

Tax Accounting

By James E. Salles

This month's column begins a two-part discussion of the new rules governing the adoption and change of accounting periods (taxable years). These rules were largely rewritten in a package of regulatory and administrative guidance released in May. The new guidance finalizes and expands upon two notices¹ and proposed regulations² issued last year. The significant changes fall into two basic categories:

1. Changes affecting the determination of the types of taxable years that certain entities are permitted to adopt ("permitted taxable years") and
2. Changes to the procedures governing so-called "automatic consent" for certain types of changes in existing taxable years.

Background

Statutory Provisions

The basic rules governing taxpayers' accounting periods are set forth in Code Section 441, which closely resembles its accounting method counterpart, Code Section 446. A taxpayer's annual accounting period is "the annual period on the basis of which the taxpayer regularly computes his income in keeping his books," if there is one, or else the calendar year.³ Once a taxable year has been established, the taxpayer needs IRS permission to change it.⁴ This generally requires a showing of a "substantial business purpose."⁵

Over time a number of additional statutory constraints have grown up on taxpayers' choice of accounting periods. The Deficit Reduction Act of 1984 required foreign sales corporations (FSCs) and domestic international sales corporations (DISCs) to use the same taxable year as their largest shareholders.⁶ The Tax Reform Act of 1986 expanded an existing similar rule that applied to partnerships, generally requiring them to use a taxable year determined by reference to that of their partners, or else the calendar year.⁷ Subchapter S corporations have generally been required to use the calendar year since 1982,⁸ and similar requirements have applied to personal service

corporations and taxable trusts since 1986.⁹ Except in the case of trusts, taxpayers can use a different year than the "required year" if they can demonstrate a business purpose for doing so.

Taxable years permitted under these statutory provisions thus come in three general flavors, depending on the type of entity involved:

1. The calendar year,
2. Taxable years determined by reference to the taxable years in use by the entity's owners, and
3. Taxable years qualifying under the "business purpose" exception.

Taxpayers may also generally use a "52-53 week year" (a year that always ends on a given day of the week) corresponding to an otherwise permitted year.¹⁰ Finally, Code Section 444 also allows, under certain conditions, partnerships, S corporations, and personal service corporations to elect a taxable year ending up to three months earlier than the default year specified by the statute.¹¹

Automatic Consents

Grants of automatic consent to changes in accounting periods, like their accounting method counterparts, have expanded over time. The regulations under Code Section 442, adopted in 1957, included a restrictive automatic consent provision for corporations,¹² allowing changes of period if there had been no previous change within 10 years, the corporation did not report a loss within the resulting "short period," and certain other conditions were met. Special purpose procedures followed allowing automatic changes by exempt organizations,¹³ certain individuals seeking to adopt the calendar year,¹⁴ and relatively small trusts managed by financial institutions.¹⁵ Beginning in 1984, the automatic change regime for corporations was expanded in a succession of revenue procedures, most recently Rev. Proc. 2000-11.¹⁶ Following the 1986 statutory changes, the IRS consolidated guidance on partnerships, subchapter S corporations, and other entities subject to statutory requirements on permitted taxable years into Rev. Proc. 87-32.¹⁷

New Regulations and Procedures

Taxpayers got a preview of the new guidance last year when the IRS released Notices 2001-34¹⁸ and 2001-35.¹⁹ Notice 2001-34 included a proposed procedure for

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“normal” discretionary applications for changes in period, while Notice 2001-35 included a new proposed automatic approval procedure for noncorporate entities, updating Rev. Proc. 87-32. The notices were accompanied by proposed regulations under Code Sections 441, 442, 706, and 1378 covering both the general rules governing taxable years and the specific restrictions on partnerships and subchapter S corporations.

Final regulations have now been issued along the lines of the 2001 proposal,²⁰ coupled with three new revenue procedures that consolidate most existing administrative guidance on changes in taxable years. The regulations have been overhauled so as to reflect various statutory changes and avoid overlap with the new procedures. Guidance is now divided between the regulations themselves and the revenue procedures in a way that resembles the rules governing accounting methods. The regulations set forth the basic operating rules and, for example, flesh out the business purpose standard. The new procedures specify the general criteria under which the IRS will consider applications for changes in year and provide automatic consent to certain changes involving business taxpayers in common circumstances:

- Rev. Proc. 2002-37 governs changes under “automatic consent” procedures for corporations, superseding former Regs. § 1.442-1(c) and Rev. Proc. 2000-11;
- Rev. Proc. 2002-38, corresponding to Notice 2001-35, governs changes under “automatic consent” procedures for partnerships, subchapter S corporations, and personal service corporations, superseding Rev. Proc. 87-32;
- Rev. Proc. 2002-39, corresponding to Notice 2001-34, prescribes general rules governing discretionary (nonautomatic) applications for method changes.

The accompanying Announcement 2002-53²¹ explains the new procedures and describes the reasoning behind some of the changes. The new provisions deal with two basic topics: permissible taxable years under the various statutory provisions (including the “business purpose” exceptions) and the mechanics of securing the IRS’s consent to proposed changes of periods. This month’s column outlines the types of taxable years permitted under the new rules. Next month’s column will discuss the consent process under the new procedures.

Permitted Years

Statutory Requirements

The taxable years of personal service corporations, partnerships, and subchapter S corporations respectively are determined under Code Sections 441(i), 706(b), and 1378. These provisions specify default taxable years, referred to in the procedures as “required taxable years,” which such taxpayers must use except

to the extent that they can establish a business purpose or make a proper election under Code Section 444.

Subchapter S corporations and personal service corporations are required to use the calendar year in the absence of a business purpose.²² Partnerships, on the other hand, must generally determine their taxable years by reference to those of their partners. Under Code Section 706(b), the required taxable year for a partnership is normally the “majority interest taxable year,” which is generally defined as the taxable year of one or more partners that control a majority interest in partnership profits and capital.²³ If there is no “majority interest taxable year,” then the required taxable year is the taxable year, if any, used by all the “principal partners” holding more than 5 percent interests. If there is no “majority interest taxable year” and the principal partners use different taxable years, then the required taxable year is the calendar year, except as regulations may provide otherwise. (The regulations have provided otherwise in the form of the “least aggregate deferral” rules,²⁴ discussed below.)

Personal service corporations, S corporations, and partnerships can all use a taxable year other than the default year if they can demonstrate a business purpose for doing so. Deferring income to the owners is *not* a business purpose.²⁵

Entity taxable years covered by these provisions, therefore, come in three basic flavors: calendar years, taxable years determined by reference to ownership, and taxable years that qualify under the “business purpose” exception. Generally, as discussed below, the last category has referred to a taxable year determined on the basis of the taxpayer’s business cycle, the so-called “natural business year.”

Calendar Years

As discussed above, the calendar year is the default taxable year for personal service corporations.

Ownership-Based Taxable Years

As explained above, Code Section 706(b) specifies the required taxable year for a partnership as the “majority interest taxable year,” if there is one, or else the taxable year that is used by all the partnership’s principal partners. If the partnership does not have a “majority interest taxable year” and the “principal partner” rule does not apply, the statute provides that the required taxable year shall be the calendar year, except as otherwise provided in regulations. Temporary regulations dating back to 1987 have provided that in such circumstances, the partnership’s “required taxable year” shall be the taxable year that produces the “least aggregate deferral” when compared to the taxable years of the partners.²⁶ The regulations included as part of the new package preserve the “least aggregate deferral” concept with some minor tweaks.²⁷

Since automatic application of the rules of Code Section 706(b) could result in frequent changes of taxable years, the Code provides that a partnership that has been required to change taxable years to conform to a “majority interest taxable year” shall not thereafter be required to change again until the third succeeding taxable year.²⁸ The IRS has declined to extend the relief by regulation to partnerships subject to the “principal partner” and “least aggregate deferral” rules.²⁹ However, Rev. Proc. 2002-38 now allows taxpayers to ignore certain transient changes in ownership affecting less than 10 percent of partnership interests,³⁰ and this relief would appear to apply in determining all types of ownership-based taxable years.

Code Section 1378, which applies to subchapter S corporations, does not contain a corresponding provision referencing the taxable years of shareholders. However, the new regulations provide that subchapter S corporations will be deemed to have a business purpose for adopting an “ownership taxable year,” to be defined in administrative procedures.³¹ Like its predecessor,³² Rev. Proc. 2002-38 allows automatic consent (subject to certain exclusions, as discussed below) for a subchapter S corporation that seeks to change to its “ownership taxable year,” defined similarly to a partnership’s “majority interest taxable year.”³³ Presumably, a taxpayer that wants such a change but does not meet the requirements for automatic consent can apply under Rev. Proc. 2002-39, the general procedure for discretionary changes.

Natural Business Years

While the regulations provide that the existence of a “business purpose” is to be determined based on all the facts and circumstances, in practice, the IRS has tended to recognize a “business purpose” only in narrowly drawn circumstances. In practice, the analysis has been dominated by the concept of the taxpayer’s “natural business year.” The old regulations under Code Section 442 provided that a “substantial business purpose” is required to secure the IRS’s consent to a proposed change in taxable year and that among the factors to be considered was “the effect of the change on the taxpayer’s annual cycle of business activity.”³⁴ The regulations under the pre-1986 version of Code Section 706(b), which required a partnership to show a business purpose to adopt a taxable year “other than that of all its principal partners,”³⁵ likewise provided that “[t]he intention of the partnership to make its tax year coincide with [its] natural business year constitutes a sufficient business purpose.”³⁶

In 1974, the IRS confirmed that the same “natural business year” would meet the business purpose standard under Code Section 442 as well as Code Section 706, and offered this definition: “Where a trade or business has a nonpeak period and a peak period of business, the natural business year is generally deemed to

end at, or soon after, the close of the peak period of business.”³⁷ Rev. Proc. 87-32, the automatic consent procedure for changes by partnerships, subchapter S corporations, and personal service corporations, fleshed out the “natural business year” standard with a “25 percent test.” A taxpayer met this test if it could show a history of reporting 25 percent or more of its gross receipts in the last two months of the requested year.³⁸ Rev. Rul. 87-57,³⁹ released at the same time, allowed a taxpayer to demonstrate a “natural business year” even if the 25 percent test was not met due to nonrecurring circumstances. The ruling also conceded that, apart from the 25 percent test, a natural business year would exist if the taxpayer’s business was seasonal and the requested year immediately preceded a three-month period during which receipts were insignificant. Taxpayers that failed to meet the 25 percent test but felt that they could qualify under the ruling could apply for discretionary consent to the proposed change.

The new guidance on “natural business years” is found in Rev. Proc. 2002-39, the general procedure for requesting discretionary changes, and draws on all the sources discussed above. Under the procedure, a proposed taxable year will qualify as a “natural business year” if ...

- It closes at or “soon after” (within a month) of the close of the highest peak period of business;
- It closes at or “soon after” a close of seasonal operations that is followed by a period of “insignificant” gross receipts; or
- It meets a slightly modified version of the 25 percent test.⁴⁰

If a taxpayer can establish a “natural business year” under the 25 percent test and meets the other conditions of the procedure, it can obtain automatic consent to a change under Rev. Proc. 2002-37⁴¹ or 2002-38,⁴² as appropriate. In the case of a partnership, subchapter S corporation, or personal service corporation, if the natural business year later changes, the taxpayer will have to apply for consent to another change.⁴³ The reasoning behind limiting this rule to such taxpayers seems to be that other taxpayers generally have a free choice among accounting periods and simply need to establish a business purpose to *change* accounting periods. That requirement would be met by establishing the existence of a “natural business year” at that time. On the other hand, partnerships, subchapter S corporations, and personal service corporations have to establish a continuing business purpose for using any year other than the required year, so that if their taxable year no longer qualifies as a natural business year, they have to change.

“Deemed Business Purpose” Years

One major innovation affecting taxpayers whose choice of taxable years is otherwise unrestricted is the introduction of the concept of “deemed business pur-

pose.” Partnerships, subchapter S corporations, and personal service corporations (as well as various other types of taxpayers in more specialized situations) have to use specific taxable years unless they can demonstrate a continuing business purpose for using some other year. Garden-variety corporations, on the other hand, have a free initial choice of taxable years, but have to demonstrate a business purpose to *change*.

The IRS’s restrictive definition of “business purpose”⁴⁴ meant that unless the corporation could show a natural business year, it likely had to wait to qualify under one of the automatic consent rules. Former Reg. § 1.442-1(c) allowed automatic consent if the corporation had not changed periods for the previous 10 years and certain other conditions were met. The alternative automatic consent provision in Rev. Proc. 2000-11⁴⁵ imposed only a six-year waiting period and allowed some exceptions, but further conditions made it unavailable, for example, to corporations with significant interests in pass-through entities.

The new rules address this problem by providing that in certain circumstances taxpayers will be “deemed” to have a business purpose if they agree to compensating adjustments. The regulations authorize the IRS to prescribe “the terms, conditions, and adjustments” for consent to its adjustments, and specify that the adjustments may include “adjustments necessary to neutralize the tax effects of a substantial distortion of income that would otherwise result.” Rev. Rul. 2002-39, the general procedure for discretionary consents, sets forth the operating rules.

As before, taxpayers that establish the existence of a “natural business year” are considered to have a business purpose for changing to such a year. The procedure recognizes that taxpayers may establish a business purpose for other types of changes, but only in “rare and unusual circumstances.” The procedure then goes on to say that taxpayers other than partnerships, subchapter S corporations, and personal service corporations that cannot establish a business purpose nonetheless will “generally” be “deemed” to have established a business purpose if they can show a “non-tax reason” for making the change and agree to additional adjustments “which are intended to neutralize the tax effects of any resulting substantial distortion of income.” A “non-tax reason” includes “administrative and convenience business reasons” that the IRS has held do not rise to the level of a business purpose, such as the use of the requested year for regulatory, financial accounting, or administrative purposes, or by related entities or competitors, or the hiring patterns or pricing cycle of the particular business concerned.⁴⁶

The special adjustments fall into three general categories. In each case, an adjustment will be imposed only if there results a “substantial” distortion of income, defined as 5 percent of the taxpayer’s gross receipts or \$500,000, whichever is less:

1. If the taxpayer’s proposed change increases the deferral associated with pass-through entities directly or indirectly owned by the taxpayer, then in addition to reporting income normally, the taxpayer must report an additional inclusion representing the income accrued by the pass-through entities during the taxpayer’s short year resulting from the change. Corresponding deductions are allowed over the following four years.
2. Similar adjustments will be required if the taxpayer’s proposed change defers income or shifts deductions to another taxpayer. This might occur, for example, if the taxpayer is an estate and the change affects reporting by a beneficiary. The procedure does not specify by whom the adjustments would be reported.
3. If income is distorted (increased) in the short period following the change, then net operating losses, capital losses, and credits that would otherwise expire may only be used to the extent that they would have been usable in a “normal” year.⁴⁷

52-53 Week Years

Code Section 441(f) grants taxpayers the general right to elect use of a “52-53 week year” (a taxable year that always ends on the same day of the week). The statute specifically authorizes the IRS to prescribe relevant regulations and in particular to “provide terms and conditions for the application of this subsection to a partnership, S corporation, or personal service corporation.”⁴⁸ Since the 1986 statutory changes, the general rules on the 52-53 week election have appeared in Reg. § 1.441-2T, while the special rules for partnerships, subchapter S corporations, personal service corporations, and their owners have appeared in Reg. § 1.441-3T.

In general, a newly formed taxpayer is automatically permitted to elect a 52-53 week year determined by reference to a calendar or fiscal year that it would otherwise be permitted to use without reference to “business purpose.” Partnerships, subchapter S corporations, or personal service corporations, for example, are entitled to adopt either the “required year” or a year allowed under Code Section 444 (which is computed by reference to the required year). A newly-formed partnership, subchapter S corporation, or personal service corporation can thus choose a 52-53 week year computed by reference to any such year (subject, if applicable, to the conditions imposed by Code Section 444).⁴⁹

Thereafter, taxpayers must obtain the IRS’s consent for changes involving 52-53 week years as with any other changes in taxable year, although the change may only be from a calendar or fiscal year to a 52-53 week year referencing the same year, or vice versa, or from one 52-53 week year to another one that references the same year but ends on a different day of the week. However, taxpayers may be eligible for automa-

ic consent if they meet the requirements of the appropriate procedures.⁵⁰

Regardless of how the taxpayer lands on a 52-53 week year, the Regulations impose certain rules to simplify accounting and reduce the resulting distortions. In general, taxpayers may treat a 52-53 week year as a 12-month year for purposes of computing particular items of income and deduction, if they do so consistently.⁵¹

The previous regulations required an owner to include income from a partnership, subchapter S corporation, or personal service corporation if the entity's

year was computed by reference to the same month-end as its owner's, even if the entity's year closed a few days later as a result of the use of a 52-53 week year.⁵² The new rules apply the same principle to other types of pass-through entities as well.⁵³ The final regulations expanded the proposed regulations' definition of "pass-through entities" to include closely held real estate investment trusts (REITs) to combat abuses.⁵⁴ The IRS is now soliciting comments on similar rules under development for foreign taxes,⁵⁵ which in many cases do not accrue under the "all events" test⁵⁶ until the last day of the foreign taxable year.

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1. Notice 2001-34, 2001-23 I.R.B. 1302, and Notice 2001-35, 2001-23 I.R.B. 1314.
 2. REG-106917-99, 2001-27 I.R.B. 4 ("2001 proposed regulations").
 3. I.R.C. § 441(c), (g).
 4. I.R.C. § 442.
 5. Reg. § 1.442-1(b)(1) (prior to amendment by T.D. 8996); Reg. § 1.442-1(b)(2), T.D. 8996.
 6. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 803(b), *codified in* I.R.C. § 441(h).
 7. Tax Reform Act of 1986, Pub. L. No. 99-514, § 806, *codified in* I.R.C. § 706(b).
 8. *See* I.R.C. § 1378.
 9. I.R.C. §§ 441(i), 644.
 10. *See generally* I.R.C. § 441(f).
 11. The guidance discussed in this column does not directly address Code Section 444.
 12. Reg. § 1.442-1(c) (prior to amendment by T.D. 8996).
 13. Rev. Proc. 66-13, 1966-1 C.B. 626, *superseded by* Rev. Proc. 76-9, 1976-1 C.B. 547, *modified by* Rev. Proc. 79-2, 1979-1 C.B. 482, *modified and superseded by* Rev. Proc. 85-58, 1985-2 C.B. 740; *see also* Rev. Proc. 76-10, 1976-1 C.B. 548, *modified by* Rev. Proc. 79-3, 1979-1 C.B. 483.
 14. Rev. Proc. 66-50, 1966-2 C.B. 1260, *modified by* Rev. Proc. 81-40, 1981-2 C.B. 604.
 15. Rev. Proc. 68-41, 1968-2 C.B. 943, *modified by* Rev. Proc. 81-40, 1981-2 C.B. 604.
 16. Rev. Proc. 84-34, 1984-1 C.B. 508, *modified and superseded by* Rev. Proc. 92-13, 1992-1 C.B. 665, *modified and amplified by* Rev. Proc. 92-13A, *further modified by* Rev. Proc. 94-12, 1994-1 C.B. 565, *modified, amplified, and superseded by* Rev. Proc. 2000-11, 2000-3 I.R.B. 309.
 17. 1987-2 C.B. 396.
 18. 2001-23 I.R.B. 1302.
 19. 2001-23 I.R.B. 1314.
 20. T.D. 8996, 2002-24 I.R.B. 1127.
 21. 2002-22 I.R.B. 1063.
 22. I.R.C. §§ 441(i), 1378.
 23. I.R.C. § 706(b)(4).
 24. Reg. § 1.706-1T(a) (withdrawn by T.D. 8996).
 25. I.R.C. §§ 441(i), 706(b)(1)(C), 1378(b).
 26. Reg. § 1.706-1T(a)(2).
 27. Reg. § 1.706-1(a)(3), T.D. 8996.
 28. I.R.C. § 706(b)(4)(B).
 29. T.D. 8996, Summary of Comments and Explanation of Revisions [Summary & Explanation], Part 3, 2002-24 I.R.B. 1127, 1130.
 30. Rev. Proc. 2002-38, § 4.01(5).
 31. Regs. §§ 1.442-1(b)(2), 1.1378-1(a) (allowing use of any taxable year "for which the corporation establishes a business purpose to the satisfaction of the Commissioner under section 442").
 32. Rev. Proc. 87-32, § 4.01(2), 1987-2 C.B. 396, 399.
 33. Rev. Proc. 2002-38, §§ 4.01(3), 5.06, 2002-22 I.R.B. 1037, 1040, 1042.
 34. Reg. § 1.442-1(b) (prior to amendment by T.D. 8996).
 35. I.R.C. § 706(b) (prior to amendment by Pub. L. No. 99-514, § 806(a)(1)).
 36. Reg. § 1.706-1(b)(4)(iii) (prior to amendment by T.D. 8996).
 37. Rev. Proc. 74-33, 1974-2 C.B. 489.
 38. Rev. Proc. 87-32, § 4.01(1), 1987-2 C.B. 396, 399.
 39. 1987-2 C.B. 117.
 40. Rev. Proc. 2002-39, § 5.03, 2002-22 I.R.B. 1046, 1051-52.
 41. Rev. Proc. 2002-37, § 4.01(3), 2002-22 I.R.B. 1030, 1032.
 42. Rev. Proc. 2002-38, § 4.01(2), 2002-22 I.R.B. 1037, 1040.
 43. Rev. Proc. 2002-37, § 6.05, 2002-22 I.R.B. 1030, 1035; Rev. Proc. 2002-38, § 6.05, 2002-22 I.R.B. 1037, 1042; Rev. Proc. 2002-39, § 5.04(4), 2002-22 I.R.B. 1046, 1052.
 44. *See, e.g.*, Rev. Rul. 87-57, 1987-2 C.B. 117.
 45. 2000-1 C.B. 309.
 46. Rev. Proc. 2002-39, § 5.02, 2002-22 I.R.B. 1046, 1051.
 47. Rev. Proc. 2002-39, § 5.05, 2002-22 I.R.B. 1046, 1053-54.
 48. I.R.C. § 441(f)(3)-(4).
 49. Reg. § 1.441-2(b)(1).
 50. Reg. § 1.441-2(b)(2).
 51. Reg. § 1.441-2(d), T.D. 8996; Reg. § 1.441-2T(d) (before withdrawal by T.D. 8996).
 52. Reg. § 1.441-2T(e) (before withdrawal by T.D. 8996).
 53. Reg. § 1.441-2(e)(1), T.D. 8996.
 54. *See* T.D. 8996, Summary & Explanation, part I.E, 2002-24 I.R.B. 1127, 1129.
 55. *Id.*, Part I.F, 2002-24 I.R.B. at 1129.
 56. *See* I.R.C. § 461(h)(4).
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