Procedures for Requesting an Adoption, Change, or Retention of Accounting Period

Notice 2001–34

This notice provides a proposed revenue procedure that, when finalized, will provide the procedures under § 442 of the Internal Revenue Code, and the regulations thereunder, to establish a business purpose and request the approval of the Commissioner to adopt, change, or retain a taxpayer's annual accounting period. The proposed revenue procedure will apply to taxpayers that are outside the scope of the revenue procedures that provide for automatic approval to adopt, change, or retain an annual accounting period. *See, e.g.*, Rev. Proc. 2000–11, 2000–3, I.R.B. 309; Notice 2001–35, 2001–23 I.R.B 1314, and Rev. Proc. 66–50, 1966–2 C.B. 1260. This proposed revenue procedure is being issued concurrently with new proposed regulations under §§ 441, 442, 706 and 1378, and a proposed revenue procedure (Notice 2001–35, 2001–23 I.R.B.) updating Rev. Proc. 87–32, 1987–2 C.B. 396, which will provide procedures under which a partnership, S corporation, electing S corporation, or PSC may obtain automatic approval to adopt, retain, or change its annual accounting period. References in this proposed revenue procedure to the regulations under §§ 441, 442, 706, and 1378 are to the new proposed regulations, and references to "Rev. Proc. 2001–XX" are to the proposed revenue procedure updating Rev. Proc. 87–32. All three documents are intended to be finalized concurrently.

Under its current ruling practice, the Internal Revenue Service weighs the merits of a taxpayer's stated business purpose for the requested annual accounting period against the amount of distortion of income or other tax consequences resulting from the adoption of, change to, or retention of that annual accounting period. In general, the only circumstance in which the Service has determined that a taxpayer's business purpose overcomes more than *de minimis* distortion of income is where the taxpayer is adopting, changing to, or retaining, its natural business year. In any other case, such as where a taxpayer is requesting to change its annual accounting period to conform to its financial reporting period, the taxpayer generally has been denied approval to use an annual accounting period that results in more than *de minimis* distortion of income.

Under the proposed revenue procedure, the Service in its ruling practice would no longer weigh the merit of a taxpayer's stated business purpose against the amount of distortion of income. Taxpayers wanting to adopt, change to, or retain a natural business year generally would be granted approval under the proposed revenue procedure (provided they agree to general terms and conditions) as under the current IRS ruling practice. Also consistent with the current IRS ruling practice, establishing a natural business year generally will be the only circumstance under which a partnership, S corporation, electing S corporation, or PSC will be granted approval. However, the IRS ruling practice for other taxpayers generally will be liberalized. These other taxpayers that do not establish a natural business year generally would be granted approval under the proposed revenue procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the tax effects of substantial distortion of income resulting from the change. Under the Service's current ruling practice, these other taxpayers generally would have been denied approval to change their annual accounting period if the change would have resulted in more than *de minimis* distortion of income.

The proposed revenue procedure provides audit protection to taxpayers adopting, changing, or retaining an annual accounting period under the revenue procedure. In conjunction with the provision of audit protection, taxpayers under examination that do not obtain consent of the appropriate director are not within the scope of the proposed revenue procedure. The Service and Treasury Department specifically request comments regarding whether the benefits of providing audit protection outweigh the burden on taxpayers under examination of having to obtain a director's consent, particularly with respect to C corporations which generally would not benefit from audit protection but still would be required to obtain a director's consent if under examination.

The Service also welcomes other comments on the proposed revenue procedure provided in this notice. Comments should be submitted by September 11, 2001, either to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU (ITA)
Room 5228

or electronically via:

Notice.Comments@m1.irscounsel.treas.gov (the Service Comments e-mail address).

Rev. Proc. 2001–XX

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SECTION 1. PURPOSE

This revenue procedure provides the general procedures under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations for establishing a business purpose and obtaining the approval of the Commissioner of Internal Revenue to adopt, change, or retain an annual accounting period for federal income tax purposes. This revenue procedure also describes the terms, conditions, and adjustments that the Commissioner may deem necessary to effect the adoption, change, or retention.

SECTION 2. BACKGROUND

.01 *Taxable year defined*.

(1) *In general*. Section 441(b) and § 1.441–1(b)(1) of the regulations provide that the term "taxable year" generally means the taxpayer's annual accounting period, if it is a calendar or fiscal year, or, if applicable, the taxpayer's required taxable year.

(2) *Annual accounting period*. Section 441(c) and § 1.441–1(b)(3) provide that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(3) *Required taxable years*. Section 1.441–1(b)(2) provides that certain taxpayers must use the particular taxable year that is required under the Code and the regulations thereunder (the "required taxable year"). For example, a partnership, S corporation, electing S corporation, or personal service corporation (PSC) has a required taxable year that generally conforms to the taxable years of its partners, shareholders, or employee-owners pursuant to §§ 706(b), 1378, and 441(i), respectively. Similarly, a specified

foreign corporation has a required taxable year that generally represents the taxable year of its majority U.S. shareholder pursuant to § 898. However, § 1.441–1(b)(2)(ii) describes exceptions under which certain taxpayers may use a taxable year other than their required taxable year. For example, a partnership, S corporation, electing S corporation, or PSC may have a taxable year other than its required taxable year if it elects to use a 52–53-week taxable year that references its required taxable year, makes an election under § 444, or establishes a business purpose and obtains approval under § 442 for that taxable year. *See also* §§ 706(b), 1378, and 441(i).

.02 *Adoption of taxable year*. Generally, a taxpayer may adopt any taxable year that satisfies § 441 and the regulations thereunder without the approval of the Commissioner. However, a partnership, electing S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a 52–53-week taxable year that references its required taxable year, or a taxable year elected under § 444, must establish a business purpose and obtain approval under § 442. *See* § 1.441–1(c).

.03 *Change in taxable year*.

(1) *In general*. Section 1.442–1(a)(1) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain approval from the Commissioner.

(2) *Annualization of* short period *return*. Section 443(b) and § 1.443–1(b)(1)(i) generally provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. *See* § 1.706–1(b)(4)(i) for an exception for partnerships.

(3) *No retroactive change in annual accounting period*. Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in annual accounting period, regardless of whether the change is to a required taxable year.

.04 *Retention of taxable year*. In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it establishes a business purpose and obtains the approval of the Commissioner under § 442, or makes an election under § 444, to retain its current taxable year. *See* § 1.441–1(d). For example, a corporation with a June 30 fiscal year that either becomes a PSC or elects to be an S corporation, and as a result is required to use the calendar year, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year generally must obtain the approval of the Commissioner to retain that taxable year if its required taxable year changes as a result of a change in ownership. *But see* § 706(b)(2)(B).

.05 *Approval of an adoption, change, or retention*.

(1) *In general*. Section 1.442–1(b) provides that in order to secure approval to adopt, change, or retain an annual accounting period, a taxpayer must file an application generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner no earlier than the day following the close of the first taxable year in which the taxpayer wants the change to be effective (the first effective year) and no later than the 15th day of the third calendar month following the close of the first effective year. In general, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention.

(2) *Automatic approval*. Under the Code and regulations, certain taxpayers are allowed to change their annual accounting periods without approval or with automatic approval (*see, e.g.,* § 859(b), § 1.442–1(c) and (d), and § 1.706–1T(c)). In addition, the Service has issued revenue procedures that enable certain taxpayers to obtain automatic approval to adopt, change, or retain their annual accounting periods. *See*, *for example*, Rev. Proc. 2000–11, 2000–3 I.R.B. 309 (or any successor) for corporations; Rev. Proc. 2001– XX, [insert cite] (or any successor) for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50, 1966–2 C.B. 1260 (or any successor) for individuals.

.06 *Business purpose*.

(1) *In general*. Section 1.442–1(b) provides that in determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. *See also* H.R. Rep. No. 99–841, 99th Cong., 2d Sess., II–318, 1986–3 (Vol. 4) C.B. 319.

(2) *Sufficient business purposes*. Section 1.442–1(b) provides that generally the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's natural business year. A taxpayer generally is deemed to have established a natural business year if it satisfies the 25-percent gross receipts test provided in section 5.04 of Rev. Proc. 2001–XX, [insert cite]. In Rev. Rul. 87–57, 1987–2 C.B. 117, the Service determined that a partnership, S corporation, or PSC established, to the satisfaction of the Secretary, a business purpose for adopting, retaining, or changing its taxable year in the following four situations:

(a) the taxpayer established that the taxable year satisfied the 25-percent gross receipts test and resulted in less deferral than its natural business year;

(b) the taxpayer would have established a natural business year under the 25-percent gross receipts test, except that a labor strike closed the taxpayer's business during a period that included its normal peak season;

(c) the taxpayer, for the past 10 years, had a three-month period of insignificant gross receipts during which, due to weather conditions, its business was not operational; and

(d) the taxpayer, which previously used the cash receipts and disbursements method and changed to an accrual method, would have established a natural business year under the 25-percent gross receipts test if it had calculated its gross receipts under an accrual method.

(3) *Insufficient business purposes*. Section 1.442–1(b) provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose for using a taxable year other than its required taxable year. In addition, the legislative history to the Tax Reform Act of 1986 provides that the following reasons ordinarily will not be sufficient for a partnership, S corporation, or PSC to establish that the business purpose requirement for a particular taxable year has been met:

(a) the use of a particular year for regulatory or financial accounting purposes;

(b) the hiring patterns of a particular business, *e.g.*, the fact that a firm typically hires staff during certain times of the year;

(c) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and

(d) the fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis.

Although the above items are not themselves sufficient to establish a business purpose, they may be considered in connection with other items by the Commissioner in determining whether a taxpayer has a business purpose for a particular taxable year. H.R. Rep. No. 99–841, 99th Cong., 2d Sess., II–318, 1986–3 (Vol. 4) C.B. 319

.07 *Section 444 elections*. Section 444 generally allows certain partnerships, S corporations, electing S corporations, and PSCs to elect a taxable year other than their required taxable year if the deferral period of the new taxable year is three months or less. Partnerships and S corporations with § 444 elections must make required payments under § 7519 that approximate the amount of the deferral benefit and PSCs with § 444 elections are subject to the minimum distribution requirements of § 280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted by § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year*. A taxpayer that wants to terminate its § 444 election must follow the automatic procedures under § 1.444–1T(a)(5) to change to its required taxable year or establish a business purpose for its taxable year pursuant to § 442 and this revenue procedure.

SECTION 3. SCOPE

.01 *Applicability*. Except as provided in section 3.02 of this revenue procedure, this revenue procedure applies to any taxpayer requesting the Commissioner's approval to adopt, change, or retain an annual accounting period for federal income tax purposes.

.02 *Inapplicability*. This revenue procedure does not apply to:

(1) *Automatic approval*. An adoption, change, or retention in annual accounting period that is permitted to be made pursuant to a provision in the Code or regulations or a published automatic approval procedure. Before submitting an application pursuant to this revenue procedure, taxpayers are encouraged to review the automatic approval procedures referenced in § 1.442–1 and the following revenue procedures: Rev. Proc. 2000–11 (for corporations); Rev. Proc. 2001–XX (for partnerships, S corporations, electing S corporations, and PSCs); Rev. Proc. 66–50, as modified by Rev. Proc. 81–40, 1981–2 C.B. 604 (for individuals); Rev. Proc. 85–58, 1985–2 C.B. 740, and Rev. Proc. 76–10, 1976–1 C.B. 548, as modified by Rev. Proc. 79–3, 1979–1 C.B. 483 (for exempt organizations); Rev. Proc. 87–27, 1987–1 C.B. 769 (for employee retirement plans and employee trusts); and Rev. Proc. 85–15, 1985–1 C.B. 516 (for changes to comply with § 441(g)).

(2) *Under examination*. A change or retention of annual accounting period if the taxpayer is under examination, unless it obtains consent of the appropriate director as provided in section 6.06(1).

(3) *Before an area office*. A change or retention in annual accounting period if the taxpayer is before an area office with respect to any income tax issue and its annual accounting period is an issue under consideration by the area office.

(4) *Before a federal court*. A change or retention in annual accounting period if the taxpayer is before a federal court with respect to any income tax issue and its annual accounting period is an issue under consideration by the federal court.

(5) *Consolidated group member*. A change or retention in annual accounting period by a taxpayer that is (or was formerly) a member of a consolidated group that is: (a) under examination for a taxable year(s) that the taxpayer was a member of the group, unless the taxpayer obtains consent of the appropriate director as provided in section 6.06(1); or (b) before an area office or before a federal court for a taxable year(s) that the taxpayer was a member of the group and the annual accounting period is an issue under consideration by the area office or the federal court.

(6) *Partnerships and S corporations.* A change or retention in annual accounting period by a partnership or S corporation if, on the date the entity would otherwise file its application with the service center, the entity's annual accounting period is an issue under consideration in the examination of a partner's or shareholder's federal income tax return or an issue under consideration by an area office or by a federal court with respect to a partner's or shareholder's federal income tax return.

SECTION 4. DEFINITIONS

.01 *Taxpayer*. The term "taxpayer" has the same meaning as the term "person" as defined in § 7701(a)(1) (an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term "taxpayer" as defined in § 7701(a)(14) (any person subject to tax).

.02 *Pass-through entity.* For purposes of this revenue procedure, the term "pass-through entity" means a partnership, S corporation (as defined in § 1361), electing S corporation (*i.e.*, a corporation attempting to make an S election for the first effective year), trust, estate, common trust fund (as defined in § 584), controlled foreign corporation (as defined in § 957), foreign personal holding company (as defined in § 552), passive foreign investment company that is a qualified electing fund (as defined in § 1295), or any other similar entity.

.03 *First effective year*. The first effective year is the first taxable year for which an adoption, change, or retention in annual accounting period is effective. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in the letter ruling granting permission to effect the adoption, change, or retention of the taxpayer's annual accounting period.

.04 *Short period*. In the case of a change in annual accounting period, a taxpayer's short period is the period beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year.

.05 *Field Office, Area Office, Director*. The terms "field office," "area office," and "director" have the same meaning as those terms have in Rev. Proc. 2001–1, 2001–1 I.R.B. 1 (or any successor).

.06 *Under examination*.

(1) *In general*.

(a) Except as provided in section 4.06(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, a Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891 or 987) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by an appeals officer that the case has been referred to an area office from a field office, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to an area office under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575.

(c) An examination resumes on the date the taxpayer (or its representative) is notified by an appeals officer (or otherwise) that the case has been referred to a field office for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA*. For a partnership or an S corporation that is subject to the TEFRA unified audit and litigation provisions (note that an S corporation is not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996)), an examination begins on the date of the notice of the beginning of an administrative proceeding sent to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in the case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of the final administrative adjustment sent to the TMP;

(b) in a fully agreed case, when all the partners or shareholders execute a Form 870–P, 870–L, or 870–S; or

(c) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by an appeals officer that the case has been referred to an area office from a field office, the date the TMP (or a partner or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires.

.07 *Issue under consideration*.

(1) *During an examination*. A taxpayer's annual accounting period is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining officer(s) specifically citing the taxpayer's annual accounting period as an issue under consideration. For example, a taxpayer's annual accounting period is an issue under consideration as a result of an examination plan that identifies the propriety of the taxpayer's annual accounting period as a matter to be examined. The question of whether the taxpayer's annual accounting period is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001–2, 2001–1 I.R.B. 79 (or any successor), or, for exempt organizations, Rev. Proc. 2001–5, 2001–1 I.R.B. 164 (or any successor).

(2) *Before an area office*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before an area office if the taxpayer's annual accounting period is included as an item of adjustment in the examination report referred to an area office or is specifically identified in writing to the taxpayer by an area office.

(3) *Before a federal court*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before a federal court if the taxpayer's annual accounting period is an item included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the government counsel.

SECTION 5. BUSINESS PURPOSE AND TERMS, CONDITIONS, AND ADJUSTMENTS

.01 *In General*.

(1) *Approval of requests*. Except as provided in section 5.01(2) of this revenue procedure, a request to adopt, change, or retain an annual accounting period ordinarily will be approved if the taxpayer:

(a) establishes a business purpose (within the meaning of section 5.02 of this revenue procedure) for the requested annual accounting period; and

(b) agrees to the Commissioner's prescribed terms, conditions, and adjustments (as described in sections 5.04 and 5.05 of this revenue procedure) under which the adoption, change, or retention will be effected.

(2) *Exceptions*. Notwithstanding the general rule of section 5.01(1)(a) of this revenue procedure, a taxpayer with a required taxable year (other than a partnership, S corporation, electing S corporation, or PSC) will not be granted approval under this revenue procedure to adopt, change to,

or retain a taxable year other than its required taxable year or, in appropriate circumstances, a 52–53-week taxable year that ends with reference to its required taxable year. In addition, a partnership, S corporation, electing S corporation, or PSC will be granted approval to adopt, change to, or retain an annual accounting period only if they establish a business purpose under section 5.02(1) for that annual accounting period. Notwithstanding the general rule of section 5.01(1)(b) of this revenue procedure, the Service may determine that, based on the unique facts of a particular case and in the interest of sound tax administration, terms, conditions, and adjustments that differ from those provided in this revenue procedure are more appropriate for an adoption, change, or retention made under this revenue procedure.

.02 *Business Purpose*.

(1) *Taxpayers that establish a business purpose*. Taxpayers that establish a business purpose for the requested annual accounting period under this section 5.02(1) ordinarily will be granted approval to adopt, change to, or retain that annual accounting period under this revenue procedure subject only to the general terms and conditions described in section 5.04 of this revenue procedure.

(a) *Natural business year*. A taxpayer (including a partnership, S corporation, electing S corporation, or PSC) requesting to adopt, change to, or retain an annual accounting period that is the taxpayer's natural business year (as described in section 5.03 of this revenue procedure) has established a business purpose to the satisfaction of the Commissioner.

(b) *Facts and circumstances*. A taxpayer (including a partnership, S corporation, electing S corporation, or PSC) may establish a business purpose for the requested taxable year based on all the relevant facts and circumstances. For this purpose, deferral of income to owners will not be treated as a business purpose. In addition, administrative and convenience business reasons such as those described in Rev. Rul. 87–57, 1987–2 C.B. 117, and the following will not be sufficient to establish a business purpose under this section:

(i) the use of a particular year for regulatory or financial accounting purposes;

(ii) the hiring patterns of a particular business, *e.g.*, the fact that a firm typically hires staff during certain times of the year;

(iii) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders;

(iv) the fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;

(v) the use of a particular year by related entities; and

(vi) the use of a particular year by competitors.

(2) *Taxpayers that are deemed to have established a business purpose*. A taxpayer other than a partnership, S corporation, electing S corporation, or PSC that does not establish a business purpose for the requested annual accounting period under section 5.02(1) of this revenue procedure generally will be deemed to have established a business purpose if it provides a non-tax reason for the requested annual accounting period and agrees to the additional terms, conditions, and adjustments described in section 5.05 of this revenue procedure, which are intended to neutralize the tax effects of any resulting substantial distortion of income. For this purpose, non-tax reasons for the requested annual accounting period may include administrative and convenience business reasons such as those described in section 5.02(1)(b) that Congress intended, and the Service has held, to be insufficient to satisfy the business purpose requirement for a partnership, S corporation, electing S corporation, or PSC to adopt, change to, or retain a taxable year other than its required taxable year. The Service anticipates that an individual taxpayer that is not a sole proprietor will be able to establish a non-tax reason for a fiscal year only in rare and unusual circumstances.

.03 *Natural business year.* A natural business year is the annual accounting period encompassing all related income and expenses. The natural business year of a taxpayer may be determined under any of the following tests (taking into account the principles of Rev. Rul. 87–57):

(1) *Annual business cycle test*. If the taxpayers's gross receipts from sales and services for the short period and the three immediately preceding taxable years indicate that the taxpayer has a peak and a non-peak period of business, the taxpayer's natural business year is deemed to end at, or soon after, the close of the peak period of business. A business whose income is steady from month to month throughout the year generally will not satisfy this test.

(2) *Seasonal business test*. If a taxpayer's business is operational for only part of the year (*e.g.*, due to weather conditions) and, as a result, the taxpayer has insignificant gross receipts during the period the business is not operational, the taxpayer's natural business year is deemed to end at, or soon after, the operations end for the season.

(3) *25-percent gross receipts test*. A natural business year may be established by any taxpayer other than a member of a tiered structure (as defined in § 444 and § 1.444–2T) using the 25-percent gross receipts test. The 25-percent gross receipts test is determined as follows:

(a) *Prior three years' gross receipts*.

(i) Gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested annual accounting period are totaled and then divided into the amount of gross receipts from sales and services for the last two months of this 12-month period.

(ii) The same computation as in (a)(i) above is made for the two preceding 12-month periods ending with the last month of the requested annual accounting period.

(b) *Natural business year*.

(i) If each of the three results described in (a)(i) and (ii) equals or exceeds 25 percent, then the requested annual accounting period is the taxpayer's natural business year.

(ii) Notwithstanding (b)(i), if the taxpayer qualifies under (b)(i) for more than one natural business year, the annual accounting period producing the highest average of the three percentages (rounded to 1/100 of a percent) described in (a)(i) and (ii) is the taxpayer's natural business year.

(c) *Special rules*.

(i) To apply the 25-percent gross receipts test for any particular taxable year, the taxpayer must compute its gross receipts under the method of accounting used to prepare its federal income tax returns for such taxable year.

(ii) Regardless of the taxpayer's method of accounting, the taxpayer's allocable share of income from a pass-through entity generally must be reported as gross receipts in the month that the pass-through entity's taxable year ends.

(iii) If a taxpayer has a predecessor organization and is continuing the same business as its predecessor, the taxpayer must use the gross receipts of its predecessor for purposes of computing the 25-percent gross receipts test.

(iv) If the taxpayer (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested taxable year plus additional 11-month period for comparing requested taxable year with other potential taxable years), then it cannot establish a natural business year using the 25-percent gross receipts test.

(v) If the requested taxable year is a 52–53-week taxable year, the calendar month ending nearest to the last day of the 52–53-week taxable year is treated as the last month of the requested taxable year for purposes of computing the 25-percent gross receipts test.

.04 *General terms and conditions*. The following general terms and conditions apply to all taxpayers that obtain approval under this revenue procedure to adopt, change, or retain an annual accounting period:

(1) *Short period tax return*. The taxpayer must file a federal income tax return for the short period required to effect a change in annual accounting period by the due date of that return, including extensions pursuant to § 1.443–1(a). However, for changes to (or from) a 52–53-week taxable year referencing the same month as the current (or requested) taxable year, see special rules in § 1.441–2. The taxpayer's taxable income for the short period must be annualized and the tax must be computed in accordance with the provisions of §§ 443(b) and 1.443–1(b). *But see* § 1.706–1(b)(4)(i) for an exception from this annualization requirement for a partnership.

(2) *Subsequent year tax returns*. Returns for subsequent taxable years generally must be made on the basis of a full 12 months (or on a 52–53-week basis) ending on the last day of the requested taxable year, unless the taxpayer secures the approval of the Commissioner to change its requested taxable year.

(3) *Book conformity*. The books of the taxpayer must be closed as of the last day of the requested taxable year. The taxpayer must compute its income and keep its books (including financial statements and reports to creditors) on the basis of the requested taxable year.

(4) *Changes in natural business year.* If a partnership, S corporation, electing S corporation, or PSC changes to or retains a natural business year under this revenue procedure and that annual accounting period no longer qualifies as a permitted taxable year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year. For this purpose, the term "permitted taxable year" means the required taxable year, a natural business year, the ownership taxable year, a taxable year elected under § 444, or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner. Certain partnerships, S corporations, electing S corporations, and PSCs may qualify for automatic approval to change their annual accounting period under Rev. Proc. 2001–XX. Other taxpayers must request approval under Rev. Proc. 2001–XX.

(5) *52–53-week taxable years.* If applicable, the taxpayer must comply with § 1.441–2(e) (relating to the timing of taking items into account in those cases where the taxable year of a pass-through entity or PSC ends with reference to the same calendar month as one or more of its partners, shareholders, or employee-owners).

(6) *Creation of net operating loss or capital loss*. If the taxpayer has a net operating loss (NOL) or capital loss (CL) in the short period required to effect a change in annual accounting period, the taxpayer may not carry the NOL or CL back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either: (a) $50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

(7) *Creation of general business credits*. If there is an unused general business credit or any other unused credit generated in the short period, the taxpayer must carry that unused credit forward. An unused credit from the short period may not be carried back.

.05 *Additional Terms, Conditions, and Adjustments*. The additional terms, conditions, and adjustments described in this section 5.05 apply to taxpayers that obtain approval under this revenue procedure to change an annual accounting period and that establish a business purpose under section 5.02(2) of this revenue procedure. These additional terms, conditions, and adjustments are necessary to neutralize the tax effects of a substantial distortion of income that otherwise would result from the change, including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary in an estate; the creation of a short period in which there is a substantial NOL, CL, or credit (including a general business credit), or the creation of a short period in which there is a substantial amount of income to offset an expiring NOL, CL, or credit.

(1) *Substantial distortion.* Distortion of income will not be considered substantial and no adjustments under this section 5.05 will be required for such distortion if the amount of the distortion is less than both:

(i) five percent of the taxpayer's estimated gross receipts for its current taxable year (computed as if the taxpayer remained on its existing taxable year); and

(ii) $500,000.

(2) *Deferral of substantial pass-through income.*

(a) *In general.* An adjustment will be required under this section 5.05(2) if the change creates a substantial distortion of income as a result of increasing the deferral of the taxpayer's distributive share of income from a pass-through entity between the taxable year of the pass-through entity and the taxpayer's taxable year. For this purpose, if the pass-through entity's taxable year is determined based on the taxable year of its owners, the taxpayer must compare the existing deferral period (*i.e.*, between the pass-through entity's and the taxpayer's current taxable years) with the proposed deferral period (*i.e.,* between the taxable year of the pass-through entity that would be required after the requested change and the taxpayer's requested taxable year) to determine whether the deferral period is increased. If the taxpayer indirectly owns an interest in a pass-through entity through one or more other pass-through entities, the existing and proposed deferral periods generally must be determined by comparing the taxable year of the directly-owned pass-through entity with the taxpayer's taxable year. However, if the proposed change does not increase the deferral period between the taxable year of the directly-owned pass-through entity and the taxpayer's taxable year, the existing and proposed deferral periods must be determined by comparing the taxable year of the next lower-tier indirectly-owned pass-through entity with the taxpayer's taxable year until either: (1) an increase in the deferral period is found, or (2) the next lower-tier entity either does not exist or is not a pass-through entity.

(b) *Computing deferral.* The amount of deferral that results from the change is the taxpayer's allocable share of income from each pass-through entity described in (a), including ordinary income or loss, rents, royalties, interest, dividends, and the deduction equivalent of credits that accrue during the taxpayer's first effective year and, in the case of a partnership, guaranteed payments to the taxpayer that are both deductible by the partnership under its method of accounting during the partnership's first taxable year ending after the taxpayer's first effective year and attributable (on a ratable basis) to the taxpayer's first effective year. A taxpayer may aggregate the deferral of income from each pass-through entity described in (a). However, if the aggregate deferral of income from all pass-through entities described in (a) is negative (*i.e.*, an aggregate loss), there is no deferral of income. For this purpose, the taxpayer may use reasonable estimates to determine the income that accrues during the first effective year. The Service may, on examination, use any available data, including information on previous years' Schedules K-1, to verify the reasonableness of the taxpayer's estimates.

(c) *Adjustment.* If the deferral of income computed in section 5.05(2)(b) represents a substantial distortion of income (as defined in section 5.05(1)), the taxpayer must include the entire amount of the distortion (and not merely the excess over the amounts specified in section 5.05(1)) as ordinary income for the first effective year. The taxpayer also must report its allocable share of income from the pass-through entity in the taxable year following the first effective year in accordance with general tax principles (*e.g.*, § 706). The taxpayer must establish a suspense account for the amount included in ordinary income for the first effective year and deduct this amount ratably over the four taxable years immediately succeeding the first effective year. Notwithstanding the preceding sentence, if all or a portion of the suspense account is attributable to an interest in a pass-through entity that is subsequently disposed of, any amount so attributable that remains in the suspense account in the year of the disposition may be deducted in that year. In all cases, the deduction under this paragraph will be treated as an ordinary deduction. The adjustments described in this section do not affect the taxpayer's basis in the pass-through entity (such as basis in a partnership determined under § 705). *See* Examples 1, 2, and 3, section 5.06 of this revenue procedure.

(3) *Special rule for certain pass-through entities.* An adjustment similar to that described in this paragraph 5.05(2) will be required in the case of a deferral of income or shifting of deductions to another taxpayer, such as a beneficiary of an estate.

(4) *Use of expiring NOLs, CLs, and credits.* An adjustment will be required under this section 5.05(4) if the change creates a substantial distortion of income as a result of the creation of income in the short period to offset expiring NOLs, CLs, or credits (including general business credits). The amount of distortion that results from a change is the amount by which any NOL, CL, and credit that is carried over to the first effective year and that expires in that year exceeds the NOL, CL, and credit that could have been used to offset income in the taxpayer's current taxable year (computed as if the taxpayer remained on its existing taxable year). If this distortion is substantial (as defined in section 5.05(1)), any NOL, CL, or credit carried over to the first effective year will be allowed to offset income in the first effective year only to the extent that such NOL, CL, or credit could have been used to offset income in the taxpayer's current taxable year. *See* Example 4, section 5.06 of this revenue procedure.

(5) *Concurrent change for related entities.* In appropriate cases, if a taxpayer owns a majority interest in a pass-through entity, the entity will be required to concurrently change its annual accounting period as a term and condition of the approval of the taxpayer's request to change its annual accounting period, notwithstanding the testing date provisions in § 706(b)(4)(A)(ii), § 898(c)(1)(C)(ii), § 1.921–1T(b)(6), and the special provision in § 706(b)(4)(B). If this condition applies, the pass-through entity must comply with the appropriate procedures to obtain approval for the change. *See, e.g.,* Rev. Proc. 2001–XX and § 1.898–4(b) of the proposed regulations.

(6) *Other terms, conditions, and adjustments.* In addition to the terms, conditions, and adjustments described in this section 5.05, the Service may impose any other term, condition, or adjustment that it deems appropriate under the circumstances.

.06 *Examples*. The following examples illustrate the additional terms, conditions, and adjustments that may be required under section 5.05 of this revenue procedure to obtain the Commissioner's approval for a change of an annual accounting period. In all the examples, the taxpayer is within the scope of this revenue procedure, the taxpayer has established a business purpose under section 5.02(2) of this revenue procedure, and a substantial distortion of income will result from a change to the requested taxable year.

Example 1. P, a foreign corporation, maintains its books and files its foreign country tax returns on the basis of a taxable year ending on March 31. In 2001, P acquires all the stock of S, a domestic corporation, that maintains its books and files its tax returns on the calendar year. S has a minority interest in a partnership that uses the calendar year. In order to facilitate the filing of consolidated financial statements for P and S, S applies for approval to change its taxable year to a taxable year ending on March 31 beginning on March 31, 2002. The change will create a substantial distortion of income as a result of increasing the deferral of S's distributive share of income from its partnership interest. Consequently, S will be required, under section 5.05(2) of this revenue procedure, to report the partnership income that accrues between January 1 and March 31, 2002, as an ordinary income adjustment on its short period tax return as a term, condition, and adjustment of the change. Thereafter, on subsequent tax returns filed for its taxable year ending on March 31 (beginning March 31, 2003), S must report the partnership income for the partnership's taxable year ending December 31 based on the Schedule K-1 in accordance with § 706. To take into account S's double inclusion of the three months of partnership income from January 1 to March 31, 2002, S must recognize an ordinary deduction adjustment in each of the four taxable years following the first effective year equal to one-fourth of the ordinary income adjustment amount included on S's short period tax return. Neither adjustment will affect S's basis in the partnership.

Example 2. D is a domestic corporation that currently maintains its books and files its tax returns on the calendar year, but applies in 2002 for approval to change its taxable year to a year ending on March 31. D owns a majority interest in a partnership, PS1, which in turn owns a minority interest in another partnership, PS2. PS1 and PS2 have taxable years ending on December 31 and June 30, respectively, as required by the majority interest rule of § 706(b)(1)(b)(i). If D changes its annual accounting period to March 31, and the first effective year ends on March 31, 2002, PS1 will be required to conform its taxable year with D using a first effective year of March 31, 2002, as required under section 5.05(5) of this revenue procedure. Accordingly, D's requested change in its taxable year would not increase the deferral of D's distributive share of income or gain from PS1. However, PS2 will retain its June 30 taxable year; thus, D's requested change will increase the deferral of D's distributive share of income and gain from PS2, which is passed through to D from PS1. Assuming the deferral results in a substantial distortion of income, D will be required, under section 5.05(2) of this revenue procedure, to report its distributive share of PS2's income and gain accruing between January 1, 2002, and March 31, 2002, as an ordinary income adjustment on its tax return for the short period ending March 31 as a term and condition of the change in D's taxable year.

Example 3. The facts are the same as in Example 2, except that PS2 owns a minority interest in partnership PS3, which has a December 31 taxable year. Because D will be required as a term and condition of the change in D's taxable year to report its distributive share of PS2's income and gain accruing between January 1, 2002, and March 31, 2002, and because that distributive share will include a portion of PS2's distributive share of income from PS3, D does not need to make any additional ordinary income adjustment to take account of any increased deferral from PS3.

Example 4. Y, a domestic corporation that files its tax returns on the calendar year, applies in 2002 for consent to change its taxable year to a year ending on March 31. Y has a general business credit carryover of $100x that will expire in the current taxable year. Y reasonably expects to incur on April 30, 2002, a substantial amount that is deductible for federal income tax purposes. If Y changes its annual accounting period to March 31, and the first effective year ends on March 31, 2002, Y reasonably expects it would be able to use $90x of the $100x credit. However, if Y continues to use the calendar year for 2002, Y reasonably estimates that it would be able to use only $25x of the expiring credit. Under section 5.05(4) of this revenue procedure, Y will be allowed to use only $25x of the credit to offset income in the first effective year as a term, condition, and adjustment of the change.

SECTION 6. GENERAL APPLICATION PROCEDURES

.01 *What to file.*

(1) *Application.* To request the Commissioner's approval to adopt, change, or retain an annual accounting period under this revenue procedure, a taxpayer (other than an electing S corporation) must complete, sign, and file a current Form 1128, *Application to Adopt, Change, or Retain a Tax Year.* An electing S corporation requesting to adopt, change, or retain an annual accounting period must complete the appropriate section of, and sign and file, a current Form 2553, *Election by a Small Business Corporation.*

(2) *Signature requirement*. The application must be signed by, or on behalf of, the taxpayer requesting the adoption, change, or retention of annual accounting period by an individual with authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, a Form 1128 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. If an agent is authorized to represent the taxpayer before the Service, receive the original or a copy of the correspondence concerning the request, or perform any other act(s) regarding the application filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this section will not be given any information regarding the application.

(3) *Additional information regarding prior applications.*

(a) *Accounting period changed.* If a taxpayer changed its annual accounting period at any time within the most recent 48-month period ending with the last month of the requested taxable year (under either an automatic change procedure or a procedure requiring prior approval), a copy of the application for the previous change, the ruling letter, and any other related correspondence from the Service, must be attached to the application filed for the requested taxable year.

(b) *Accounting period not changed*. If a prior application (filed under either an automatic change procedure or a procedure requiring prior approval) was withdrawn, not perfected, or denied, or if the change in annual accounting period was not made, and the taxpayer files another application to change its annual accounting period within the most recent 48-month period ending with the last month of the requested taxable year, a copy of the earlier application, together with any related correspondence from the Service, must be attached to the application filed for the requested taxable year. An explanation must be furnished stating why the earlier application was withdrawn or not perfected, or why the change in annual accounting period was not made. The Service will consider the explanation in determining whether the subsequent request for a change in the taxpayer's annual accounting period will be granted.

(4) *Additional information for section 5.03 (1) and (2).* If the taxpayer requests to establish a natural business year under section 5.03(1) or (2) of this revenue procedure, it must provide its gross receipts from sales or services and approximate inventory costs (where applicable) for each month in the requested short period and for each month of the three immediately preceding taxable years.

(5) *Additional information for section 5.04*. The taxpayer must indicate whether it has an NOL or CL in the short period required to effect the change and provide the type and amount of any credits generated in the short period.

(6) *Additional information for section 5.05.* If a taxpayer requests to change an annual accounting period and establishes a business purpose under section 5.02(2) of this revenue procedure, the taxpayer must provide the following additional information necessary to determine whether a substantial distortion of income

(within the meaning of section 5.05(1)) exists and, thus, whether the additional terms, conditions, and adjustments of section 5.05 apply:

(a) If the taxpayer has an interest in a pass-through entity:

(i) Reasonable estimates of the taxpayer's gross receipts for its current taxable year (computed as if the taxpayer remained on its existing taxable year);

(ii) a comparison of the existing deferral period of any pass-through entity in which the taxpayer has a direct or, as appropriate, indirect interest (*i.e.*, the period between the pass-through entity's and the taxpayer's current taxable years) with the proposed deferral period for such pass-through entity (*i.e.,* the period between the taxable year of the pass-through entity that would be required after the requested change and the taxpayer's requested taxable year); and

(iii) Reasonable estimates of the aggregate deferral of income from all pass-through entities described in section 5.05(1);

(b) the amount of any NOL, CL, or credit carried over to the first effective year and the taxable year in which such NOL, CL, or credit was generated; and

(c) identification of any partnership, specified foreign corporation (as defined in § 898), foreign sales corporation (as defined in former § 922), or domestic international sales corporation (as defined in § 992) in which the taxpayer has a majority interest.

.02 *When to file.*

(1) *In general.* Except as provided in section 6.02(2) of this revenue procedure, a taxpayer must file a Form 1128 no earlier than the day following the end of the first effective year and no later than the 15th day of the third calendar month following the end of the first effective year. However, the Service recommends that the Form 1128 be filed as early as possible to provide the Service adequate time to respond to the request prior to the due date of the taxpayer's return for the first effective year. A taxpayer that fails to file a Form 1128 within the time period prescribed in this section 6.02(1) may request an extension of time to file under § 301.9100 of the Procedure and Administration Regulations. Under § 301.9100–3, a Form 1128 filed within 90 days after the time period prescribed in this section 6.02(1) may be considered as timely filed if the taxpayer establishes that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. If a Form 1128 is filed more than 90 days after this period, prejudice to the interests of the government will be presumed and such requests will be approved only in unusual and compelling circumstances. *See* § 301.9100–3(c)(3).

(2) *Electing S corporations.* An electing S corporation must file the Form 2553 when the election to be an S corporation is filed pursuant to § 1362(b) and § 1.1362–6. Generally, such election must be filed at any time during (a) the taxable year that immediately precedes the taxable year for which the election is to be effective, or (b) the taxable year for which the election is to be effective, provided the election is made before the 16th day of the third month of the taxable year.

.03 *Where to file.*

(1) *In general.* A taxpayer, other than an electing S corporation or exempt organization, applying for an adoption, change, or retention in annual accounting period pursuant to this revenue procedure must file its Form 1128, together with the appropriate user fee, with the Service at the following address: Internal Revenue Service, Associate Chief Counsel (Income Tax & Accounting), Attention: CC:PA:T:CRU, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Internal Revenue Service, Associate Chief Counsel (Income Tax & Accounting), Attention: CC:PA:T:CRU, Room 6561, 1111 Constitution Avenue, N.W., Washington, DC 20224).

(2) *Electing S corporations.* An electing S corporation requesting to adopt, change, or retain an annual accounting period pursuant to this revenue procedure must file its Form 2553 with the appropriate service center designated in the instructions to the Form 2553. The taxpayer should not include the user fee with the Form 2553 mailed to the service center. The service center will send the Form 2553 to the national office of the Service, which will then notify the taxpayer that the fee is due.

(3) *Exempt organizations*. An exempt organization applying for a change in annual accounting period pursuant to this revenue procedure must file its Form 1128, together with the appropriate user fee, with the Service at the following address: Internal Revenue Service, Commissioner, TE/GE, Attention: T:EO:RA, P.O. Box 27720, McPherson Station, Washington, DC 20038.

.04 *User fee*. Taxpayers are required to pay user fees for requests to adopt, change, or retain an annual accounting period under this revenue procedure. Rev. Proc. 2001–1, 2001–1 I.R.B. 1 and, for tax-exempt organizations, Rev. Proc. 2001–8, 2001–1 I.R.B. 239 (or any successors) contain the schedule of user fees and provide guidance for complying with the user fee requirements.

.05 *Consolidated groups – Separate Forms 1128 not required*. The common parent of a consolidated group files a Form 1128 on behalf of the consolidated group and pays only a single user fee. The common parent must indicate that the Form 1128 is for the common parent and all its subsidiaries and answer all relevant questions on the application for each member of the consolidated group. If one or more of the members of the group is requesting to use a 52–53-week taxable year that ends within the same 7-day period of the other members requested taxable year, the parent must attach a statement to its tax return for the first effective year as required by Rev. Proc. 89–56, 1989–2 C.B. 643 (or any successor). The consolidated group must also comply with all of the provisions of Rev. Rul. 72–184, 1972–1 C.B. 289 (or any successor). *See* § 1.1502–76(a)(1).

.06 *Additional procedures if under examination, before an area office, or before a federal court*.

(1) *Taxpayers under examination*.

(a) A taxpayer under examination may apply for approval to change or retain its annual accounting period under this revenue procedure only if the appropriate director consents to the change or retention. The director will consent to the change or retention unless, in the opinion of the director, the taxpayer's annual accounting period would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the director will consent to a change where the taxpayer is using a clearly permissible annual accounting period. The director also will consent to a change from an impermissible annual accounting period where the period became impermissible (*e.g.*, due to a change in ownership or a change in the taxpayer's business) subsequent to the years under examination. The question of whether the taxpayer's annual accounting period from which the taxpayer is changing is permissible or became impermissible subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001–2, or, for tax-exempt organizations, Rev. Proc. 2001–5.

(b) A taxpayer changing or retaining an annual accounting period under this revenue procedure with the consent of the appropriate director must attach to the application a statement from the director consenting to the change or retention. The taxpayer must provide a copy of the application to the director at the same time it files the application with the national office. The application must contain the name(s) and telephone number(s) of the examining officer(s).

(2) *Taxpayer before an area office*. A taxpayer that is before an area office must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the taxpayer's annual accounting period is not an issue under consideration by the area office. The taxpayer must provide a copy of the application to the appeals officer at the same time it files the application with the national office. The application must contain the name and telephone number of the appeals officer.

(3) Taxpayer before a federal court. A taxpayer that is before a federal court must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the taxpayer's annual accounting period is not an issue under consideration by the federal court. The taxpayer must provide a copy of the application to the government counsel at the same time it files the application with the national office. The application must contain the name and telephone number of the government counsel.

SECTION 7. PROCESSING OF APPLICATION

.01 *Service discretion*. Notwithstanding any other provision of this revenue procedure, the Service reserves the right to decline to process any application filed under this revenue procedure in situations in which it would not be in the best interest of sound tax administration to permit the requested adoption, change, or retention. In this regard, the Service will consider whether the adoption, change, or retention in annual accounting period would clearly and directly frustrate compliance efforts of the Service in administering the income tax laws.

.02 *Applicability of Rev. Proc. 2001–1, Rev. Proc. 2001–4, and any successor revenue procedures*. Rev. Proc. 2001–1 or, for tax-exempt organizations, Rev. Proc. 2001–4, 2001–1 I.R.B. 121, (or any successors) will apply to any annual accounting period adoption, change, or retention request made under the provisions of this revenue procedure.

.03 *Incomplete application – 21 day rule*. If the Service receives an application that is not completed properly in accordance with the instructions on the Form 1128 (or Form 2553) and the provisions of this revenue procedure, or if supplemental information is needed, the Service will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 21 days from the date of the notification to furnish the necessary information. The Service reserves the right to impose shorter reply periods if subsequent requests for additional information are made. If the required information is not submitted to the Service within the reply period, the application will not be processed. A reasonable additional period to furnish information may be granted to a taxpayer. Any request for an extension of time to furnish necessary information must be made in writing and submitted within the 21-day period. If the extension request is denied, there is no right of appeal.

.04 *Conference in the national office*. The taxpayer must complete the appropriate line on the Form 1128 or attach a statement to the Form 2553, to request a conference of right if an adverse response is contemplated by the Service. If the taxpayer does not complete the appropriate line on the Form 1128, attach a statement to the Form 2553, or request a conference in a later written communication, the Service will presume that the taxpayer does not desire a conference. If requested, a conference will be arranged in the national office prior to the Service's formal reply to the taxpayer's application. For taxpayers other than exempt organizations, see section 11 of Rev. Proc. 2001–1 (or any successor). For exempt organizations, see section 12 of Rev. Proc. 2001–4, 2001–1 I.R.B. 121 (or any successor).

.05 *Letter ruling*. Unless otherwise specifically provided, the Commissioner's approval to adopt, change, or retain a taxpayer's annual accounting period will be set forth in a letter ruling from the national office that identifies the taxpayer's former annual accounting period; the annual accounting period the taxpayer is adopting, changing to, or retaining; the short period necessary to effect a change; and the terms, conditions, and adjustments under which the adoption, change, or retention is to be effected. *See* § 1.442–1(b). A copy of the letter ruling must be attached to the taxpayer's federal income tax return for the first effective year.

.06 *Effect of noncompliance*. If a taxpayer adopts, changes, or retains an annual accounting period without authorization or without complying with all of the provisions of this revenue procedure and the letter ruling granting permission for the change, the taxpayer has initiated an adoption, change, or retention in annual accounting period without obtaining the approval of the Commissioner as required by §§ 441(i), 442, 706(b), and 1378. Upon examination, a taxpayer that has initiated an unauthorized adoption, change, or retention of annual accounting period may be denied the adoption, change, or retention. For example, the taxpayer may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

.07 *Effect on other offices of the Service*. The provisions of this revenue procedure are not intended to preclude an appropriate representative of the Service (for example, an appeals officer with delegated settlement authority) from settling a particular taxpayer's case involving an accounting period issue by agreeing to terms, conditions, and adjustments that differ from those that might be provided under this revenue procedure when it is in the best interest of the government to do so.

SECTION 8. EFFECT OF APPROVAL

.01 *Audit Protection*

(1) *In general*. Except as provided in section 8.01(2) of this revenue procedure, a taxpayer that files a Form 1128 in compliance with all the applicable provisions of this revenue procedure will not be required by the Service to change its annual accounting period for a taxable year prior to the first effective year.

(2) *Exceptions*. The Service may change a taxpayer's annual accounting period for a prior taxable year if:

(a) the taxpayer withdraws or does not perfect its request;

(b) the national office denies the request;

(c) the taxpayer declines to implement the change;

(d) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure and the letter ruling granting permission for the change; or

(e) the national office modifies or revokes the ruling because there has been a misstatement or omission of material facts.

.02 *Subsequently required changes*.

(1) *In general*. A taxpayer that adopts, changes, or retains its annual accounting period pursuant to this revenue procedure may be required thereafter to change its annual accounting period for the following reasons:

(a) the enactment of legislation;

(b) a decision of the United States Supreme Court;

(c) the issuance of temporary or final regulations;

(d) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(e) the issuance of written notice to the taxpayer that the change in accounting period was granted in error or is not in accord with the current views of the Service; or

(f) a change in the material facts on which the approval was based.

(2) *Retroactive change or modification*. Except in rare or unusual circumstances, if a taxpayer that adopted, changed, or retained its annual accounting period under this revenue procedure is subsequently required under section 8.02(1) of this revenue procedure to change its annual accounting period, the required change will not be applied retroactively provided that:

(a) the taxpayer complied with all the applicable provisions of the letter ruling granting permission for the change and this revenue procedure;

(b) there has been no misstatement or omission of material facts;

(c) there has been no change in the material facts on which the approval was based;

(d) there has been no change in the applicable law; and

(e) the taxpayer to whom approval was granted acted in good faith in relying on the approval and applying the change retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW BY DIRECTOR

.01 *In general*. A director must apply a ruling obtained under this revenue procedure in determining the taxpayer's tax liability unless the director recommends that the ruling should be modified or revoked. The director will ascertain if:

(1) the representations on which the ruling was based reflect an accurate statement of the material facts;

(2) the amount of the adjustments required to effect the change, if any, were properly determined;

(3) the adoption, change, or retention in annual accounting period was implemented as proposed in accordance with the terms and conditions of the letter ruling and this revenue procedure;

(4) there has been any change in the material facts on which the ruling was based during the period that the new or retained annual accounting period was used; and

(5) there has been any change in the applicable law during the period the new or retained annual accounting period was used.

.02 *National office consideration*. If a director recommends that the ruling (other than the amount of the adjustments required to effect the change) should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2001–2 or, for tax-exempt organizations, Rev. Proc. 2001–5, will be followed.

SECTION 10. EFFECTIVE DATE

.01 *In general*. Except as provided in section 10.02 of this revenue procedure, this revenue procedure is effective for applications filed on or after [INSERT DATE THIS REVENUE PROCEDURE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN].

.02 *Transition rule for pending applications*. If a taxpayer filed an application before [INSERT DATE THIS REVENUE PROCEDURE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN] and the application is pending with the national office on [INSERT DATE THIS REVENUE PROCEDURE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN], the taxpayer may request that the application be processed in accordance with this revenue procedure. However, the national office will process applications filed before [INSERT DATE THIS REVENUE PROCEDURE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN] in accordance with prior authorities unless, prior to the later of [INSERT DATE THAT IS 45 DAYS AFTER THE DATE THIS REVENUE PROCEDURE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN] or the issuance of the letter ruling granting or denying consent to the adoption, change, or retention, the taxpayer notifies the national office that it requests that its application be processed in accordance with this revenue procedure.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 85–16 and Rev. Proc. 74–33 are superseded.

SECTION 12. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been submitted to the Office of Management and Budget for review and approval in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)) under control number _____.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are set forth in section 6.01. The information is required to determine whether the taxpayer's requested annual accounting period will result in a distortion of income. This information will be used by the Service to determine which terms, conditions, and adjustments will be necessary to effect the adoption, change, or retention in annual accounting period. The collections of information are required to obtain the Service's approval for the adoption, change, or retention. The likely respondents are the following: individuals, farms, business or other for-profit organizations, non-profit organizations, and small businesses or organizations.

The estimated total annual reporting burden is 2,000 hours.

The estimated annual burden per respondent varies from .5 of an hour to 5 hours, depending on the individual circumstances, with an estimated average of 2 hours.

The estimated number of respondents is 1,000.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The author of this revenue procedure is Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Scully at (202) 622-4960 (not a toll-free call).