Part III. Administrative, Procedural, and Miscellaneous

Service-Initiated Accounting Method Changes

Notice 98-31

This notice provides a proposed revenue procedure that, when finalized, will provide the procedures under § 446(b) of the Internal Revenue Code and § 1.446-1(b) of the Income Tax Regulations for changes in method of accounting initiated by the Internal Revenue Service, and the procedures that the Service will use for accounting method issues raised and resolved by the Service on a nonaccounting-method-change basis.

As part of these procedures, the proposed revenue procedure describes the discretion the Service may exercise in resolving an accounting method issue as an accounting method change or on a nonaccounting-method-change basis. Except as otherwise provided in published guidance, the proposed revenue procedure requires Examination to resolve any timing issue as an accounting method change and to make the change in the earliest taxable year under examination with a § 481(a) adjustment and a 1-year § 481(a) adjustment period. The proposed revenue procedure does not alter the authority of Appeals or counsel for the government to resolve or settle any accounting method issues.

The Service intends to publish additional guidance making the Coordinated Examination Program (CEP) early referral process provided in Rev. Proc. 96-9, 1996-1 C.B. 575, available to non-CEP taxpayers for the resolution of accounting method issues. This will permit faster resolution of timing issues that non-CEP taxpayers want to refer to Appeals.

In addition, the Service intends to publish guidance that will delegate limited discretionary authority to Examination to resolve certain accounting method issues, allow taxpayers and the Service to resolve accounting method issues for taxable years beyond the years under examination, before Appeals, or before a federal court, and permit taxpayers under examination who otherwise cannot request certain voluntary changes in method of accounting from an impermissible method to request such changes without audit protection. The Service also intends to publish guidance that provides a model closing agreement for Service-initiated accounting method changes. This guidance will increase the number of accounting method issues that the Service may resolve earlier in the examination/appeals process, provide a more efficient use of Service and taxpayer resources, and facilitate greater uniformity in the Service's resolution of accounting method issues.

The Service welcomes comments on the proposed revenue procedure provided in this notice. Comments should be submitted by July 31, 1998, either to:

Internal Revenue Service
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:DOM:CORP:R (IT&A, Branch 7), Room 5228

or electronically via the Service internet site at:

http:/www.irs.ustreas.gov/prod/tax_regs/comments.html

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SECTION 1. PURPOSE

.01 In general. This revenue procedure provides the procedures under § 446(b) of the Internal Revenue Code and § 1.446-1(b) of the Income Tax Regulations for changes in method of accounting initiated by the Internal Revenue Service. This revenue procedure also provides the procedures that the Service will use for timing issues raised and resolved by the Service on a nonaccounting-method-change basis.

.02 Voluntary compliance. This revenue procedure provides terms and conditions for Service-initiated changes that are intended to encourage taxpayers to voluntarily request a change from an impermissible method of accounting prior to being contacted for examination. Under this approach, a taxpayer that is contacted for examination and required to change its method of accounting by the Service generally receives less favorable terms and conditions (for example, an earlier year of change and a shorter § 481(a) adjustment period for a positive adjustment) than if the taxpayer had filed its request to change before the taxpayer was contacted for examination. See Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 97-37, 1997-33 I.R.B. 18, which provide the procedures for voluntary requests to change an accounting method.

.03 Procedures for Examination, Appeals, and counsel for the government for resolving timing issues. This revenue procedure sets forth procedures for Examination, Appeals, and counsel for the government to resolve timing issues. It does not alter Examination's authority to examine the returns of a taxpayer. It provides parameters for Examination to resolve timing issues, but does not limit or expand Examination's authority to resolve any issues under Delegation Order No. 236, Application of Appeals Settlement to Coordinated Examination Program Taxpayers, or Delegation Order No. 247, Authority of Examination Case Managers to Accept Settlement Offers and Execute Closing Agreements on Industry Specialization Program and International Field Assistance Program Issues. This revenue procedure does not alter the authority of Appeals or counsel for the government to resolve or settle any issues.

SECTION 2. BACKGROUND

.01 Change in method of accounting defined.

(1) Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. See Rev. Proc. 91-31, 1991-1 C.B. 566.

(2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, it is not

necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax returns(s). See Rev. Rul. 90-38, 1990-1 C.B. 57.

(3) A change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another. For example, a change from treating an item as income to treating the item as a deposit is a change in method of accounting. See Rev. Proc. 91-31.

(4) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). See § 1.446-1(e)(2)(ii)(b).

.02 Method changes initiated by the Service.

(1) Section 446(b) and § 1.446-1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in the manner that, in the opinion of the Commissioner, does clearly reflect income.

(2) The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be

upheld unless it is clearly unlawful. _See_ _Thor Power Tool Co. v. Commissioner_, 439 U.S. 522 (1979); _RCA Corp. v. United States_, 664 F.2d 881 (2nd Cir. 1981), _cert_. _denied_, 457 U.S. 1133 (1982).

(3) The Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, and the Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. _See_ _Wilkinson-Beane, Inc. v. Commissioner_, 420 F.2d 352 (1st Cir. 1970); _Standard Paving Company v. Commissioner_, 190 F.2d 330 (10th Cir.), _cert_. _denied_, 342 U.S. 860 (1951).

(4) The Commissioner has the discretion to change a taxpayer's method of accounting even though the Commissioner previously changed the taxpayer to the method if the Commissioner determines that the method of accounting does not clearly reflect the taxpayer's income. The Commissioner is not precluded from correcting mistakes of law in determining a taxpayer's tax liability, including the power to retroactively correct rulings or other determinations on which the taxpayer may have relied. _See_ _Dixon v. United States_, 381 U.S. 68 (1965); _Automobile Club of Michigan v. Commissioner_, 353 U.S. 180 (1957); _Massaglia v. Commissioner_, 286 F.2d 258 (10th Cir. 1961).

(5) The Commissioner does not have discretion, however, to require a taxpayer to change from a method of accounting that

clearly reflects income to a method that, in the Commissioner's view, more clearly reflects income. See Capitol Federal Savings & Loan v. Commissioner, 96 T.C. 204 (1991); W.P. Garth v. Commissioner, 56 T.C. 610 (1971), acq., 1975-1 C.B. 1.

(6) The Commissioner may change the accounting method of a taxpayer that is under examination, before an appeals office, or before a federal court, except as otherwise provided in published guidance. See, for example, section 9 of Rev. Proc. 97-27, which generally precludes the Service from changing a taxpayer's method of accounting for an item for prior taxable years if the taxpayer timely files a Form 3115 pursuant to Rev. Proc. 97-27 requesting to change its method of accounting for the item.

.03 No right to retroactive method change. Although the Commissioner is authorized to consent to a retroactive accounting method change, a taxpayer does not have a right to a retroactive change, regardless of whether the change is from a permissible or impermissible method. See generally, Rev. Rul. 90-38.

.04 Service ordinarily will not initiate a taxpayer favorable method change. Consistent with the policy of encouraging prompt voluntary compliance with proper tax accounting principles, the Service ordinarily will not initiate an accounting method change if the change will place the taxpayer in a position more favorable than the taxpayer's position would have been had the taxpayer not been contacted for examination. For example, an examining agent ordinarily will not initiate a change from an impermissible method that results in a negative § 481(a) adjustment. If the Service declines to initiate such an accounting method change, the district director will consent to the taxpayer requesting a voluntary change under Rev. Proc. 97-27. See section 6.01(4) of Rev. Proc. 97-27.

.05 Method change with a § 481(a) adjustment.

(1) Need for adjustment. Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Example. A taxpayer, although not permitted to use the cash receipts and disbursements method of accounting by § 448, uses the overall cash method and changes to an overall accrual method. The taxpayer has $120,000 of income earned but not yet received (accounts receivable) and $100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change. A positive § 481(a) adjustment of $20,000 ($120,000 accounts receivable less $100,000 accounts payable) is required as a result of the change.

(2) Adjustments attributable to pre-1954 years. Section 481(a)(2) and § 1.481-3 provide that if the adjustments required by § 481(a) are attributable to a change in method of accounting not initiated by the taxpayer, no portion of any

adjustments which is attributable to pre-1954 taxable years is taken into account in computing taxable income.

(3) Adjustment period. Section 481(c) and §§ 1.446-1(e)(3)(i) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the § 481(a) adjustment is taken into account completely in the year of change, subject to § 481(b) which limits the amount of tax where the adjustment is substantial.

.06 Method change using a cut-off method. The Commissioner may determine that certain changes in method of accounting will be made without a § 481(a) adjustment, using a "cut-off method." Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.07 Previous method change without consent. The Commissioner may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. The Commissioner may do so even when the taxpayer changed from an impermissible to a permissible method. The change back to the former method may be made in the taxable year the taxpayer changed without consent, or if that year is closed by the running of the period of limitations, in the earliest open year. See Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961); Handy Andy T.V. and Appliances, Inc., T.C. Memo. 1983-713.

.08 Penalties. Any otherwise applicable penalty for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under § 6662 or the fraud penalty under § 6663) may be imposed if the Service initiates an accounting method change. See § 446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under § 6694.

SECTION 3. DEFINITIONS

.01 Timing issue. The term "timing issue" means any issue regarding the propriety of a taxpayer's method of accounting for an item. See the definition of change in method of accounting in § 1.446-1(e)(2)(ii)(a) and section 2.01 of this revenue procedure.

.02 Year of change. The year of change is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is used, even if no affected items are taken into account for that year. The year of change is also the first taxable year for complying with all the terms and conditions accompanying the change.

.03 Section 481(a) adjustment period. The § 481(a) adjustment period is the applicable number of taxable years for taking into account the § 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the § 481(a) adjustment is taken into account ratably over the number of taxable years in the adjustment period.

SECTION 4. SCOPE

Except as otherwise provided in published guidance, this revenue procedure applies to any accounting method change initiated by the Service, and to any timing issue raised and resolved by the Service on a nonaccounting-method-change basis.

SECTION 5. EXAMINATION DISCRETION TO RESOLVE TIMING ISSUES

.01 In general. Except as otherwise provided in published guidance (for example, Delegation Order No. 236), the discretion of an examining agent to resolve a timing issue is set forth in sections 5.02 through 5.05 of this revenue procedure. See section 10.01 of this revenue procedure for an example of the application of section 5 of this revenue procedure.

.02 Requirement to treat a timing issue as a method change. An examining agent proposing an adjustment with respect to a timing issue will treat the issue as a change in method of accounting.

.03 Requirement to apply the law to the facts. An examining agent changing a taxpayer's method of accounting will properly apply the law to the facts without taking into account the hazards of litigation when determining the new method of accounting.

.04 Requirement to impose a § 481(a) adjustment. An examining agent changing a taxpayer's method of accounting will impose a § 481(a) adjustment. The change may be made using a cut-off method only in rare and unusual circumstances when the examining agent determines that the taxpayer's books and records do not contain sufficient information to compute the adjustment and the adjustment is not susceptible to reasonable estimation.

.05 Terms and conditions of change. An examining agent changing a taxpayer's method of accounting will effect the change in the earliest taxable year under examination (or, if later, the first taxable year the method is considered impermissible) with a one-year § 481(a) adjustment period, subject to the computation of tax under § 481(b) (if applicable).

SECTION 6. APPEALS AND COUNSEL FOR THE GOVERNMENT DISCRETION TO RESOLVE TIMING ISSUES

.01 Authority to resolve timing issues. An appeals officer or counsel for the government may resolve a timing issue when it is in the interest of the government to do so.

.02 Types of resolutions.

(1) In general. An appeals officer or counsel for the government, to reflect the hazards of litigation, may resolve a timing issue by changing the taxpayer's method of accounting using compromise terms and conditions, or on a nonaccounting-method-change basis using either an alternative-timing or a time-value-of-money resolution. See sections 10.02 through 10.04 of

this revenue procedure for examples of the application of section 6 of this revenue procedure.

(2) Accounting method change with compromise terms and conditions.

(a) Treating a timing issue as a method change. An appeals officer or counsel for the government resolving a timing issue may treat the issue as a change in method of accounting.

(b) Requirement to apply the law to the facts. An appeals officer or counsel for the government changing a taxpayer’s method of accounting will properly apply the law to the facts without taking into account the hazards of litigation when determining the new method of accounting.

(c) Using a § 481(a) adjustment or a cut-off method. An appeals officer or counsel for the government changing a taxpayer's method of accounting may make the change using a § 481(a) adjustment or a cut-off method.

(d) Terms and conditions of change.

(i) In general. An appeals officer or counsel for the government changing a taxpayer's method of accounting may agree to terms and conditions that differ from those applicable to an Examination-initiated accounting method change. The appeals officer or counsel for the government may compromise the year of change (for example, by agreeing to a later year of change), the amount of the § 481(a) adjustment (for example, by agreeing to a reduced § 481(a) adjustment), or the § 481(a) adjustment period (for example, by agreeing to a longer § 481(a) adjustment period). If an appeals officer or counsel for the government agrees to compromise the amount of the § 481(a) adjustment, the agreement must be in writing.

(ii) Limitation on year of change. An appeals officer or counsel for the government changing a taxpayer's method of accounting ordinarily will not defer the year of change to later than the most recent taxable year under examination on the date of the agreement finalizing the change, and, in no event, will defer the year of change to later than the taxable year that includes the date of the agreement finalizing the change.

(3) Alternative timing. An appeals officer or counsel for the government may resolve a timing issue by not changing the taxpayer's method of accounting, and by the Service and the taxpayer agreeing to alternative timing for all or some of the items arising during, or prior to and during, the taxable years before Appeals or a federal court. The resolution of a timing issue on an alternative-timing basis for certain items will not affect the taxpayer's method of accounting for any items not covered by the resolution. For example, the Service and the taxpayer may agree that the taxpayer will capitalize the inventoriable costs incurred during 1995 that were deducted under the taxpayer's method of accounting. The taxpayer's inventoriable costs covered by the agreement must be capitalized and accounted for under the taxpayer's inventory method. The

inventoriable costs that are not covered by the agreement (that is, those costs incurred in taxable years prior and subsequent to 1995) are not affected by the resolution and thus, consistent with the taxpayer's method of accounting, must continue to be deducted.

(4) Time-value of money.

(a) In general. An appeals officer or counsel for the government may resolve a timing issue by not changing the taxpayer's method of accounting, and by the Service and the taxpayer agreeing that the taxpayer will pay the government a "specified amount" that approximates the time-value-of-money benefit the taxpayer has derived from using its method of accounting for the taxable years before appeals or a federal court (instead of the method of accounting determined by the appeals officer or counsel for the government to be the proper method of accounting), reduced by an appropriate factor to reflect the hazards of litigation. The specified amount is not interest under § 163(a), and may not be deducted or capitalized under any provision of the Code.

(b) Computation of specified amount.

(i) In general. An appeals officer or counsel for the government may use any reasonable manner to compute the specified amount, including the sample computation described in section 6.02(4)(b)(ii) of this revenue procedure.

(ii) Sample computation. Under the sample computation, the specified amount equals the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year before Appeals or a federal court. However, if the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year is negative, the specified amount will be zero and no refund will be made to the taxpayer. The time-value-of- money benefit (detriment) with respect to each taxable year before Appeals or a federal court equals the "hypothetical underpayment (overpayment)" (as defined in section 6.02(4)(b)(ii)(A) of this revenue procedure), multiplied by the "applicable time-value rate" (as defined in section 6.02(4)(b)(ii)(B) of this revenue procedure), compounded daily for the "applicable period" (as defined in section 6.02(4)(b)(ii)(C) of this revenue procedure).

(A) <u>Hypothetical underpayment (overpayment)</u>. The hypothetical underpayment (overpayment) for each taxable year before Appeals or a federal court is equal to the net increase or decrease in taxable income (including the § 481(a) adjustment) that would have been reflected on the return for the taxable year if the Service had changed the taxpayer's method of accounting (in the earliest taxable year before Appeals or a federal court, or, if later, the first taxable year the method is considered impermissible), multiplied by the applicable tax rate for the taxable year of the underpayment (overpayment). For this purpose, only adjustments associated with the change are taken into account. The applicable tax rate is the highest rate of income tax applicable to the taxpayer (for example, the highest rate in effect under section 1 for individuals or section 11 for corporations).

(B) Applicable time-value rate. The applicable time-value rate generally equals an average of the quarterly underpayment rates in effect under § 6621(a) for the applicable period. However, for a taxpayer that would be entitled to a deduction under § 163(a) for the specified amount if the specified amount were treated as interest arising from the underpayment of tax, the applicable time-value rate is computed at a reduced rate equaling an average of the quarterly underpayment rates in effect under § 6621(a) for the applicable period, multiplied by the excess of 100% over the applicable tax rate for the taxable year of the underpayment (overpayment).

(C) Applicable period. The applicable period begins on the due date (without regard to extensions) of the return for the taxable year of the underpayment (overpayment) and ends on the date on which the specified amount is paid.

SECTION 7. PROCEDURES FOR A SERVICE-INITIATED ACCOUNTING METHOD CHANGE

.01 Requirement to notify of treatment as method change.

(1) In general. An examining agent, appeals officer, or counsel for the government changing a taxpayer's method of accounting will provide notice that a timing issue is being treated as an accounting method change.

(2) Form of notice. The notice must be in writing. If the taxpayer and the Service execute a closing agreement

finalizing the change, the notice will be provided in the closing agreement. If the taxpayer and the Service do not execute a closing agreement, the notice ordinarily will be provided in the examiner's report or the Form 870AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and of Acceptance of Overpayment). However, the Service may also provide the notice in a preliminary notice of deficiency, a statutory notice of deficiency, a notice of claim disallowance, a notice of final administrative adjustment, a pleading (for example, a petition, complaint, or answer) or amendment thereto, or in any other similar writing provided to the taxpayer.

(3) Content of notice. The notice must include (a) a statement that the timing issue is being treated as an accounting method change or a clearly labeled § 481(a) adjustment, and (b) a description of the new method of accounting.

(4) Method not established without notice. The resolution of a timing issue will not establish a new method of accounting if the Service does not provide the notice required by section 7.01 of this revenue procedure. See section 9 of this revenue procedure for the procedures applicable if the Service does not provide this notice.

.02 Finalizing a Service-initiated method change.

(1) In general. To finalize a Service-initiated accounting method change, the taxpayer and the Service must execute a closing agreement under § 7121 in which the taxpayer agrees to the change and the terms and conditions of the

change. In the absence of such an agreement, a Service-initiated accounting method change is final only upon the expiration of the period of limitations for filing a claim for refund under § 6511 for the year of change or the date of a final court order requiring the change.

(2) Content of closing agreement. A closing agreement finalizing a Service-initiated accounting method change must comply with the requirements of Rev. Proc. 68-16, 1968-1 C.B. 770, and must include a statement setting forth:

(a) the name, address, telephone number, and taxpayer identification number of any taxpayer included in the agreement;

(b) the timing issue(s) covered by the agreement;

(c) the taxable years covered by the agreement;

(d) the facts and representations upon which the taxpayer and the Service relied in reaching the agreement;

(e) the taxpayer's current method of accounting;

(f) the notification required by section 7.01 of this revenue procedure;

(g) the year of change;

(h) the § 481(a) adjustment and the § 481(a) adjustment period, or that a cut-off method is being used;

(i) any computations under § 481(b);

(j) the adjustments to taxable income necessary to reflect the new method (including the § 481(a) adjustment required as a result of the change), and any collateral adjustments to taxable income or tax liability resulting from the change for each of the taxable years covered by the agreement;

(k) the taxable years that are covered by the audit protection provided in section 7.04(3) of this revenue procedure;

(l) if appropriate, a condition requiring the taxpayer to file amended returns to reflect the change for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement; and

(m) any other appropriate conditions for implementing the closing agreement, including any requirements for waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax overpayment.

.03 Implementing a Service-initiated method change.

(1) Years before the Service. The Service will make the adjustments necessary to effect a Service-initiated accounting method change to the taxpayer's returns for the taxable years under examination, before Appeals, or before a federal court. These adjustments include the adjustments to taxable income necessary to reflect the new method (including the § 481(a) adjustment required as a result of the change), and any collateral adjustments to taxable income or tax liability resulting from the change.

(2) Succeeding years for which returns have been filed. If a Service-initiated accounting method change is finalized by a closing agreement, the Service may require the taxpayer to file amended returns to reflect the change for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement. The amended returns must include the adjustments to taxable income and any collateral adjustments to taxable income or tax liability resulting from the change necessary to reflect the new method. The Service may require that the amended returns be filed prior to execution of the closing agreement finalizing the change. If the Service does not require the amended returns, the taxpayer should file such amended returns. If the Service does not require the amended returns and the taxpayer does not file the amended returns, the Service will make the adjustments necessary to reflect the change for affected succeeding taxable years when it examines the returns for those years. A taxpayer that files an amended return using the new method prior to the date a Service-initiated change becomes final must continue to use the new method on all subsequent returns, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. See Rev. Rul. 90-38.

(3) Future years. The taxpayer must use the new method of accounting on all returns filed after the date that a Service-initiated accounting method change becomes final (see section

7.02 of this revenue procedure), unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. A taxpayer that files a return using the new method prior to the date a Service-initiated change becomes final must continue to use the new method on all subsequent returns, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. If the taxpayer does not use the new method on any return filed prior to the date a Service-initiated change becomes final, and does not file amended returns to reflect the change, the Service will make the adjustments necessary to reflect the change for the affected taxable years when it examines those returns.

.04 Effect of final Service-initiated method change.

(1) New method established. A Service-initiated change that is final establishes a new method of accounting within the meaning of § 446(e) and § 1.446-1(e). As a result, the taxpayer is required to use the new method of accounting for the year of change and for all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination.

(2) Subsequent examination. Except as provided in section 7.04(3) of this revenue procedure, the Service is not precluded from changing the taxpayer from the new method of

accounting if the Service determines that the new method does not clearly reflect the taxpayer's income.

(3) Audit protection.

(a) In general. A taxpayer that executes a closing agreement finalizing a Service-initiated accounting method change will not be required to change or modify the new method for any taxable year for which a federal income tax return has been filed as of the date of the closing agreement, provided that:

(i) the taxpayer has complied with all the applicable provisions of the closing agreement;

(ii) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact;

(iii) there has been no change in the material facts on which the closing agreement was based; and

(iv) there has been no change in the applicable law on which the closing agreement was based.

(b) Limitations. The Service may require the taxpayer to change or modify the new method in the earliest open taxable year if the taxpayer fails to comply with the applicable provisions of the closing agreement or upon a showing of the taxpayer's fraud, malfeasance, or misrepresentation of a material fact. The Service may require the taxpayer to change or modify the new method in the earliest open taxable year in which the material facts have changed. The Service may also require the taxpayer to change or modify the new method in the earliest open taxable year in which the applicable law has changed. For this purpose, a change in the applicable law includes: (i) the enactment of legislation; (ii) a decision of the United States Supreme Court; (iii) the issuance of temporary or final regulations; or (iv) the issuance of a revenue ruling, revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin. Except in rare and unusual circumstances, a retroactive change in applicable law is deemed to occur when one of the events described in the preceding sentence occurs and not when the change in law is effective.

.05 Coordination with Examination. An appeals officer or counsel for the government changing a taxpayer's method of accounting will coordinate the resolution with Examination if the appeals officer or counsel for the government proposes to defer the year of change to any taxable year not before appeals or a federal court. Examination will advise the appeals officer or counsel for the government of any changes in material fact in any taxable year under examination and may comment on the proposed resolution, but the approval of the resolution by Examination is not required.

.06 Deemed cut-off method. If the Service does not impose a § 481(a) adjustment but otherwise provides the notice required by section 7.01 of this revenue procedure, the Service-initiated change will be treated as being made using a cut-off method, unless the Service and the taxpayer specifically have agreed in writing to compromise the amount of the § 481(a) adjustment.

SECTION 8. PROCEDURES FOR RESOLVING TIMING ISSUES ON A NONACCOUNTING-METHOD-CHANGE BASIS

.01 Closing agreement required. To resolve a timing issue raised by the Service on a nonaccounting-method-change basis, the Service and the taxpayer will execute a closing agreement under § 7121. If the timing issue is being resolved on an alternative-timing basis as described in section 6.02(3) of this revenue procedure, the taxpayer must agree to pay the government any taxes and interest due as a result of the resolution. If the timing issue is being resolved on a time-value-of-money basis as described in section 6.02(4) of this revenue procedure, the taxpayer must agree to pay the government the specified amount as a result of the resolution. See section 9 of this revenue procedure for the procedures applicable if a closing agreement is not executed as required by section 8.01 of this revenue procedure.

.02 Content of closing agreement. A closing agreement finalizing the resolution of a timing issue on a nonaccounting-method-change basis must comply with the requirements of Rev. Proc. 68-16, and must include a statement setting forth:

(1) the name, address, telephone number, and taxpayer identification number of any taxpayer included in the agreement;

(2) the timing issue(s) covered by the agreement;

(3) the facts and representations upon which the taxpayer and the Service relied in reaching the agreement;

(4) that the Service is not changing the taxpayer's

method of accounting;

(5) if the timing issue is being resolved on an alternative- timing basis as described in section 6.02(3) of this revenue procedure:

(a) the items covered by the closing agreement and the manner in which the items are to be accounted for in any affected taxable year;

(b) that any items not covered by the closing agreement are not affected by the closing agreement;

(c) that the Service is not precluded from changing the taxpayer’s method of accounting in any open taxable year for the items not covered by the closing agreement;

(d) that if the taxpayer’s method of accounting is changed (voluntarily or involuntarily) in a subsequent taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change, except those items covered by the closing agreement (that is, those items for which the closing agreement specifically provides the manner in which the items are to be accounted for); and

(e) if appropriate, a condition requiring the taxpayer to file amended returns to reflect the alternative-timing resolution for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement;

(6) if the timing issue is being resolved on a time-value-of-money basis as described in section 6.02(4) of this

revenue procedure:

(a) the taxable years covered by the agreement;

(b) the computation of the specified amount as provided in section 6.02(4)(b) of this revenue procedure;

(c) that the specified amount is not interest under § 163(a) and may not be deducted or capitalized under any provision of the Code;

(d) that the Service is not precluded from changing the taxpayer's method of accounting in any open taxable year not covered by the closing agreement;

(e) that if the taxpayer's method of accounting is changed (voluntarily or involuntarily) in a subsequent taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change; and

(f) that if the Service changes the taxpayer's method of accounting in a subsequent taxable year and imposes a § 481(a) adjustment, the interest that is assessed on any underpayment or the interest that is due on any overpayment for the year of change will be treated as paid to the extent necessary to prevent the duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment; and

(7) any other appropriate conditions for implementing the closing agreement, including any requirements for waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax

overpayment.

.03 Implementing resolution of a timing issue on a nonaccounting-method-change basis.

(1) Resolution on an alternative-timing basis.

(a) Years before the Service. The Service will make the adjustments necessary to effect an alternative-timing resolution for the taxable years before appeals or before a federal court. These adjustments include the adjustments to taxable income necessary to reflect the resolution and any collateral adjustments to taxable income or tax liability resulting from the resolution.

(b) Succeeding years for which returns have been filed. The Service may require the taxpayer to file amended returns to reflect an alternative-timing resolution for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement. The amended returns must include the adjustments to taxable income and any collateral adjustments to taxable income or tax liability resulting from the resolution necessary to reflect the resolution. The Service may require that the amended returns be filed prior to execution of the closing agreement finalizing the resolution. If the Service does not require the amended returns, the taxpayer should file such amended returns. If the Service does not require amended returns and the taxpayer does not file amended returns, the Service will make the adjustments necessary to reflect the resolution for affected succeeding taxable years when it examines the returns for those years.

(c) Future years. The taxpayer must reflect the alternative-timing resolution on the returns for any affected succeeding taxable years for which a return has not been filed as of the date of the closing agreement. The taxpayer must continue to file its returns on its current method of accounting for all items not covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

(2) Resolution on a time-value-of-money basis. The taxpayer must pay the specified amount required by the time-value-of-money resolution. The Service will not change or otherwise propose adjustments to taxable income with respect to the taxpayer’s method of accounting for the taxable years covered by the closing agreement. The taxpayer must continue to file its returns on its current method of accounting, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

.04 Effect of resolving a timing issue on a nonaccounting-method-change basis.

(1) No change in method. If the Service resolves a timing issue on a nonaccounting-method-change basis, the resolution does not constitute a change in method of accounting. If the timing issue is resolved on an alternative-timing basis,

the taxpayer is required to use its current method of accounting for all items not covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination. If the timing issue is resolved on a time-value-of-money basis, the taxpayer is required to continue to use its current method of accounting on all returns for taxable years subsequent to the years covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

(2) Subsequent change.

(a) Resolution on an alternative-timing basis. If a timing issue is resolved on an alternative-timing basis, the Service is not precluded from changing the taxpayer’s method of accounting in any open taxable year for any item not covered by the closing agreement.

(b) Resolution on a time-value-of-money basis. If a timing issue is resolved on a time-value-of-money basis, the Service is not precluded from changing the taxpayer’s method of accounting in any open taxable year not covered by the closing agreement.

(3) Effect of subsequent change.

(a) Resolution on an alternative-timing basis. If a timing issue is resolved on an alternative-timing basis and the taxpayer’s method of accounting is changed (voluntarily or involuntarily) in a subsequent taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change, except those items covered by the closing agreement (that is, those items for which the closing agreement specifically provides the manner in which the items are to be accounted for).

(b) Resolution on a time-value-of-money basis. If a timing issue is resolved on a time-value-of-money basis and the taxpayer's method of accounting is changed (voluntarily or involuntarily) in a subsequent taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change. If the Service changes the taxpayer's method of accounting in a subsequent taxable year and imposes a § 481(a) adjustment, the interest that is assessed on any underpayment or the interest that is due on any overpayment for the year of change will be treated as paid to the extent necessary to prevent the duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment.

SECTION 9. DEFAULT PROCEDURES

.01 In general. Section 9 of this revenue procedure applies to the resolution of any timing issue unless the Service provides the notice required by section 7.01 of this revenue procedure, or the Service resolves the timing issue on a nonaccounting-method-change basis and the Service and the taxpayer execute a closing agreement as required by section 8.01 of this revenue procedure.

See section 10.05 of this revenue procedure for an example of the application of section 9 of this revenue procedure.

.02 Effect of adjustments. For timing issues resolved under section 9 of this revenue procedure:

(1) No omission or duplication. The Service and the taxpayer are required to treat all items in a manner that prevents the duplication or omission of items of income or deduction;

(2) No change in method. The resolution does not constitute a change in method of accounting. The taxpayer is required to continue to use its current method of accounting for all items not affected by the adjustments made by the Service, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination;

(3) Subsequent change. The Service is not precluded from changing the taxpayer’s method of accounting in any open taxable year; and

(4) Effect of subsequent change. If the taxpayer’s method of accounting is changed (voluntarily or involuntarily) in a subsequent taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change (including the items affected by the adjustment made by the Service).

SECTION 10. EXAMPLES

.01 Examination-initiated change.

(1) Facts. A taxpayer that is a corporation deducted certain costs that, as a matter of law, should have been capitalized as part of the cost of a nondepreciable asset that was acquired in 1994. The taxpayer incurred and deducted $1,000,000 of the costs in 1994, $2,000,000 in each of 1995 and 1996, and $5,000,000 in each of 1997 and 1998. The taxpayer is examined for the 1995 and 1996 taxable years (1995 is the earliest open year) and the examining agent discovers the taxpayer's impermissible method of accounting.

(2) Effect. Under section 5 of this revenue procedure, the examining agent is required to properly apply the law to the facts and change the taxpayer to the capitalization method of accounting for the costs for 1995. The examining agent will provide the notice required by section 7.01 of this revenue procedure. The examining agent will impose a § 481(a) adjustment of $1,000,000 (representing the $1,000,000 of the costs deducted in 1994) the entire amount of which will be taken into account in computing taxable income in 1995. The examining agent will also disallow the deductions of $2,000,000 in each of 1995 and 1996. The taxpayer's basis in the property as of the end of 1996 is increased by $5,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The method change (once final) is effective for 1995. Thus, the taxpayer is required to capitalize

the costs in 1995 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.02 Appeals resolution of timing issue as a method change with compromise terms and conditions.

(1) Facts. The facts are the same as in section 10.01 of this revenue procedure, except that the issue of whether the costs should be capitalized is referred to Appeals. The appeals officer believes there is substantial merit to the Service's position that the costs must be capitalized as a matter of law, but believes there are hazards of litigation. The appeals officer and the taxpayer agree to resolve the timing issue by changing the taxpayer's method of accounting for the costs, but with compromise terms and conditions to reflect the hazards of litigation.

(2) Effect. Under section 6.02 of this revenue procedure, when the appeals officer changes the taxpayer's method of accounting, the appeals officer is required to properly apply the law to the facts and change the taxpayer to the capitalization method of accounting for the costs. The appeals officer will provide the notice required by section 7.01 of this revenue procedure.

The appeals officer may make the change using the cut-off method. If the appeals officer makes the change in 1995 using the cut-off method, the appeals officer will disallow the deductions of $2,000,000 in each of 1995 and 1996. The taxpayer’s basis in the property as of the end of 1996 will be increased by $4,000,000 (representing the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The method change (once final) is effective for 1995. Thus, the taxpayer is required to capitalize the costs in 1995 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Alternatively, the appeals officer may compromise the amount of the § 481(a) adjustment. If the appeals officer makes the change in 1995 and agrees to reduce the § 481(a) adjustment by 25%, the appeals officer will impose a § 481(a) adjustment of $750,000 (representing 75% of the amount of the costs deducted in 1994), the entire amount of which will be taken into account in computing taxable income in 1995. The appeals officer will disallow the deductions of $2,000,000 in each of 1995 and 1996. The taxpayer's basis in the property as of the end of 1996 will be increased by $5,000,000 (representing the unreduced § 481(a) adjustment of $1,000,000 and the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The method change (once final) is effective for 1995. Thus, the taxpayer is required to capitalize the costs in 1995 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

As another alternative, the appeals officer may compromise the year of change and/or the § 481(a) adjustment period. For example, the appeals officer may agree to make the change in 1996 with a two-year § 481(a) adjustment period. The appeals officer will impose a § 481(a) adjustment of $3,000,000 (representing the $1,000,000 of costs deducted in 1994 and the $2,000,000 of costs deducted in 1995) one-half of which will be taken into account in computing taxable income in each of 1996 and 1997. The appeals officer will disallow the deduction of $2,000,000 in 1996. The taxpayer's basis in the property as of the end of 1996 will be increased by $5,000,000 (representing the $3,000,000 § 481(a) adjustment and the disallowance of the $2,000,000 of deductions in 1996). The method change (once final) is effective for 1996. Thus, the taxpayer is required to capitalize the costs in 1996 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.03 Appeals resolution of timing issue on an alternative-timing basis.

(1) Facts. The facts are the same as in section 10.02 of this revenue procedure, except that the appeals officer and the taxpayer agree to resolve the issue on an alternative-timing basis as described in section 6.02(3) of this revenue procedure and they enter into a closing agreement as required by section 8.01 of this revenue procedure. The timing issue is resolved by providing in the closing agreement that the taxpayer will deduct

50% of the costs incurred in 1995 and 1996 and capitalize the other 50% of the costs incurred in those years.

(2) Effect. The appeals officer will disallow $1,000,000 of the deductions in each of 1995 and 1996. The taxpayer’s basis in the property as of the end of 1996 is increased by $2,000,000 (representing the disallowance of the $1,000,000 of deductions in each of 1995 and 1996). The taxpayer’s current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs not covered by the closing agreement (that is, the costs incurred in 1994 and the costs incurred in 1997 and all subsequent taxable years), unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer’s method in 1997, the Service will compute a § 481(a) adjustment of $1,000,000 (including the amount of the costs deducted in 1994 which are not covered by the closing agreement and excluding the amount of the costs deducted in 1995 and 1996 because the costs are covered by the closing agreement). The Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer's basis in the property as of the end of 1997 will be increased by an additional $6,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent

taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Alternatively, the timing issue may be resolved by providing in the closing agreement that the taxpayer will capitalize $1,000,000 of the costs incurred in each of 1995 and 1996 (when the closing agreement is silent as to the manner in which the other $1,000,000 of costs incurred in each of 1995 and 1996 are to be accounted for). The results for 1995 and 1996 will be the same as under the closing agreement in the original facts described in section 10.03(1) of this revenue procedure. That is, the appeals officer will disallow $1,000,000 of the deduction in each of 1995 and 1996. The taxpayer's basis in the property as of the end of 1996 is increased by $2,000,000 (representing the disallowance of the $1,000,000 of deductions in each of 1995 and 1996). Because the taxpayer's current method of accounting for the costs is not changed, the taxpayer is required to continue to deduct the costs not covered by the closing agreement (that is, the costs incurred in 1994, the remaining $1,000,000 of costs incurred in each of 1995 and 1996, and the costs incurred in 1997 and all subsequent taxable years). However, if the Service changes the taxpayer's method in 1997, the Service will compute a § 481(a) adjustment of $3,000,000 (including the $1,000,000 of the costs deducted in 1994, and the remaining $2,000,000 of the costs deducted in 1995 and 1996 because the costs are not items covered by the closing agreement). The

Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer’s basis in the property as of the end of 1997 will be increased by an additional $8,000,000 (representing the $3,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Assuming, in the alternative, that the timing issue is resolved by providing in the closing agreement that, for the costs incurred in 1994 through 1996, the taxpayer will deduct 50% of the costs and capitalize the other 50% of the costs, and will increase taxable income by $500,000 in 1995 (representing the disallowance of $500,000 of costs in 1994). The appeals officer will disallow $1,000,000 of the deductions in each of 1995 and 1996. The taxpayer's basis in the property as of the end of 1996 is increased by $2,500,000 (representing the disallowance of the $500,000 of deductions in 1994 and the $1,000,000 of deductions in each of 1995 and 1996). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs not covered by the closing agreement (that is, the costs incurred in 1997 and all subsequent taxable years), unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer’s method in 1997, the Service will compute a § 481(a) adjustment of $0 (excluding the amount of the costs deducted in 1994 through 1996 because the manner in which the costs are to be accounted for is specifically covered by the closing agreement). The Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer's basis in the property as of the end of 1997 will be increased by an additional $5,000,000 (representing the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.04 Appeals resolution of timing issue on time-value-of-money basis.

(1) Facts. The facts are the same as section 10.02 of this revenue procedure, except that the appeals officer and the taxpayer agree to settle the issue on a time-value-of-money basis as described in section 6.02(4) of this revenue procedure. The taxpayer files its return on a calendar year basis. The appeals officer believes that an appropriate factor to reflect the hazards of litigation is 25%. The taxpayer pays the specified amount on May 15, 1998. The highest marginal tax rate applicable to the taxpayer for 1995 and 1996 is 35% and the quarterly large

corporation underpayment rates in effect for January 1, 1996 through June 30, 1998 are: 11%, 10%, 11%, 11%, 11%, 11%, 11%, 11%, 11%, 10%. The specified amount under section 6.02(4) of this revenue procedure would by deductible under § 163(a) by the taxpayer if it were treated as interest expense arising from an underpayment of tax.

(2) Computation of specified amount. The hypothetical underpayment of tax for 1995 is $1,050,000, computed as follows: the net increase in taxable income of $3,000,000 (representing the § 481(a) adjustment of $1,000,000 and the disallowance of the deduction of $2,000,000 computed as if Examination had changed the taxpayer's method in 1995) multiplied by the applicable tax rate of 35%. The hypothetical underpayment of tax for 1996 is $700,000, computed as follows: the net increase in taxable income of $2,000,000 (representing the disallowance of the deduction of $2,000,000 computed as if Examination had changed the taxpayer's method in 1995) multiplied by the applicable tax rate of 35%.

The applicable time-value rate for 1995 is 7.02%, which is computed as follows: The applicable period for 1995 is March 15, 1996 (the due date of the return) to May 15, 1998 (the date the specified amount is paid). The underpayment rates in effect for the applicable period are 11%, 10%, 11%, 11%, 11%, 11%, 11%, 11%, 11%, and 10%. The average underpayment rate in effect for the applicable period is 10.8% [(11+10+11+11+11+11+11+11+11+10)/10]. The applicable after-tax time-value rate is 7.02%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [10.8% * (1-.35)].

The applicable time-value rate for 1996 is 7.04%, which is computed as follows: The applicable period for 1996 is March 15, 1997 (the due date of the return) to May 15, 1998 (the date the specified amount is paid). The underpayment rates in effect for the applicable period are 11%, 11%, 11%, 11%, 11%, and 10%. The average underpayment rate in effect for the applicable period is 10.83% [(11+11+11+11+11+10)/6]. The applicable after-tax time-value rate is 7.04%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [10.83% * (1-.35)].

The time-value-of-money benefit for each taxable year is computed by using the following formula:

$$U * \{[1+(r/365)]^{n}-1\}$$

where U = hypothetical underpayment for the taxable year

r = the applicable time-value rate

n = the number of days in the applicable period

The time-value-of-money benefit for 1995 is $172,512, computed as follows: $\$1,050,000 * \{[1+(.0702/365)]^{791}-1\}$. The time-value-of-money benefit for 1996 is $59,939, computed as follows: $\$700,000 * \{[1+(.0704/365)]^{426}-1\}$.

The specified amount is the sum of the time-value-of-money benefit for 1995 and 1996 reduced by 25% to reflect the hazards of litigation. The specified amount is $174,338 computed as follows: ($172,512+$59,939)*(1-.25).

(3) Effect. The Service will not propose any adjustments to taxable income with respect to the taxpayer’s method of accounting for the costs for 1995 and 1996. The taxpayer’s basis in the property as of the end of 1996 is not changed. The taxpayer’s current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1997, the Service will compute a § 481(a) adjustment of $5,000,000 (representing the $1,000,000 of the costs deducted in 1994 and the $2,000,000 of costs deducted in each of 1995 and 1996). The Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer's basis in the property as of the end of 1997 will be increased by $10,000,000 (representing the $5,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

The interest on the taxpayer's deficiency (which reflects the inclusion of the $5,000,000 § 481(a) adjustment in taxable income) for 1997 is $100,000. A portion of the $100,000 of interest will be treated as paid to the extent necessary to prevent duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment. The interest on the deficiency for 1997 includes the time-value-of-money benefit attributable to the § 481(a) adjustment for the period March 15, 1998, through the date of payment of the deficiency. The taxpayer previously paid the Service the time-value-of-money benefit attributable to $3,000,000 of the § 481(a) adjustment for the period March 15, 1996, through May 15, 1998, and $2,000,000 of the § 481(a) adjustment for the period March 15, 1997 through May 15, 1998. The interest on the deficiency for 1997 attributable to the overlap period of March 15, 1998, through May 15, 1998, is $20,073, computed as follows:

$$A * t * \{[1+(r/365)]^{n}-1\}$$

where A = the § 481(a) adjustment

t = highest marginal tax rate applicable to the taxpayer

r = the applicable time-value rate (computed for the overlap period)

n = the number of days in the overlap period

$$\$5,000,000 * .35 * \{[1+(.06825/365)]^{61}-1\}$$

The $15,055 is reduced by 25% (the factor used by the appeals officer to reflect the hazards of litigation). The Service will treat the $15,055 as a payment toward the $100,000 of interest on the taxpayer's deficiency for 1997.

.05 Default procedures.

(1) Facts. The facts are the same as section 10.01 of this revenue procedure, except that the examining agent does not provide the notice required by section 7.01 of this revenue procedure. Specifically, the examining agent disallows the deductions of $2,000,000 in each of 1995 and 1996, but does not compute the § 481(a) adjustment of $1,000,000 or otherwise provide notice that the timing issue is being treated as an accounting method change.

(2) Effect. The taxpayer's basis in the property as of the end of 1996 is increased by $4,000,000 (representing the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1997, the Service will compute a § 481(a) adjustment of $1,000,000 (representing the $1,000,000 of the costs deducted in 1994). The Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer's basis in the property as of the end of 1997 will be increased by an additional $6,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is

required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Assume that the examining agent disallows the deductions of $2,000,000 in each of 1995 and 1996 and computes the § 481(a) adjustment of $1,000,000, but does not label the § 481(a) adjustment or otherwise provide notice that the timing issue is being treated as an accounting method change. The taxpayer's basis in the property as of the end of 1996 is increased by $5,000,000 (representing the $1,000,000 adjustment and the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1997, the Service will compute a § 481(a) adjustment of $0 (excluding the $1,000,000 of the costs deducted in 1994 and the $2,000,000 of the costs deducted in each of 1995 and 1996 because the costs were accounted for in the prior adjustments). The Service will also disallow the deduction of $5,000,000 in 1997. The taxpayer's basis in the property as of the end of 1997 will be increased by an additional $5,000,000 (representing the disallowance of the $5,000,000 deduction in 1997). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

SECTION 11. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Ave., NW, Washington D.C. 20224.

SECTION 12. EFFECTIVE DATE

.01 In general. Except as provided in section 12.02 of this revenue procedure, this revenue procedure is effective for:

(1) examiner’s reports issued on or after [insert date that is 90 days from the date this revenue procedure is published in the Internal Revenue Bulletin]; and

(2) Forms 870AD and closing agreements executed on or after [insert date that is 90 days from the date this revenue procedure is published in the Internal Revenue Bulletin] (regardless of when the underlying examiner’s report was issued).

.02 Transition rule. The Service and the taxpayer may agree to apply this revenue procedure to closing agreements executed on or after [insert the date this revenue procedure is published in the Internal Revenue Bulletin].

DRAFTING INFORMATION

The principal authors of this revenue procedure are Robert A. Testoff and Dwight N. Mersereau of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Testoff on (202) 622-4990 or Mr. Mersereau on (202) 622-4970 (not toll-free calls).