Changes in Annual Accounting Period

Announcement 2002–53

PURPOSE

This announcement discusses some of the more significant issues raised in connection with finalizing Notice 2001–34, 2001–23 I.R.B. 1302, and Notice 2001–35, 2001–23 I.R.B. 1314, which proposed procedures for obtaining the Commissioner’s approval to adopt, change, or retain an annual accounting period under §§ 441 and 442 of the Internal Revenue Code and the regulations thereunder.

BACKGROUND

Notice 2001–34 proposed procedures for obtaining the Commissioner’s prior approval to adopt, change, or retain an annual accounting period, applicable to a taxpayer that is not within the scope of any automatic approval procedure. Notice 2001–35 proposed new automatic approval procedures for partnerships, S corporations, electing S corporations, and personal service corporations (PSCs). Both notices requested comments from the public in connection with the proposed procedures. At the same time that the Service published these notices, it also issued new proposed regulations (REG–106917–99, 2001–27 I.R.B. 4) under §§ 441, 442, 706, and 1378, relating to annual accounting periods, which also requested public comments.

Rev. Proc. 2002–39, finalizing Notice 2001–34, and Rev. Proc 2002–38, finalizing Notice 2001–35, appear elsewhere in this Bulletin, along with Rev. Proc. 2002–37, which provides updated automatic approval procedures for corporations. These revenue procedures, together with final regulations (T.D. 8996, published in the May 17, 2002, Federal Register (67 FR 35009)) under §§ 441, 442, 706, and 1378, issued concurrently, are intended to provide comprehensive guidance on the adoption, change, and retention of an annual accounting period. The most significant comments received in connection with Notice 2001–34 and Notice 2001–35, along with certain other changes to the proposed procedures, are discussed below. Comments specific to the proposed regulations are discussed in the preamble to the final regulations.

CHANGES TO NOTICE 2001–34 (PRIOR APPROVAL PROCEDURES)

A. *Natural Business Year*

One commentator suggested that the final revenue procedure clarify the terms "peak and nonpeak periods," "at or soon after," and "insignificant gross receipts," in connection with the annual business cycle and seasonal business tests. Rev. Proc. 2002–39 provides clarification by including safe harbor rules for administrative convenience, as well as examples. One safe harbor provides that 1 month will be deemed to be "soon after" the end of a peak period (in the case of the annual business cycle test) or the close of operations (in the case of the seasonal business test). Under a second safe harbor, gross receipts will be deemed to be "insignificant" for purposes of the seasonal business test if they are less than 10 percent of the taxpayer's total gross receipts for the year. The examples illustrate the application of these safe harbor rules. Taxpayers that do not meet the safe harbor rules nevertheless may establish that their requested taxable year meets the annual business cycle test or seasonal business test using all of the facts and circumstances.

Notice 2001–34 provided that a taxpayer seeking to establish a natural business year under section 5.03 must provide information about its gross receipts for the three taxable years immediately preceding the first effective year. Although Rev. Proc. 2002–39 continues to require this information, and to require that the annual business cycle, seasonal business, or 25-percent gross receipts test be met for each of the three preceding years for taxpayers that have been in existence for that length of time, the Service and Treasury realize that newly formed taxpayers may be uncertain about whether and how they can establish a natural business year under these tests. Accordingly, Rev. Proc. 2002–39 clarifies that a taxpayer that has not been in existence for 3 taxable years may satisfy the annual business cycle or seasonal business test by providing information other than prior years' gross receipts, such as a description of its business and reasonable estimates of its gross receipts. However, the Service and Treasury believe that the more objective 25-percent gross receipts test should continue to apply only to established taxpayers that can produce actual gross receipts information for the required 3-year period.

B. *Additional Acceptable Business Purposes*

Section 5.02(1)(b) of Notice 2001–34 provides that a taxpayer, including a partnership, S corporation, electing S corporation, or PSC, may establish a business purpose for a requested taxable year for purposes of section 5.02(1) (to which only general terms and conditions apply) based on all of the facts and circumstances. A commentator requested that the Service provide examples of the kinds of facts and circumstances that would be sufficient for a taxpayer to demonstrate a sufficient business purpose. The commentator further suggested that the final revenue procedure explain whether and how facts such as a taxpayer's gross receipts would be evaluated to determine whether the taxpayer has demonstrated a sufficient business purpose under the facts and circumstances test of section 5.02(1)(b). The Service and Treasury intend for the facts and circumstances test of section 5.02(1)(b) to apply only in rare and unusual circumstances. Rev. Proc. 2002–39 has been clarified to that effect. Accordingly, examples such as those suggested by the commentator have not been included in Rev. Proc. 2002–39.

It should be noted that, if a taxpayer (other than a taxpayer with a required taxable year) fails to satisfy one of the three alternative tests for showing a natural business year (annual business cycle, seasonal business, or 25-percent gross receipts), then the taxpayer still may obtain approval for the change if it demonstrates some nontax reason for the change and accepts additional terms and conditions that are necessary to eliminate substantial distortion created by the change. Under Rev. Proc. 2002–39, this nontax reason can be a reason not heretofore accepted by the Service as a sufficient business purpose in cases where substantial distortion is present, and can be based on criteria, such as gross receipts, that are also the focus of the natural business year tests. For example, such a business purpose could include having significant gross receipts in the last months of the requested taxable year, albeit less than 25 percent of the taxpayer's annual gross receipts.

C. *Changes Within 48 Months*

Some taxpayers have expressed concern that the Service will deny most, or even all, applications to change or retain an annual accounting period under the final prior approval procedures if the taxpayer made a change within the previous 48 months ("prior change"). Although a prior change may disqualify a taxpayer for automatic approval of a change or retention, the Service expects that, for the vast majority of applications under Rev. Proc. 2002–39, approval will not be denied because of a prior change. However, in certain cases, approval may be denied because of the taxpayer's accounting period history (for example, where there exists a pattern of prior changes). *See generally* section 7.01 of Rev. Proc. 2002–39.

D. *Director Consent/Audit Protection*

Notice 2001–34 proposed to offer audit protection to all taxpayers that received prior approval under the final revenue procedure to retain or change an annual accounting period. Consistent with procedures of the Service in the accounting method area, taxpayers under examination were required to secure the consent of the Director to the change or retention. One commentator argued that the requirement to obtain the Director's consent was burdensome, particularly for corporate taxpayers for whom an annual accounting period ordinarily would not be an issue under consideration. The commentator suggested either that all taxpayers under examination be permitted to provide a representation (under penalties of perjury) that their annual accounting period is not an issue under consideration, in lieu of a letter of consent from the Director, or that audit protection be limited to taxpayers that provide the letter of consent.

After carefully weighing the benefits of audit protection against the burden of obtaining the requisite Director consent, the Service and Treasury Department have determined that it is appropriate to extend audit protection only to certain taxpayers with required taxable years, namely, partnerships, S corporations, electing S corporations, and PSCs. Accordingly, other corporate taxpayers, and taxpayers with required taxable years other than those identified above, that are under examination or before an area office or a federal court will not be required to obtain Director consent as a prerequisite to applying for a change under Rev. Proc. 2002–39, and will not be offered audit protection. Similarly, no consent letter is required, and no audit protection is offered, by Rev. Proc. 2002–37, which provides automatic consent procedures for corporations.

E. *Failure to Satisfy Natural Business Year Test in Future Years*

Notice 2001–34 provides that if a partnership, S corporation, electing S corporation, or PSC changes to a natural business year, and that year later fails to qualify as a permitted year, the taxpayer must then change to a permitted year. One commentator objected to this condition, arguing that it effectively mandates annual monitoring of the taxpayer's continued compliance with the natural business year requirement, and as such is overly burdensome. The commentator suggested that the final procedures instead adopt a 3-year testing period.

The Service and Treasury Department believe that a 3-year testing period is inconsistent with the statutory framework imposing required years on such taxpayers, and that the taxpayer's year must continue to be a permitted year in order for the taxpayer to retain it. It should be noted, however, that even if the requested taxable year fails in some later year to qualify as a permitted year under the original test for which approval was granted (for example, the 25-percent gross receipts test), the taxpayer need not change its existing taxable year if the taxpayer can demonstrate that the year is a permitted year under some other test (for example, the annual business cycle test). The same would be true for a taxpayer that changed to or retained a natural business year under one of the automatic approval revenue procedures.

F. *Substantial Distortion of Income*

Notice 2001–34 provides that, for purposes of determining whether the additional terms and conditions of section 5.05 apply, distortion of income resulting from the requested taxable year change will not be considered substantial if the amount of the distortion is less than both: (1) 5 percent of the taxpayer's estimated gross receipts for its current taxable year; and (2) $500,000. The amount of the distortion or deferral is the taxpayer's allocable share of income from a pass-through entity, including ordinary income or loss, rents, royalties, interest, dividends, and deduction equivalents of credits. A similar *de minimis* rule is provided in Rev. Proc. 2000–11 (applied to each of the 3 prior taxable years) for determining whether a corporation with an interest in a pass-through entity is within the scope of that automatic approval revenue procedure.

One commentator suggested that the final prior approval procedures eliminate the $500,000 floor. The commentator believes that, in the case of prior approval applications processed by the national office, it is more appropriate for the Service to determine on a case-by-case basis whether an estimated amount of distortion is *de minimis*.

The Service and Treasury Department believe that the $500,000 floor is appropriate in order to promote consistency of results and facilitate the administration of prior approval applications. Thus, the $500,000 floor is retained in Rev. Proc. 2002–39. Similarly, the $500,000 floor contained in Rev. Proc. 2000–11 is retained in Rev. Proc. 2002–37.

The commentator also recommended that, regardless of the *de minimis* distortion test, the additional terms and conditions of section 5.05 of Notice 2001–34 not apply if the taxpayer's interest in the pass-through entity is less than 5 percent of the entity's profits and capital. The Service and Treasury do not believe that such a rule would be appropriate, as even a 1 percent interest in profits and capital can potentially result in a significant amount of distortion.

CHANGES TO NOTICE 2001–35 (AUTOMATIC APPROVAL PROCEDURES FOR PASS-THROUGH ENTITIES)

A. *Natural Business Year*

One commentator suggested that the final procedures for obtaining automatic approval by a pass-through entity clarify whether a taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is required to recompute the 25-percent gross receipts test. Section 7.02(6) of Rev. Proc. 2002–38 requires only a taxpayer changing to a natural business year using the 25-percent gross receipts test to provide the gross receipts information with its application, in compliance with the instructions for Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. A taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is not required to provide this information. However, as discussed above, for a taxpayer with a required year to continue to use a fiscal year, that year must continue to be a permitted year.

B. *Ownership Taxable Year*

Notice 2001–35 provided that, for purposes of determining the ownership tax year of an S corporation or electing S corporation, a shareholder that is tax-exempt under § 501(a) is disregarded if such shareholder is not subject to tax on any income attributable to the S corporation. One commentator suggested that tax-exempt shareholders should not be disregarded if the S corporation is wholly owned by such shareholders. This suggestion has been adopted in Rev. Proc. 2002–38.

C. *Certain Minor Changes in Ownership of Partnerships*

To alleviate taxpayer burden associated with temporary and minor changes in ownership of a partnership that result in a new required year under § 706(b), a new rule has been added to Rev. Proc. 2002–38. The rule provides that a partnership required under § 706(b) to change its taxable year due to a change of less than 10 percent of the aggregate interests of all partners in the partnership's profits and capital may continue to use its current taxable year for one taxable year if it is foreseeable that the change in ownership will be reversed after one taxable year.

CHANGES TO REV. PROC. 2000–11

A. *Automatic Changes to Natural Business Year*

Rev. Proc. 2000–11 did not allow corporations with disqualifying interests in pass-through entities to change automatically to a natural business year under the 25-percent gross receipts test. Under the final prior approval procedures of Rev. Proc. 2002–39, a corporation qualifying to change to a natural business year based on the 25-percent gross receipts test generally would receive approval to do so (subject only to general terms and conditions) notwithstanding any resulting deferral or distortion attributable to an interest in a pass-through entity. Accordingly, the Service and Treasury Department believe that it is appropriate to provide automatic approval for corporations to change to a natural business year, based on the 25-percent gross receipts test, notwithstanding their interest in a pass-through entity. Rev. Proc. 2002–37 reflects this change.

B. *Conforming Changes*

Certain conforming changes have been made to Rev. Proc. 2002–37, consistent with the rules set forth in the final regulations, Rev. Proc. 2002–38, and Rev. Proc. 2002–39. For example, the limitation on changes within 6 years has been reduced to the most recent 48 months, corporations that are shareholders of a closely-held real estate investment trust are considered to have an interest in a pass-through entity for purposes of the scope limitations of Rev. Proc. 2002–37, and certain scope limitations are waived for changes to (or from) certain 52–53-week taxable years that reference the same calendar month. In addition, Rev. Proc. 2002–37 has been modified to provide that a *de minimis* interest in a controlled foreign corporation, foreign personal holding company, or passive foreign investment company may be disregarded under section 4 of that revenue procedure for purposes of determining whether a corporation is within the scope of Rev. Proc. 2002–37, similar to the treatment of *de minimis* interests in partnerships.

FURTHER INFORMATION

For further information regarding this announcement, contact Martin Scully, Jr. or Michael F. Schmit of the Office of the Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4960 (not a toll-free call).