INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, MANHATTAN CC:NER:MAN
ATTN DRITA TONUZI

FROM: Heather Maloy
Associate Chief Counsel CC:IT&A

SUBJECT: Audit Protection under Rev. Proc. 92-20

This Field Service Advice responds to your memorandum dated June 6, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

DISCLOSURE STATEMENT

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LEGEND:

A =
Year 1 =
Year 2 =
Year 3 =

Year 4 =
Year 5 = ___

ISSUE:

Whether A is entitled to audit protection under Rev. Proc 92-20, 1992-1 C.B. 685, where a change in method of accounting was made under I.R.C. § 475.

CONCLUSION:

A is not entitled to audit protection.

FACTS:

During the years in issue (1 through 4), A was a dealer in interest rate swaps, a device used to protect customers against adverse interest rate changes. A traded interest rate swaps that called for substantial nonperiodic payments at the end of the contract. These payments are referred to as backloaded payments. The backloaded payments compensated for the off-market interest rates that were used to calculate periodic payments, which were lower than they would have been if market rates were used. A was an accrual basis taxpayer with a taxable year ending on December 31 of each year.

A reported its backloaded payments when received. The Service proposed adjustments for Years 1-4, amortizing the backloaded payments ratably over the life of the swap. Beginning with taxable year 5, A changed its method of accounting for swaps to the mark to market method pursuant to section 475, Revenue Reconciliation Act of 1993, which requires securities dealers to mark to market certain securities, including swaps after December 31, 1993. The law provided that in the case of any taxpayer required to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer and shall be treated as made with the consent of the Secretary. Under the mark to market method of accounting, dealers are required to recognize gains and losses as if their securities were sold at fair market value on the last business day of the taxable year.

A seeks audit protection under section 10.12 of Rev. Proc. 92-20, 1992-1 C.B. 685 for backloaded swap payments for tax years prior to the 1993 enactment of section 475. If A were granted audit protection, it would be entitled to a full concession by the Commissioner of the adjustments set forth above for the years in issue. As a protective measure, A attached a Form 3115 to its federal income tax return for Year 5, the year that it changed to the mark to market method under section 475.

The examining agent argues that A is not entitled to audit protection for backloaded payments for the years in issue under Rev. Proc. 92-20 because the revenue procedure does not apply to an accounting method changed under section 475. Alternatively, the agent argues that

audit relief is not available under the revenue procedure because the audit of backloaded swap payments began prior to the enactment of section 475 and A's change of accounting under that provision. The Service's position is that the backloaded payments issue was raised prior to August 10, 1993, the date that section 475 was enacted.

In a letter dated June 18, 1998, A set forth its argument that it is entitled to audit protection under Rev. Proc. 92-20. A argues that the Revenue Reconciliation Act of 1993 designated the mark to market change as an accounting method change initiated by the taxpayer and made with the consent of the Service. Section 10.12 of Rev. Proc. 92-20 provides that a taxpayer which changes its accounting method with the consent of the Service is protected from an examining agent changing the same method of accounting for a prior year. In this case the agents are proposing to change A's method of accounting pertaining to swaps for Years 1-4 (pre-1993 years) even though A, with the deemed consent of the Service, changed its method in Year 5.

In summary, section 475 was enacted on August 10, 1993, and requires securities dealers to mark to market certain securities for taxable years ending on or after December 31, 1993. A is a securities dealer that began marking to market its swaps beginning with Year 5. Prior to Year 5 and during the years in issue, A included income from swaps when the payments were received. In the case of backloaded payments, A's accounting method provided a deferral of income until the end of the swap contract. After audit, however, the Service determined that A should have amortized the swap payments ratably over the life of the swap contracts for Years 1-4. A now seeks audit protection under the provisions of Rev. Proc. 92-20.

LAW:

Section 475, enacted on August 10, 1993, requires securities dealers to mark to market certain securities for taxable years ending on or after December 31, 1993. Under this method of accounting, dealers must recognize gains and losses each year as if their securities were sold at fair market value on the last business day of such taxable year. For any taxpayer required to change its method of accounting due to section 475, such change shall be treated as initiated by the taxpayer, treated as made with the consent of the Secretary, and the net amount of the adjustment required to be taken into account by the taxpayer under section 481 shall be taken into account ratably over the 5 taxable year period beginning with the first taxable year ending on or after December 31, 1993. Thus, the change of accounting method was automatic under section 475.

Rev. Proc. 92-20, 1992-1 C.B. 685, provides the general procedures under Treas. Reg. § 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting. A gradation of incentives, including prior year audit protection, is available to encourage prompt voluntary compliance if the taxpayer files a Form 3115 within designated time frames and complies with all other requirements in the revenue procedure.

ANALYSIS:

We agree with your view that the audit protection provisions of Rev. Proc. 92-20 do not apply in this case because the section 475 accounting method change was mandated by statute. In contrast, the revenue procedure was enacted to encourage prompt compliance with proper tax accounting principles and uses a gradation of incentives to encourage prompt voluntary compliance. Under this approach, a taxpayer generally receives better terms and conditions for any change in accounting method if the taxpayer files its request to change methods before it is contacted for examination by the Service. Audit protection, as described in section 10.12, applies when taxpayer has filed a timely Form 3115 as prescribed in the revenue procedure, and the agent is then prevented from proposing a change in the same method of accounting for a year prior to a year of change required under the revenue procedure.

We concur that there is no other legal authority other than Rev. Proc. 92-20 which provides taxpayers who comply with statutory changes in accounting methods with audit protection for prior years. Recent revenue procedures (such as, Rev. Procs. 97-43 and 99-17) provide automatic consent for accounting changes to comply with certain aspects of section 475, and do not grant prior year audit protection.

Rev. Proc. 92-20 is not applicable, and none of the automatic accounting method changes have extended audit protection for the treatment of the issue in prior years.

Furthermore, as you point out, even if Rev. Proc. 92-20 was applicable, A has not complied with the terms and conditions for obtaining audit protection. That is, it did not file a Form 3115 in any of the possible time frames as set out in the revenue procedure.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We believe that our position in this case is fully supportable with no significant litigation hazards.

HEATHER MALOY
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Income Tax & Accounting Division