

# ***IRS updates rules for accounting method changes***

*February 3, 2015*

## ***In brief***

The IRS on January 16 issued two new revenue procedures (Rev. Procs. 2015-13 and 2015-14) that update the procedural rules to change a method of accounting for federal income tax purposes.

Rev. Proc. 2015-13 revises the general procedures under Section 446(e) to obtain IRS consent to make a change in accounting method. Notably, it addresses the general procedures to obtain either advance (non-automatic) or automatic consent of the IRS, thereby modifying and superseding the non-automatic consent procedures previously contained in Rev. Proc. 97-27 and the automatic consent procedures previously contained in Rev. Proc. 2011-14.

Rev. Proc. 2015-14 contains the list of accounting method changes that are eligible for the automatic change procedures in Rev. Proc. 2015-13.

## ***In detail***

### ***Background***

A taxpayer must secure IRS consent before changing its method of accounting for any item for federal income tax purposes. In general, consent is obtained by filing Form 3115, *Application for Change in Accounting Method*.

Prior to the release of Rev. Proc. 2015-13, such a request was made either under Rev. Proc. 97-27 for a non-automatic method change or Rev. Proc. 2011-14 for an automatic method change. These procedures were designed to encourage prompt voluntary compliance with proper tax accounting principles by providing

favorable terms and conditions for taxpayer-initiated method changes, including a prospective year of change, a four-year spread of an unfavorable Section 481(a) adjustment, and audit protection that prevents the IRS from raising the same issue in an earlier year.

Rev. Proc. 2015-13, which supersedes both Rev. Proc. 97-27 and Rev. Proc. 2011-14, now provides the general procedures to obtain either non-automatic or automatic consent of the IRS to change a method of accounting. Rev. Proc. 2015-14 contains the list of accounting method changes that are eligible for the automatic change

procedures contained in Rev. Proc. 2015-13.

The new guidance is effective for accounting method change applications filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014, but certain transitional rules may apply. For a detailed discussion of these transition rules, see Tax Insights from Washington National Tax Services, '[New accounting method change procedures could affect timing of planned method changes](#),' January 26, 2015.

**Rev. Proc. 2015-13**

Rev. Proc. 2015-13 made several significant changes to the previous rules for requesting permission to change a method of accounting, primarily affecting taxpayers under IRS examination. The rules for filing changes in method of accounting for taxpayers not under IRS examination essentially are unchanged. Thus, a taxpayer that is not under IRS examination and voluntarily files a request for change in accounting method continues to receive favorable terms and conditions, including a prospective year of change, a four-year spread of an unfavorable Section 481(a) adjustment, and audit protection.

The significant changes to the rules are described below.

**Audit protection for taxpayers under IRS examination**

Under Rev. Procs. 97-27 and 2011-14, taxpayers under IRS examination generally were limited in their ability to file a request for change in method of accounting to one of two window periods or with the consent of the director if audit protection was desired. A taxpayer under IRS examination also could file a request for change for an issue pending in a current IRS examination; however, such change would not receive audit protection.

Rev. Proc. 2015-13 substantially modifies the prior rules for taxpayers under IRS examination. Rev. Proc. 2015-13 replaces the 'issue pending' and 'director consent' rules with broad eligibility rules that allow taxpayers under IRS examination to request changes in method of accounting at any time, provided all other conditions outlined in the revenue procedure are met.

While the IRS has expanded the ability to request a change in

accounting method for taxpayers under IRS examination, such a request generally will not receive audit protection unless one of the exceptions applies. Rev. Proc. 2015-13 provides that a taxpayer under IRS examination will receive audit protection in the following situations:

- **Three-month window.** A taxpayer under IRS examination will receive audit protection during the three-month window if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the three-month window, and the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration. A three-month window begins on the 15th day of the seventh month of the taxpayer's tax year and ends on the 15th day of the tenth month of the taxpayer's tax year. However, if the tax year is a short tax year that ends before the 15th day of the tenth month after the short tax year begins, the three-month window begins on the first day of the second month preceding the month in which the short tax year ends and ends on the last day of the short tax year.

**Observation**

*Rev. Procs. 97-27 and 2011-14 provided that a taxpayer was eligible for audit protection if it filed an accounting method change during the first 90 days of the tax year if the taxpayer had been under continuous IRS examination for 12 consecutive months as of the first day of the tax year and the item to be changed was not an issue under consideration in the current IRS examination (the '90-day window'). Rev. Proc. 2015-13 replaces the 90-day window with the*

*three-month window. The 90-day window was very important for taxpayers desiring to make method changes to receive audit protection, which in some cases was preferred before signing off on a year-end tax provision. As a result of the elimination of the 90-day window, taxpayers that do not identify an impermissible method until after the 15th day of the tenth month — and do not have a 120-day window — should consider the impact of their assessment of uncertain tax positions in their year-end provision.*

The three-month window is available to foreign corporations only if:

- all the controlling domestic shareholders that are under IRS examination have been under IRS examination for at least 24 consecutive months as of the first day of the three-month window;
- as of the date the designated shareholder files Form 3115, the foreign corporation's method of accounting for the item to be changed is not an issue under consideration or has been an issue under consideration for at least 24 consecutive months; and
- the foreign corporation's method of accounting for the item to be changed is not an issue under consideration as of the date the designated shareholder files Form 3115.

**Observation**

*Rev. Proc. 2015-13 modifies the definition of an issue under consideration for certain foreign corporations. Rev. Proc. 2015-13 generally retains the broad rule that a foreign corporation's method of accounting for an item is an issue under consideration if any of the corporation's controlling domestic*

shareholders receives notification that the treatment of a distribution, deemed distribution, or inclusion from the foreign corporation, or the amount of its earnings and profits or foreign taxes deemed paid, is an issue under consideration. However, Rev. Proc. 2015-13 now incorporates the more narrow definition of 'issue under consideration' for certain foreign corporations when determining eligibility for the three-month window. Thus, under these new rules, a foreign corporation that has an issue under consideration under the broad, general rule, but not under the narrow rule, may be able to use the three-month window, but only after being under examination for 24 months.

- **120-day window:** A taxpayer under IRS examination still can receive audit protection for an item that is not an issue under consideration during the 120-day window (the first 120 days after an IRS examination ends, even if a subsequent IRS examination commences). Importantly, however, foreign corporations no longer are eligible to receive audit protection during a 120-day window.

#### Observation

The AICPA previously recommended that the IRS clarify the definition of 'issue under consideration' for foreign corporations due to its broad definition. Under Rev. Procs. 97-27 and 2011-14, a foreign corporation's method of accounting for an item was an issue under consideration if any of the foreign corporation's controlling domestic shareholders received notification that the treatment of a distribution or deemed distribution from the foreign corporation, or the amount of its earnings and profits, or foreign taxes deemed paid, is an issue under consideration. This effectively precluded many US multinational

corporations from voluntarily complying with proper tax accounting principles by filing accounting method changes on behalf of their foreign corporations. Unfortunately, under Rev. Proc. 2015-13, the definition of when a foreign corporation's method of accounting for an item is an issue under consideration remains substantially unchanged. Therefore, the addition of the special eligibility rules for foreign corporations to qualify for a three-month window and the removal of the 120-day window for foreign corporations make it more difficult for taxpayers to file accounting method changes on behalf of foreign corporations.

- **Issue not before the director:**

A taxpayer will receive audit protection while under IRS examination if the current method of accounting for the item is not before the director. The current method is not before the director when it is a change from a clearly permissible method of accounting or a change from an impermissible method of accounting and the impermissible method of accounting was adopted subsequent to the tax years under IRS examination on the date the taxpayer files Form 3115.

- **New member of a consolidated group in the Compliance Assurance Process (CAP):** Provided certain requirements are met, audit protection will be provided for a change in method of accounting for an item requested by the common parent of a consolidated group in CAP on behalf of a new member of the consolidated group for the tax year in which the new member became a member of the consolidated group.

Audit protection will be provided if, as of the date the common parent of the consolidated group files Form 3115, the new member is under IRS examination solely because it became a member of the consolidated group during the tax year in which the consolidated group participates in CAP and if the method of accounting for the item the new member is requesting to change is not an issue under consideration as of the date the taxpayer files Form 3115. In the case of a non-automatic method change filed on behalf of the new member, Form 3115 must be filed by the earlier of 90 calendar days after the date the new member becomes a member of the consolidated group or 30 calendar days after the end of the tax year in which the new member becomes a member of the consolidated group.

- **Changes resulting in a negative section 481(a) adjustment:** A taxpayer under IRS examination will receive audit protection if a change in method of accounting for an item results in a negative Section 481(a) adjustment for that item for the year of change and would have resulted in a negative Section 481(a) adjustment in each tax year under IRS examination if the change in method of accounting for that item had been made in the tax years under IRS examination.
- **No examination imposed change and item not under consideration:** A taxpayer under IRS examination for one or more tax years filing a request for change in method of accounting under this exception does not receive audit protection at the time Form 3115 is filed but may receive audit protection if certain events occur after the filing of Form 3115.

In this case, audit protection will be provided as of the date immediately following the earliest date that any of those IRS examinations ends for the tax years subsequent to that tax year and prior to the year of change to which the Form 3115 applies if, by the earliest date that any of those IRS examinations ends, the examining agent does not propose an adjustment for the same item that is the subject of the Form 3115 for the tax year(s) under IRS examination and the method of accounting for that same item is not an issue under consideration.

#### **Observation**

*Under this rule, if a taxpayer has two or more active IRS examinations, and the later cycle were to close first, a taxpayer filing a request for change in method of accounting under this exception would continue to have exposure for the earlier years. For example, if a taxpayer were under examination for 2009-2010 and separately for 2011-2012, and the 2011-2012 cycle were to close first, a taxpayer filing a method change under this rule would not have audit protection for the item subject to the method change request for any tax year prior to 2011. As a result, the item still would be subject to adjustment by the IRS during the examination of the earlier tax years.*

#### **Observation**

*The changes in Rev. Proc. 2015-13 will make it easier for taxpayers under IRS examination to file a method change from a clearly permissible method or a change with a negative (i.e., favorable) Section 481(a) adjustment. However, taxpayers under IRS examination changing from an impermissible method or filing a change with a positive (i.e., unfavorable) Section 481(a) adjustment likely still will want to file in a window period to obtain audit protection. That is,*

*although Rev. Proc. 2015-13 provides audit protection for taxpayers under IRS examination that do not file in a window period once an IRS examination ends, it is expected that most taxpayers changing from an impermissible method with a positive Section 481(a) adjustment will still want to file in a window period to get immediate audit protection that prevents IRS agents from raising the issue in the current IRS examination.*

#### **Section 481(a) spread periods**

In general, the Section 481(a) adjustment is taken into account in one tax year for a negative Section 481(a) adjustment and four tax years for a positive Section 481(a) adjustment. However, under Rev. Proc. 2015-13, there are a number of modifications to the Section 481(a) spread periods.

As discussed above, taxpayers may request a change in method of accounting while under IRS examination. However, the Section 481(a) spread period is shortened to two tax years (year of change and next tax year) for a positive Section 481(a) adjustment related to a change in method of accounting requested while a taxpayer is under IRS examination. The Section 481(a) spread period will continue to be four tax years if the change is filed in a window period, the current method is not before the director, or the change is filed on behalf of a new member of a consolidated group in CAP.

A taxpayer may elect a one-year Section 481(a) spread period for a positive Section 481(a) adjustment in two limited circumstances. First, a taxpayer may continue to elect a one-year Section 481(a) spread period for a positive Section 481(a) adjustment that is de minimis. Rev. Proc. 2005-13 increases the de minimis amount for purposes of this election from \$25,000 to \$50,000.

Second, Rev. Proc. 2015-13 creates a new election whereby a taxpayer may use a one-year Section 481(a) spread period if it engages in an 'eligible acquisition transaction.'

An eligible acquisition transaction for a CFC or a corporation that is not an S corporation is defined as either (1) an acquisition of stock ownership in the taxpayer by another party that either results in the acquisition of control of the taxpayer or causes the taxpayer's tax year to end, or (2) an acquisition of assets in a transaction to which Section 381(a) applies. In the case of all other taxpayers, an eligible acquisition transaction is an acquisition of an ownership interest in the taxpayer by another party that does not cause the taxpayer to cease to exist for federal income tax purposes (e.g., the sale or exchange of a partnership interest that does not cause a technical termination of the partnership under Section 708(b)(1)(B)).

The eligible acquisition transaction election can be made if an eligible acquisition transaction occurs during the year of change or in the subsequent tax year on or before the due date (including extensions) for filing the taxpayer's federal income tax return for the year of change. Once this election is made, it is irrevocable and will apply to all changes in method of accounting the taxpayer makes pursuant to Rev. Proc. 2015-13 for the year of change.

#### **Observation**

*The IRS did not take into account some of the recommendations made by the AICPA with respect to the spread periods for Section 481(a) adjustments. The AICPA recommended that the IRS give taxpayers the option of taking the entire amount of a positive Section 481(a) adjustment into account in one tax year regardless of the size of the adjustment. Alternatively, the AICPA*



*suggested modifying the de minimis election amount to be \$1 million or less to alleviate the administrative burden of tracking immaterial Section 481(a) adjustments.*

*Unfortunately, unless a taxpayer has an eligible acquisition transaction or a de minimis positive Section 481(a) adjustment, it still will be required to use a four-year spread period and keep track of Section 481(a) adjustments.*

### Transition rules

Although Rev. Proc. 2015-13 is effective immediately, several transition rules are provided in an attempt to alleviate the compliance burden associated with applying the new rules.

### Observation

*The IRS on February 2 republished Rev. Proc. 2015-13 with modified transition rules. Importantly, the IRS added a new transition rule for automatic accounting method changes covered by Rev. Proc. 2011-14. This new transition rule allows taxpayers to continue to file Form 3115 under Rev. Proc. 2011-14 for tax years ending on or after May 30, 2014, and on or before January 31, 2015, until the fully extended due date of the taxpayer's timely filed original tax return for the requested year of change.*

### Other modifications

In addition to the changes discussed above, there are a number of smaller clarifications and modifications that may affect taxpayers filing accounting method changes.

- A technical termination under Section 708(b)(1)(B) constitutes the cessation of a partnership's trade or business. Therefore, if a partnership has a technical termination, it must take into

account the remaining balance of any Section 481(a) adjustment in the tax year of the technical termination.

- In the case of a foreign corporation, the IRS may not grant audit protection if any of the controlling domestic shareholders computed an amount of foreign taxes deemed paid with respect to the foreign corporation that exceeds 150 percent of the average amount of foreign taxes deemed paid by the shareholder with respect to the foreign corporation for the three preceding tax years.
- If the director makes a correction to a taxpayer's Section 481(a) adjustment, the director normally will take the entire amount of the correction into account for the earliest tax year in the Section 481(a) adjustment period that is under IRS examination.
- All automatic method changes are now filed with the IRS in Ogden, Utah. Any additional correspondence (e.g., a revised Section 481(a) adjustment or power of attorney) related to a previously filed automatic method change also is submitted to the IRS in Ogden, and a copy must be provided to the examining agent, appeals officer, or counsel for the government, as appropriate.
- In very limited circumstances, a taxpayer may file an automatic method change via a short Form 3115, which includes a limited amount of information required by Rev. Proc. 2015-13 and the applicable automatic method change. These changes are specifically identified in Rev. Proc. 2015-14.

- A taxpayer's Consent Agreement for a non-automatic change will be invalidated if the method change is not implemented by the later of either the due date of its federal income tax return for the tax year succeeding the year of change or one year from the date of issuance of the letter ruling.
- If a taxpayer files its Form 3115 on or before the last day of the sixth month of the year of change, it may submit a written request to revise the year of change on or after, but not before, the first day of the tax year following the original year of change.
- The taxpayer may revise the year of change to a subsequent tax year, but no later than the taxpayer's current tax year.
- The Section 481(a) acceleration requirement is modified for a revised year of change to generally require that no more than 75 percent of a positive Section 481(a) adjustment be taken into account in the revised year of change.

### Rev. Proc. 2015-14

As discussed above, Rev. Proc. 2015-14 contains the list of accounting method changes that are eligible for the automatic change procedures contained in Rev. Proc. 2015-13. Rev. Proc. 2015-14 modifies and supersedes the Appendix of Rev. Proc. 2011-14.

### Significant changes to existing automatic method changes

The following non-exhaustive list highlights key changes to automatic method changes that were previously available under the Appendix of Rev. Proc. 2011-14:

- Section 7.01, relating to changes for research and experimental

- (R&E) expenditures under section 174, now applies to a method change from treating such expenditures under any provision of the code other than Section 174 (including Section 263A) to treating such expenditures under Section 174.
  - Section 7.01 also now applies when a taxpayer already has a valid Section 174 election in effect, but fails to treat a portion of its R&E expenditures in accordance with its valid election. A taxpayer may change its method regarding that portion of its R&E expenditures to confirm to its election.
  - Section 14.01, relating to overall change from the cash method to an accrual method, now provides that a concurrent change to a special method is permitted to be made, if such change is also an automatic change.
  - Section 15.07, relating to advance payments, now includes a change for advance payments that are defined in section 1.451-5(a)(1).
  - Section 15.11, relating to changes in applicable financial statements for advance payments, now provides that this change is made without audit protection.
  - Section 18.01, relating to changes for long-term contracts, now includes a change made by a taxpayer that is required to change its method of accounting for its long-term contracts as defined in Section 460(f) to the percentage-of-completion method described in Reg. sec. 1.460-3(b)(2) if the taxpayer fails to use the percentage of completion method in the first tax year and the succeeding tax year(s).
- New automatic method changes**
- The following sections were added to Rev. Proc. 2015-14 to provide additional method changes that now can be made under the automatic change procedures:
- Section 4.02, relating to changes for conformity election by bank after previous election automatically revoked
  - Section 5.02, relating to changes to comply with Section 163(e)(3)
  - Section 10.12, relating to railroad track structure expenditures
  - Section 11.13, relating to changes to or within the US ratio method
  - Section 11.14, relating to depletion
  - Section 23.02, relating to changes from the mark-to-market method of accounting in Section 475 to a realization method of accounting
  - Section 25.03, relating to changes in qualification as life/nonlife insurance company under Section 816(a).

### ***The takeaway***

The new revenue procedures make significant changes to the accounting method change procedural rules, particularly with respect to taxpayers under IRS examination, and are effective immediately. As a result, taxpayers that are planning to file Form 3115 should consider the impact of the new procedures for future accounting method changes once the transition rules no longer apply.

## ***Let's talk***

For a deeper discussion of how this might affect your business, please contact:

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