INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-135731-01/CC:ITA:B3

Director of Field Operations, Laguna Niguel

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

x =

Y =

ISSUE:

Whether a ruling letter issued by the National Office to the Taxpayer under the provisions of Rev. Proc. 92-20, 1992-1 C.B. 685, should be retroactively revoked or modified.

CONCLUSION:

The Taxpayer initiated a change of accounting method without the consent of the Commissioner for the year of change and failed to comply with the terms and conditions of the ruling letter, and thus, it is unnecessary to revoke or modify the ruling letter. The Taxpayer may not rely upon the ruling letter to amend returns filed in accordance with the unauthorized method.

FACTS:

In an application dated June 27, 1996, the Taxpayer timely filed a Form 3115 requesting to change its method of accounting for three categories of items--sales returns, markdown allowances, and disputes and chargebacks. Each of these items was dealt with in a separate ruling letter, and only the treatment of the third category, disputes and chargebacks, is included in this request for technical advice. The Taxpayer requested the change for disputes and chargebacks for the taxable year beginning January 1, 1996 (year of change).

According to the Form 3115, the Taxpayer was an S corporation engaged in the trade or business of designing, developing and marketing x. The term "disputes" represented disagreements with customers over an entire invoice, while "chargebacks" represented disagreements with customers over a portion of an invoice. The Taxpayer's "current method" was to include income when a sale was made and invoiced, and to maintain a reserve for disputes and chargebacks. Thus, the Taxpayer reduced gross income by an allowance for the anticipated future disputes and chargebacks (Method 1). The Taxpayer's "proposed method" was to take a deduction for disputes and chargebacks when the Taxpayer determined that the disputed or questioned amount were uncollectible, i.e., in the taxable year when the dispute was finally resolved under § 461 (Method 2).

Between July 1997 and September 1997, the National Office considered whether the Taxpayer's method of recognizing income was correct, and suggested that the proper method for the Taxpayer would be to exclude invoiced amounts that were in question from income under § 451, rather than to deduct these amounts when the dispute was resolved (Method 3). While the Form 3115 was pending, the Taxpayer assumed that the request would be granted and filed two returns for 1996 using Method 2, the proposed method change.[1]

On October 20, 1997, a conference of right was held during which Method 3 was suggested as the proper method the Taxpayer should request, rather than Method 2. Accordingly, by letter dated November 13, 1997, Taxpayer amended its method change request to reflect Method 3 as the new requested proposed method.

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[1] Although Taxpayer operated as an S corporation at the time the application was sent in, Taxpayer changed its status to a C corporation while the application was pending. Thus, for the year of change, Taxpayer filed a final S corporation return (Form 1120S) for the year ended August 11, 1996, and a C corporation return (Form 1120) for the year ended December 31, 1996. These two returns will be collectively referred to as the FYE 1996 returns.

On January 13, 1998, the National Office issued a ruling letter granting the Taxpayer permission to change its method of accounting from Method 1 to Method 3, and giving the Taxpayer a three-year spread of the § 481 adjustment.[2] On March 27, 1998 the Taxpayer signed the consent agreement, which included a notation stating that "[a]pplicant intends to request a Reconsideration." The Taxpayer pursued a reconsideration of the three-year spread period, and argued that the change was a Category B change that should result in a six-year spread.

On April 9, 1998, the National Office issued a second ruling letter (April ruling letter) superceding the original ruling letter. The second ruling letter was identical to the original ruling letter, except the spread period was changed to six years following resolution of the Category A versus Category B issue. Taxpayer signed the second consent agreement without qualification on May 22, 1998. In September of 1998, approximately four months after signing the second consent agreement, Taxpayer filed a Form 1120 for its fiscal year ended December 31, 1997 (FYE 1997 return), following Method 2, rather than Method 3. Taxpayer did not file a return following Method 3 until September of 1999, when it filed a Form 1120 for its fiscal year ended December 31, 1998 (FYE 1998 return).

The Form 3115 and all federal income tax returns involved in this request for technical advice were prepared by Y, an outside accounting firm on behalf of the Taxpayer. The Taxpayer was placed under examination on February 10, 1999, for its FYE 1996 returns, and on January 18, 2000, for its FYE 1997 return. In all three returns, the Taxpayer reported the § 481 (a) income attributable to the disputes and chargebacks using Method 2. In June of 1999, while the Taxpayer was under examination, the Taxpayer raised an affirmative issue requesting that Method 3 be applied to the FYE 1996 returns, and later made the same request for the FYE 1997 return. Prior to this point, Taxpayer did not make any attempts to amend its FYE 1996 and 1997 returns in order to implement Method 3. Moreover, the Taxpayer did not use Method 3 on any return until its FYE 1998 return, which was filed in September of 1999 after the Taxpayer was under examination.

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[2] It is unclear whether the Taxpayer disclosed the fact that it had filed the two FYE 1996 returns using Method 2, the original proposed method change to National Office personnel handling the method change request. However, we note that the ruling letter ultimately issued to the Taxpayer described the "present method" as Method 1, which suggests the National Office was unaware that the Taxpayer had made an unauthorized change in method of accounting for the year of change. Moreover, in correspondence dated November 13, 1997, and January 12, 1998, the Taxpayer explained that the computation of its § 481 adjustment was based on a reversal of sales relating to the year of change. In essence, we believe the § 481 adjustment reflected a change from Method 1 to Method 3, rather than a change from Method 2 to Method 3.

The April ruling letter granted permission for Taxpayer to make the change from Method 1 to Method 3, under the facts as presented and subject to a number of terms and conditions beginning with the year of change. The pertinent terms and conditions of consent included the requirement that "the taxpayer keeps its books and records for the year of change and for subsequent taxable years (provided they are not closed on the date it receives this letter) on the method of accounting granted in this letter" and that "the taxpayer takes one-sixth of the § 481(a) adjustment into account in computing taxable income each taxable year of the adjustment period, beginning with the year of change."

Under the heading "Examination Protection," the April ruling letter stated that "[a]n examining agent may not propose that the taxpayer change the same method of accounting as that changed by the taxpayer under this ruling for a year prior to the year of change. Examination protection applies provided the taxpayer implements the change as proposed in accordance with the terms and conditions of this ruling and the ruling is not modified or revoked retroactively. See section 10.12 of Rev. Proc. 92-20."

Under the heading "Consent Agreement," the April ruling letter provided that "if the taxpayer agrees to the terms and conditions set forth above, a duly authorized officer of the taxpayer is to sign and date the attached copy and return it within 45 days from the date of this letter," and the "signed copy constitutes an agreement regarding the terms and conditions under which the change is to be effected . . . within the meaning of § 481(c) and as required by § 1.481-4(b)." Moreover, the "CONSENT AGREEMENT shall be binding upon both parties except that it will not be binding upon a showing of fraud, malfeasance or misrepresention of a material fact. In addition, a copy of the executed CONSENT AGREEMENT must be attached to the consolidated income tax return for the year of change. For further instructions, see section 10.09 of Rev. Proc. 92-20."

Under the heading "Effect of This Accounting Method Change," the April ruling letter stated:

> "The accounting method change granted in this letter is a letter ruling as defined in section 2.01 of Rev. Proc. 98-1, 1998-1 I.R.B. 7, 14. The taxpayer ordinarily may rely on this ruling subject to the conditions and limitations set forth in section 12 of Rev. Proc. 98-1. When determining the taxpayer's liability, the district director will ascertain whether (1) the representations upon which this ruling was based reflect an accurate statement of the material facts, (2) the change in method of accounting was implemented as proposed, (3) there has been any change in the material facts on which the letter ruling was based during the period the proposed method of accounting was used, and (4) there has been any change in the applicable law during the period the proposed method of accounting was used. If the district director finds that the letter ruling should be

modified or revoked, the findings and recommendations of the district director will be forwarded to the national office for consideration before further action is taken by the district director. Such referral to the national office will be treated as a request for technical advice and the provisions of Rev. Proc. 98-2, 1998-1 I.R.B. 74, will be followed.

The district director will also verify the § 481(a) adjustment and otherwise determine whether the taxpayer has fully complied with the terms and conditions of this ruling."

LAW AND ANALYSIS:

Section 446(a) of the Internal Revenue Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(e) and §1.446-1(e)(2)(i) of the Income Tax Regulations provide that, except as otherwise expressly provided, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary. Consent must be secured whether or not such method is proper or is permitted under the Code or the regulations thereunder.

Section 1.446-1(e)(3)(i) of the regulations provides that in order to secure the Commissioner's consent to a change of the taxpayer's method of accounting, the taxpayer must file an application on Form 3115 during the taxable year in which the taxpayer desire to make the change. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary under § 481(a) is to be taken into account.

Rev. Proc. 92-20, 1992-1 C.B. 685, superseded by Rev. Proc. 97-27, 1997-1 C.B. 680, implements the provisions of § 1.446-1(e) of the regulations, and prescribes the administrative procedures for obtaining the required advance consent for a taxpayer's change in accounting method.

Section 3.03 of Rev. Proc. 92-20 provides that 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 to be applied, even if no affected items are taken into account for that year. It is the first taxable year for taking the net § 481 adjustment (if any) into account and for complying with any other terms and conditions set forth in the Commissioner's consent letter.

Section 10.02 of Rev. Proc. 92-20 provides that if a taxpayer changes it method of accounting without authorization or without complying with all the provisions of this

revenue procedure, the taxpayer will be deemed to have initiated a change in method of accounting without obtaining the consent of the Commissioner required by § 446(e) of the Code. See subsection 4.01 for the rule excluding a taxpayer from the scope of this revenue procedure if a taxpayer is under examination for the taxable year in which the taxpayer made an unauthorized change in accounting method. Upon examination, a taxpayer that has initiated an unauthorized change in method of accounting may be required to effect the change in an earlier (or later) taxable year and may be denied the benefit of spreading the net § 481(a) adjustment over the number of taxable years otherwise prescribed by this revenue procedure. See subsection 2.02.

Section 4.01 of Rev. Proc. 92-20 provides that a taxpayer under examination may not request to change an impermissible method of accounting if the taxpayer is under examination for the year in which the taxpayer adopted the method, and the method was an impermissible method of accounting with respect to the taxpayer in the year of adoption. A taxpayer under examination may not request to change a method to which it changed without permission if the taxpayer is under examination for the year in which the taxpayer made the unauthorized method change. Section 2.02 of Rev. Proc. 92-20 provides that if a taxpayer under examination is not eligible to change an accounting method under this revenue procedure, the change may be made by the district director.

A ruling letter that grants a taxpayer permission to change its accounting method is an agreement between the Service and the taxpayer that a change may be made and contains the terms and conditions under which the change will be made. The April ruling letter was specific in its terms, conditions and adjustments. First, permission was granted for Taxpayer to change its method of accounting from Method 1 to Method 3 beginning with the year of change. Second, the books were to be kept on the new method for the year of change and subsequent taxable years. Third, the Taxpayer was required to take one-sixth of the § 481 (a) adjustment into account in computing taxable income each taxable year of the adjustment period, beginning with the year of change.

In this case, while the Taxpayer's Form 3115 was pending, the Taxpayer assumed that the original requested method change (Method 2) would be granted and filed its FYE 1996 and 1997 returns in accordance with Method 2. When a taxpayer is faced with filing a return for the year of change prior to the issuance of a change in accounting method ruling letter, that taxpayer must file the return in accordance with the "present" method. If a ruling letter is subsequently issued granting permission to change to the "proposed" method, the taxpayer may amend its previously filed return to implement the terms and conditions in the year of change. The Taxpayer failed to follow these procedures. The implementation of Method 2 by the Taxpayer for the FYE 1996 and 1997 returns should be viewed as an unauthorized method change for which no permission was granted. This change may be accepted or rejected by the district director upon examination in accordance with section 10.02 of Rev. Proc. 92-20.

The Taxpayer argues that the unauthorized method change for the FYE 1996 returns should be overlooked by the Service because the National Office had not yet provided the Taxpayer with a ruling letter by the filing due date for those returns, and because Method 2 resulted in a positive § 481(a) adjustment, which was more favorable to the Government. Despite the Taxpayer's arguments, however, both the Code and regulations under § 446 make it clear that consent of the Commissioner is necessary before a taxpayer makes a change in method, regardless of whether the change is to a proper or permissible method.

The Taxpayer argues that because the ruling letter was not issued until 1998, it did not have enough time to implement Method 3 by due date of the FYE 1996 and 1997 returns. Even assuming the Taxpayer was not aware of the National Office's consideration of Method 3 prior to the due date of the FYE 1996 returns, it is difficult to accept the Taxpayer's argument that it was not on notice or aware in time to implement Method 3 for the FYE 1997 return. The Consent Agreement for the April ruling letter was signed by the Taxpayer on May 22, 1998, and the FYE 1997 return was filed approximately four months after this date. In this situation, we believe the Taxpayer had ample opportunity to implement Method 3 on its FYE 1997 return, or at the very least, to contact the Service and request a modification to the year of change. Regardless of the merits of any length of notice arguments, the fact remains that the Taxpayer initiated an unauthorized method change in 1996.

The Taxpayer argues that there is no requirement in the Consent Agreement or Rev. Proc. 92-20 stating that a taxpayer must implement a method change by the due date of the return for the year of change or for any subsequent taxable year. The Taxpayer essentially argues that by implementing Method 3 in its FYE 1998 return after raising an affirmative issue requesting that Method 3 apply to allow the Taxpayer to amend its FYE 1996 and 1997 returns, it has complied with the terms and conditions of the April ruling letter. The Taxpayer argues that it intended to implement Method 3 and did so at the first possible opportunity, which was not until it filed its FYE 1998 return, given the complexity of the Taxpayer's returns, the change in internal key tax personnel, and the multiple state tax returns that were involved.

This argument requires that we ignore the Taxpayer's unauthorized method change. Even assuming we could do so by ignoring the specific requirements of § 446 of the Code and underlying regulations, we do not believe Taxpayer's view comports with a literal reading of the terms and conditions of the Consent Agreement or the requirements of Rev. Proc. 92-20. First, permission was granted in the April ruling letter for Taxpayer to change its method of accounting from Method 1 to Method 3 beginning with the year of change. Second, the books were to be kept on the new method for the year of change and subsequent taxable years. Third, the Taxpayer was required to take one-sixth of the § 481 (a) adjustment into account in computing taxable income each taxable year of the adjustment period, beginning with the year of change. None of these terms and conditions were followed by the Taxpayer in the year of change or the

following taxable year. In addition, the Taxpayer's alleged inability to implement Method 3 prior to FYE 1998 is not persuasive given that the Taxpayer outsourced the preparation of its tax returns.

Section 3.03 of Rev. Proc. 92-20 provides that 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 to be applied, even if no affected items are taken into account for that year. It is the first taxable year for taking the net § 481 adjustment (if any) into account and for complying with any other terms and conditions set forth in the Commissioner's consent letter. We believe this language and other provisions of Rev. Proc. 92-20 in conjunction with the language of the Consent Agreement contemplates a system where taxpayers implement the terms and conditions of a change in accounting method granted under advance consent procedures in the year of change, rather than waiting until they are under examination to try to implement the change. Where a taxpayer fails to take active and reasonable measures to implement the terms and conditions of a change in accounting method for the year of change, there is no longer a binding ruling letter or agreement upon which the taxpayer can rely in order to effectuate the change in a year subsequent to the year of change.

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.