer may be able to take the position that it can knowingly continue to use the method. However, the taxpayer’s ability to continue using the method may be jeopardized if the taxpayer deliberately changed to the method without consent, or if the change permanently reduced the taxpayer’s income, e.g., because the taxpayer did not effect the change on a cut-off basis.

Tax Advisors’ Exposure

The question of whether a taxpayer changes a method of accounting could be important to the taxpayer’s tax advisors, because they must consider their own exposure, e.g., under Code Sec. 6694.

Compliance with the requirements for changing a method of accounting. A taxpayer’s best shot at effecting the change with audit protection is to change to a method of accounting that is subject to automatic consent. Accordingly, the taxpayer should determine whether the proposed method of accounting is subject to automatic consent and, if so, whether the taxpayer can comply with the procedural requirements for securing automatic consent. If the proposed method of accounting is not subject to automatic consent, the taxpayer should (i) confirm that the proposed method of accounting is a correct method, and (ii) determine whether the taxpayer can comply with the procedural requirements for securing non-automatic consent. If the deadline for the change has passed by the time when the taxpayer discovers that it may have an obligation to effect the change, the taxpayer should determine whether it can qualify for any exceptions to the deadline, e.g., by seeking the director’s consent to request the IRS’s consent.
Is the Taxpayer Willing to Accept the Consequences of an Involuntary Change?

If a taxpayer’s current method is incorrect and is detrimental to the taxpayer, voluntarily changing to a correct method may allow the taxpayer to (i) qualify for audit protection and a taxpayer-favorable spread of any Code Sec. 481(a) adjustment, and (ii) select a correct method of accounting that is most beneficial (or least detrimental) to the taxpayer. By contrast, if the IRS were to impose an involuntary change (which it might choose not to do if the present incorrect method is detrimental to the taxpayer), the taxpayer may be subject to a taxpayer-detrimental Code Sec. 481(a) adjustment spread period, the IRS may impose the change for the earliest open year, and the IRS may select a correct accounting method that is detrimental to the taxpayer.

Certain Accounting Method Issues Arising in the Partnership Context—Potential for Inconsistent Positions

If a partner’s treatment of a partnership item on the partner’s return is inconsistent with the treatment of that item on the partnership return, the partner must notify the IRS of the inconsistency. Allocation of Code Sec. 481(a) adjustments. If a partnership changes its method of accounting, the resulting Code Sec. 481(a) adjustment, if any, is a partnership item that must be allocated among the partners. This may lead to unexpected consequences if, for example, the partners that have been allocated the item that is the subject of the accounting method change have left the partnership prior to the change. As a practical matter, the best time to prepare for the effects of a potential Code Sec. 481(a) adjustment is the time of the acquisition (or disposition) of partnership interests.

Potential for the use of several methods of accounting. It is not clear whether the requirement that partners must report partnership items by using the partnership’s method of accounting conflicts with the requirement that a taxpayer cannot use different methods of accounting for the item unless the taxpayer has two or more separate and distinct trades or businesses. For example, if a taxpayer is individually a hairdresser and is a partner in a separate hairdressing partnership, and does not treat the two as separate and distinct trades or businesses, it is not clear whether the taxpayer can use the cash method with respect to its individual hairdressing business if the partnership uses the accrual method.

ENDNOTES

1. IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, any U.S. federal tax advice contained in this article is not intended or written by us to be used, and cannot be used, (i) by any taxpayer for the purpose of avoiding tax penalties under the Code or (ii) for promoting, marketing or recommending to another party any transaction or matter addressed herein.


3. See Reg. §1.446-1(d)(1).

4. See Code Sec. 446(b).

5. See Reg. §1.446-1(e)(1).


7. Code Sec. 381 applies to tax-free liquidations and certain tax-free reorganizations. See Code Sec. 381(a).

8. See Reg. §1.381(c)(4)-1, (c)(5)-1, (c)(6)-1. In general, these rules provide that the acquiring corporation must use (i) methods of accounting used by each party to the Code Sec. 381 transaction, if the acquiring corporation operates the trades or businesses of the parties as separate and distinct trades or businesses after the date of the Code Sec. 381 transaction (each method, the “carryover method”), and (ii) the method of accounting used by the party whose component trade or business is the largest, if the acquiring corporation operates the trades or businesses of the parties as an integrated trade or business (such method, the “principal method”). However, the acquiring corporation (i) cannot use the principal method or the carryover method to the extent that such methods are incorrect, and (ii) generally must use the transferor’s method for computing the depreciation allowance for property acquired in the Code Sec. 381 transaction.


10. See section 2(g), below.

11. Code Sec. 446(e). The acquiring corporation in a Code Sec. 381 transaction does not need the IRS’s consent to use the principal method, even if the use of such method is treated as a change in method of accounting. See Reg. §1.381(c)(4)-1(d)(1)(ii)(A), (c)(5)-1(d)(1)(ii)(A).

12. Reg. §1.446-1(e)(2)(i). The purpose of the consent requirement is to give the IRS advance notice to protect the fisc, to avoid burdensome administrative uncertainties and to promote accounting uniformity. See Diebold, Inc., ClsCt, 89-1 ustc ¶9141, 16 ClsCt 193 (1989), aff’d, CA-FC, 90-1 ustc ¶50,003, 891 F2d 1579 (1989), cert. denied, 498 US 823 (1990). See also Capital

13 Code Sec. 446(b).

14 Reg. §1.446-1(c)(1)(ii)(C).


16 See Reg. §301.9100-3. It is not clear whether the IRS would (or even could) consent to a change that occurred without consent in a closed year.

17 See Lee A. Sheppard, Credit Default Swaps in Bankruptcy Court, 132 Tax Notes 323, 329 (July 25, 2011).

18 Specifically, an item would be duplicated if it was realized again under the old method of accounting for the item, and the item would be realized again under the new method. Similarly, an item would be omitted if the item wasn’t realized under the old method of accounting for the item as of the year of change, and the item would not be realized under the new method.

19 See Reg. §1.446-1(e)(3)(ii). In some instances, express authority provides whether a change must be effected with a Code Sec. 481(a) adjustment or on a cut-off basis. In most other instances, the IRS will require the change to be effected with a Code Sec. 481(a) adjustment.

20 The period of time over which the taxpayer must take the Code Sec. 481(a) adjustment into account is called the “section 481(a) adjustment period.” See Rev. Proc. 2011-14, infra note 24, at §3.07.

21 See Rev. Proc. 2011-14, infra note 24, at §2.06.

22 See Reg. §1.446-1(e)(3)(ii).

23 See, e.g., Diebold, Inc., supra note 12.


26 See Reg. §1.446-1(e)(3)(ii); Rev. Proc. 2011-14, supra note 24, at §6.02(1).

27 See Rev. Proc. 2011-14, supra note 24, at §6.02. A taxpayer must also file a copy of Form 3115 with the national office on or before the date when the original Form 3115 is filed with the timely-filed federal income tax return for the year of change. Special rules may apply if the taxpayer is a foreign corporation.

28 Rev. Proc. 2011-14, supra note 24, at §6.03. An issue is “under consideration” if the taxpayer receives written notification from the government, e.g., the examining agent(s) or Appeals, specifically citing the treatment of the item as an issue under consideration. Rev. Proc. 2011-14, supra note 24, at §3.09. If the taxpayer files for change and then the IRS gives the taxpayer written notification, e.g., if the letters cross in the mail, presumably the IRS would not assert that the issue was “under consideration.”

29 Rev. Proc. 2011-14, supra note 24, at §6.03. An issue is “pending” if the IRS has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer’s method of accounting.

30 The term “director” refers to the Director, Field Operations, LB&I Area Director, Field Examination, SB/SE; Chief, Estate & Gift Tax Operations, SB/SE; Chief, Employment Tax Operations, SB/SE; Chief, Excise Tax Operations, SB/SE; Director, Compliance, W&I; Director, Employee Plans Examinations; Director, Exempt Organizations Examinations; Director, Federal, State & Local Governments; Director, Tax Exempt Bonds; or Director, Indian Tribal Governments, as appropriate. Rev. Proc. 2011-1, IRB 2011-1, at §1.01(3).

31 The director’s consent is requested through the IRS audit team, or its manager.


33 See Rev. Proc. 2011-14, supra note 24, at §4.02(7).


35 The rules for non-automatic consent changes are described in Rev. Proc. 97-27, 1997-1 CB 680 (as amended by subsequent guidance).

36 The deadline for requesting nonautomatic consent is generally earlier than the deadline for requesting automatic consent because a taxpayer cannot file under the new method without the IRS’s consent. However, the deadline for requesting consent to certain accounting method changes in connection with a Code Sec. 381 transaction can be after the end of the year in which the Code Sec. 381 transaction occurred. See Reg. §1.381(c)(4)(i)(d)(2)(iii), (c)(5)(i)(d)(1)(ii). The preamble to the proposed Code Sec. 381 regulations that contained the same rule explained that the rule was meant to conform the due dates for requesting an accounting method change in connection with a Code Sec. 381 transaction with “the due dates for requesting other accounting method changes under section 446(e), while providing sufficient time to request the IRS’s consent if the Code Sec. 381(a) transaction occurs at or near the end of a taxable year.” See 72 FR 64,545, at 64,547 (Nov. 16, 2007).

37 Code Sec. 703(b)(i) (providing that, with certain exceptions, “[a]ny election affecting the computation of taxable income derived from a partnership shall be made by the partnership”); Reg. §1.481-2(c)(5)(i) (providing that “[i]n the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership”). See also McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners, ¶9.01(6) (Warren, Gorham & Lamont, 4th ed. 2011) (observing that “[a] partnership is entitled to choose its method of accounting pursuant to §446(e)”).


39 The IRS can also resolve accounting method issues on a nonaccounting-method-change basis, e.g., by agreeing that the taxpayer will pay the government an amount that approximates the time-value-of-money benefit the taxpayer has derived from using its method of accounting for the tax years at issue, reduced by an appropriate factor to reflect the hazards of litigation. Rev. Proc. 2002-18, supra, at §6.02. A resolution on a nonaccounting-method-change basis is reflected in a closing agreement under Code Sec. 7121. Rev. Proc. 2002-18, supra, at §8.01.

40 Rev. Proc. 2002-18, supra note 37, at §2.02(5).

41 Rev. Proc. 2002-18, supra note 37, at §2.06.

42 A taxpayer that changes a method of accounting without consent because consent is not required, i.e., in connection with a Code Sec. 381 transaction, is not subject to audit protection for the change. Reg. §1.381(c)(4)(i)(d)(1)(ii); (c)(5)(i)(d)(1)(ii). It is not clear whether lack of audit protection in this context means that the IRS could impose an involuntary change from a correct method to another correct method.

43 Code Sec. 446(f).

44 Among other things, these taxpayers may be required to disclose the issue in any event under the disclosure requirements for uncertain tax positions. See Announcement 2010-75, IRB 2010-41, 428.

45 See Reg. §§1.451-1(a), 1.461-1(a)(3); see also E. Badaracco, Sr., SCt, 84-1 USC ¶9150, 464 US 386, 397 (1984) (observing that the regulations do not require taxpayers to file amended returns).

46 In addition, the statute of limitations may remain open longer with respect to a return that contains an item that the taxpayer knew was incorrect at the time when the return was filed.

47 A taxpayer may be reluctant to seek the director’s consent to request the IRS’s consent, because that would alert the IRS audit team to the accounting method issue. In practice, the risks associated with alerting the IRS audit team to the account-
ing method issue depend in large part on whether the taxpayer has a good working relationship with the audit team. 48 As discussed above, whether a taxpayer qualifies for audit protection depends, inter alia, on the proposed method of accounting, and whether the taxpayer’s current method of accounting is an issue under consideration or an issue pending. The taxpayer may find it useful to change its method of accounting even if the taxpayer does not qualify for audit protection.

49 See Code Sec. 6222(b)(1). The partner does this by filing a notice of inconsistent position, Form 8082, which is required whether the inconsistent position arises out of an accounting method inconsistency or otherwise.