

**INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

January 23, 2004

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CASE-MIS No.: TAM-148322-03/CC:ITA:B6

Taxpayers' Names:
Taxpayers' Address:
Taxpayers' Identification #s:
Year Involved:
Date of Conference:

LEGEND:

Taxpayers:

Company:

Year 1:

Month 1:

Year 2:

ISSUE:

After the Internal Revenue Service issued Notice 2001-76, 2001-2 C.B. 613, which permitted some taxpayers to use the cash receipts and disbursements accounting method ("the cash method") for 2001 and later tax years, will a taxpayer that now qualifies to use the cash method be allowed to change to it retroactively if its use of the method was disallowed previously by the Service during an examination of its federal income tax returns?

CONCLUSION:

The taxpayer may not change to the cash method retroactively. Instead, it must change its accounting method prospectively using the terms and conditions of Notice 2001-76.

FACTS:

The Taxpayers are shareholders in the Company, an S Corporation. The Company is primarily engaged in installing glass, that is, glazing work. Its average annual gross receipts are not in excess of \$.¹

Subsequent to Year 1, the Service examined some of the Company's tax returns. The Company had used the overall cash method in preparing these returns. During this examination, the Service considered the Company's use of this method. After study, the examiner determined that the Company had incorrectly computed its taxable income using the cash method. The examiner determined that the Company needed to account for inventories and that an accrual method was required to reflect the Company's taxable income clearly. The examiner required the Company to change its accounting method from the cash method to an accrual method for Year 1. The examiner computed the appropriate adjustment under § 481(a) of the Internal Revenue Code and Income Tax Regulations thereunder to reflect this Service mandated accounting method change. In Month 1, the Company and the Taxpayers signed their respective Form 4549, Income Tax Examination Changes, regarding this accounting method change. By signing these Forms 4549, the Company and the Taxpayers consented to the immediate assessment and collection of any increase in tax and penalties and accepted any decrease in tax and penalties, plus appropriate additional interest. The Company has used an accrual method for all tax years since Year 1.

In Year 2, the Taxpayers submitted a Form 656, Offer in Compromise. The Taxpayers requested that their liability arising from the Year 1 Service mandated accounting method change be "abated." The Taxpayers have stated that the Company had "no real inventory" and that the change to an overall accrual method was "contra to existing standards."²

¹. The Company's average annual gross receipts are in excess of \$1 million. Therefore, Rev. Proc. 2001-10, 2001-2 C.B. 272, which permits certain taxpayers, with average annual gross receipts not in excess of \$1 million, to use the cash method specified in the revenue procedure is not applicable.

². No opinion is expressed and none should be inferred regarding the Company's need to account for inventories. To resolve the issue presented to the National Office by the field, this Technical Advice Memorandum assumes that the Company did need to account for inventories and that the examiner was correct to change the Company's

The Company has not filed a Form 3115, Application for Change in Accounting Method, to change from its current overall accrual method.

LAW AND ANALYSIS:

IRC § 446(a) provides that taxable income must be determined under the accounting method on the basis of which the taxpayer regularly computes its income in keeping its books.

IRC § 446(c) generally allows a taxpayer to select the accounting method it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods, including the cash method or an accrual method, subject to certain restrictions. For example, § 446(b) provides that the selected method must clearly reflect income. In addition, Treas. Reg. § 1.446-1(c)(2)(i) requires that a taxpayer use an accrual method with regard to purchases and sales of merchandise whenever § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under § 1.446-1(c)(2)(ii). Under § 1.446-1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use an accounting method that clearly reflects income even though the method is not specifically authorized by the regulations.

IRC § 446(e) and Treas. Regs. § 1.446-1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing an accounting method for federal income tax purposes.

IRC § 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of a taxpayer, inventories must be taken by the taxpayer. Treas. Reg. § 1.471-1 requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

IRC § 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 determined under an accounting method different from the method used to determine taxable income for the preceding tax year.

Rev. Rul. 90-38, 1990-1 C.B. 57, describes how accounting methods are established. The treatment of a material item in the same way in determining gross income or deductions in two or more consecutively filed tax returns (without regard to any change

overall accounting method to an accrual method for Year 1 in order to reflect the Company's taxable income clearly.

in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of Treas. Reg. § 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. If a taxpayer has adopted an accounting method under these rules, the taxpayer may not change the method by amending its prior tax return(s).

Rev. Proc. 97-27, 1997-1 C.B. 680, as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, provides the general procedures under IRC § 446(e) and Treas. Reg. § 1.446-1(e) for obtaining the advance consent of the Commissioner to change an accounting method for federal income tax purposes. Generally, these procedures require the taxpayer to file an Application for Change in Accounting Method with the National Office prior to the end of the year of the method change. Section 2.04 of Rev. Proc. 97-27 states that a taxpayer may not request, or otherwise make, a retroactive change in accounting method, regardless of whether the change is from a permissible or an impermissible method, unless specifically authorized by the Commissioner.

Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and amplified by Rev. Proc. 2002-19, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, and as amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, provides the procedures by which a taxpayer may obtain automatic consent to change specified accounting methods. Generally, these procedures require the taxpayer to attach an Application for Change in Accounting Method to the timely filed (with extensions) original federal income tax return for the year of the method change and timely file a copy of this application with the National Office. Section 2.04 of Rev. Proc. 2002-9 states that a taxpayer may not request, or otherwise make, a retroactive change in accounting method, regardless of whether the change is from a permissible or an impermissible method, unless specifically authorized by the Commissioner. Rev. Proc. 2002-9 clarified, modified, amplified, and superseded Rev. Proc. 99-49, 1992 C.B. 725.

Notice 2001-76, issued in December 2001, permits certain taxpayers, with average annual gross receipts not in excess of \$10 million, to use the cash method specified in the Notice. By issuing the Notice, the Service intended to reduce the administrative and tax compliance burdens on these taxpayers and to minimize disputes between the Service and taxpayers regarding the need to use an accrual method because of the requirement to account for inventories. The cash method is available for all tax years ending on or after December 31, 2001, and a taxpayer desiring to use such method must follow the accounting method change filing procedures of the predecessor of Rev. Proc. 2002-9, that is, Rev. Proc. 99-49. However, the Notice specifies that the Service would not challenge a taxpayer's use of the cash method or the taxpayer's failure to account for inventories in an earlier year if the taxpayer, for that year, would have qualified to use the cash method if the Notice had been applicable to that tax year.

Section 9 of Notice 2001-76. Notice 2001-76 was incorporated into Rev. Proc. 2002-28, 2002-1 C.B. 815, in April 2002.

Implicitly, by filing their Offer in Compromise in Year 2, the Taxpayers are representing that the Company qualifies to use the cash method under Notice 2001-76.³ Further, they are implicitly requesting that the Commissioner allow the Company to use the cash method in Year 1, a year prior to the Notice's effective date, tax years ending on or after December 31, 2001. Section 9 of Notice 2001-76 arguably supports this request with its audit protection rule.

Notice 2001-76 is an administrative exception to the general requirement of Treas. Reg. § 1.446-1(c)(2)(i) that taxpayers must use an accrual method with regard to purchases and sales of merchandise whenever IRC § 471 requires them to account for inventories. Notice 2001-76 is effective for only tax years ending on or after December 31, 2001, and requires that any change to the cash method be made using the accounting method change filing procedures of the predecessor of Rev. Proc. 2002-9, that is, Rev. Proc. 99-49. These procedures require the taxpayer to attach an Application for Change in Accounting Method to the timely filed (with extensions) original federal income tax return for the year of the method change and timely file a copy of this application with the National Office. This procedure is consistent with the provisions of Rev. Proc. 97-27 and 2002-9, which generally prohibit changes in accounting method to be made retroactively. See sections 2.04 of Rev. Proc. 97-27 and 2002-9. In lieu of complying with Notice 2001-76, by their Offer in Compromise, the Taxpayers are attempting to obtain for the Company the benefits of Notice 2001-76 retroactively and for a year that is earlier than the Notice's effective date. The Service required that the Company use an accrual method for Year 1, the Company agreed, and the Company has used this method to prepare its federal income tax returns since that year. Thus, the Company has established this method as its accounting method under IRC § 446. See Rev. Rul. 90-38. When the Company decides to change from this method, it will need to follow the procedures provided by the appropriate published guidance. For example, the Company will need to file an Application for Change in Accounting Method using the procedures of Rev. Proc. 2002-9 to change to the cash method.

CAVEAT:

A copy of this Technical Advice Memorandum is to be given to the Taxpayers. IRC

³. No opinion is expressed and none should be inferred regarding the Company's ability to use the cash method under Notice 2001-76. To resolve the issue presented to the National Office by the field, this Technical Advice Memorandum assumes that the Company qualifies to use this method.

§ 6110(k)(3) provides that it may not be used or cited as precedent.