CHAPTER 14

Premature Accruals and the Relationship Between Accounting Methods and the Penalty Provisions

by

LESLIE J. SCHNEIDER*

BERNARD A. FINKELSTEIN**

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* Ivins, Phillips & Barker, Chartered, Washington, D.C., Member of Maryland and D.C. Bars, Author, *Federal Income Taxation of Inventories*, 3 Vols. (Matthew Bender 1979).

** Ernst & Whinney, Cleveland, Ohio, Member of AICPA, D.C. and Ohio Society of CPAs, Co-Author, *Federal Income Taxation of Corporations Filing Consolidated Returns*, 3 Vols. (Matthew Bender 1975).

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¶ 1400 INTRODUCTION

In prior efforts at tax reform, Congress focused on broadening the tax base and restricting the availability of various deductions in the Internal Revenue Code. In these prior efforts, one area of taxation that escaped Congress' attention was income tax accounting—the timing of income and expenses. In fact, for many years the Treasury was not concerned with the deferral of income and did not take steps to measure the revenue loss resulting from either the deferral of income or the acceleration of deductions.

However, in recent years, the dramatic increase in prevailing interest rates and the proliferation of tax shelters that result in the deferral of taxable income heightened the Treasury's concern about this area of the tax law. As a result, in the 1984 Congressional deliberations on tax reform, the Treasury was instrumental in having Congress address perceived abuses in the tax accounting area.

The particular tax accounting abuses which Congress focused on in the 1984 legislative session were in three principal areas: (1) the timing of the accrual of liabilities to perform services or deliver goods which would not be paid for until many years into the future; (2) the relationship between the penalty provisions in the Code and the use of an improper accounting method; and (3) perceived inadequacies in the rules dealing with deferred payment transactions in which no interest or below market interest rates are charged. In addition to the legislative changes in these areas, the Internal Revenue Service promulgated a new revenue procedure in 1984 to revise the administrative procedures for changing an accounting method. The impetus for this new revenue procedure was in part a need to respond to the legislative changes in this area.

The purpose of this Article is to analyze the various legislative changes enacted by Congress in the area of accrual accounting and the relationship between these changes and the penalty provisions in the Code. In addition, the impact of the Service's recent revision of the procedures for requesting permission to change a method of accounting is discussed.

¶ 1401 PREMATURE ACCRUALS

¶ 1401.1 Historical Background

The timing of deductions is governed by section 461 of the Code, which provides that "[t]he amount of any deduction . . . allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."[1] If a taxpayer uses the accrual method of accounting, the income tax regulations provide that an expense is deductible in "the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."[2] This provision has been described as the "all events test."

Prior to the enactment of the Deficit Reduction Act of 1984,[3] the precise application of the all events test had been uncertain in a variety of situations. In particular, if a taxpayer incurred a fixed obligation to perform services in the future, a question existed whether the taxpayer was entitled to accrue the reasonably determinable cost of performing the services prior to their actual performance. Similarly, if a taxpayer had a fixed liability to pay a third party who was obligated to perform services for the taxpayer, there was an issue as to whether the actual performance of the services was a prerequisite to accrual. In addition to these situations, the impact of the uncertainty of the time for performance of the

[1] I.R.C. § 461(a) (1982).

[2] Treas. Reg. § 1.461–1(a)(2), T.D. 6772, 1964–2 C.B. 121.

[3] Pub. L. No. 98–369, 98 Stat. 494 (codified at scattered sections of 26 U.S.C.) [hereinafter cited as 1984 Act or DEFRA].

services on the ability to determine the amount of the liability was a subject of considerable dispute.

In an early decision of the Board of Tax Appeals, *Ostheimer v. Commissioner*,[4] the taxpayer was a lessee of a restaurant. Under the terms of the lease, the taxpayer was required upon the termination of the lease to restore the movable property to the same condition as when the lease began. The taxpayer claimed a deduction for the increase in a reserve to restore such property. The Board rejected the taxpayer's deduction both in the year prior to the end of the lease and in the year of termination on the grounds that it was not a present liability. Similarly, in *Amalgamated Housing Corp. v. Commissioner*,[5] the Board of Tax Appeals rejected a deduction for additions to a reserve to renovate apartments at least once every thirty months in accordance with government regulations.

In *Spencer, White & Prentis, Inc. v. Commissioner*,[6] the Second Circuit followed the same approach as the Board of Tax Appeals. In this case, the taxpayer was required to restore property damaged by the construction of the New York City subway system. The Second Circuit concluded that the liability to pay for work in the future was not currently deductible. Finally, in *National Bread Wrapping Machine Co. v. Commissioner*,[7] the Tax Court followed the *Spencer, White* decision in disallowing a current deduction for a taxpayer's unperformed obligation to install each bread wrapping machine that was sold by year end.

In contrast to the foregoing decisions, a series of cases in various circuit courts have allowed current deductions for fixed obligations to perform services in the future. In *Harrold v. Commissioner*,[8] the Fourth Circuit ruled in favor of a cur-

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[4] 1 B.T.A. 18 (1924).

[5] 37 B.T.A. 817 (1938), *aff'd per curiam*, 108 F.2d 1010 (2d Cir. 1940).

[6] 144 F.2d 45 (2d Cir. 1944), *aff'd per curiam* 2 T.C.M. (CCH) 320, 12 T.C.M. ¶ 43,306 (1943), *cert. denied*, 323 U.S. 780 (1944).

[7] 30 T.C. 550 (1958).

[8] 192 F.2d 1002 (4th Cir. 1951).

rent deduction for a coal mining partnership's liability to backfill a strip mine after the completion of mining operations. The court concluded that the actual performance of the backfilling was not a prerequisite for deductibility. Moreover, the court found that the taxpayer was able to estimate the amount of the liability with reasonable accuracy. This same approach was followed by the Third Circuit in *Denise Coal Co. v. Commissioner*,[9] notwithstanding that the deductions for future backfilling were claimed as much as eleven years prior to the completion of the backfilling.

Other circuits have expanded on this approach in varying factual situations. For example, in *Pacific Grape Products Co. v. Commissioner*,[10] the Ninth Circuit permitted a taxpayer to deduct in the year of sale of certain products the estimated future costs of packaging and shipping the products sold. In *Schuessler v. Commissioner*,[11] the Fifth Circuit allowed a seller of furnaces to deduct in the year of sale of a furnace the estimated cost of satisfying a contractual requirement to turn the furnace on and off for a five-year period. In *Gillis v. United States*,[12] the taxpayer was engaged in the purchase of cotton from a government agency at an extremely low price. However, as a condition of such purchase, the taxpayer was obligated to export a like quantity of cotton. The Fifth Circuit held that the taxpayer could deduct the loss it would incur on the export sale in the same taxable year that it resold the cotton purchased from the government agency even though the export sale would take place in a future taxable year.

Apparently, in one type of situation, even the Tax Court and its predecessor, the Board of Tax Appeals, agreed that an accrual-basis taxpayer could deduct the estimated future cost of performing services prior to their actual performance. In *Haynsworth v. Commissioner*,[13] the Tax Court held that a tax-

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[9] 271 F.2d 930 (3d Cir. 1959).

[10] 219 F.2d 862 (9th Cir. 1955).

[11] 230 F.2d 722 (5th Cir. 1956).

[12] 402 F.2d 501 (5th Cir. 1968).

[13] 68 T.C. 703 (1977). *See also* Cambria Dev. Co. v. Commissioner, 34 B.T.A. 1155 (1936), *nonacq. on this issue* 1937–1 C.B. 31.

payer engaged in the subdivision of real estate could include in its basis of the subdivided lots for gain or loss purposes the estimated cost of future improvements it was obligated to make. Even the Service agreed with this approach in this limited area.[14]

Notwithstanding these precedents, in the more general area of accrual prior to the performance of services, the Service's position was that the services had to be performed and an amount of money owed before an accrual-basis taxpayer could claim its deduction. For example, in a strip mining case identical to *Harrold* and *Denise Coal*, the Service ruled that the taxpayer could not accrue the estimated backfilling expense until the backfilling occurred.[15]

The other principal area of uncertainty under prior law related to the uncertainty of the time for payment of a fixed obligation because such payment depended upon the occurrence of future events or acts. For example, in *Washington Post Co. v. United States*,[16] the taxpayer established a profit-sharing plan for the dealers which distributed the taxpayer's newspapers. Under the plan, the taxpayer irrevocably committed itself to pay dealers a certain amount annually depending upon whether the dealer died, became disabled or attained the age of fifty-five. The dealers were not employees of the taxpayer, therefore, section 404(a)(5) of the Code was inapplicable.[17] The Court of Claims ruled that the taxpayer was entitled to currently accrue its liability to pay the dealers in the future. The court stated that while "the time of actual payout [is] undetermined, at least in part, . . . the indeterminancy involved does not make the liability any less real, or any less fixed."[18] However, in Revenue Ruling 76–345,[19] the Service announced that it would not follow the *Washington Post* decision.

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[14] *See* Rev. Proc. 75–25, 1975–1 C.B. 720.

[15] Letter Ruling 7831003.

[16] 405 F.2d 1279 (Ct. Cl. 1969).

[17] Section 404 of the Code was subsequently amended by the Revenue Act of 1978, Pub. L. No. 95–600, 92 Stat. 2763 (codified at scattered sections of 26 U.S.C.), so that § 404(a)(5) was made applicable to independent contractors, as well as to employees of a taxpayer. I.R.C. § 404(d) (1982).

[18] 405 F.2d at 1283.

[19] 1976–2 C.B. 134.

Another very interesting case in this area is *Crescent Wharf and Warehouse Co. v. Commissioner.*[20] In this case, a taxpayer acted as a self-insurer of its workmen's compensation liability. The taxpayer accrued deductions in situations of uncontested liability where the fact of injury occurred during the taxable year in question. The taxpayer's accrual procedures did not depend on the injured employee's filing of a claim or his completion of treatment. Nevertheless, the Ninth Circuit held that the taxpayer's expense was currently accruable and remanded to the lower court for a finding on the amount of the deduction. The uncertainty of the time for payment, which depended on future medical treatment or disability was held not to bar the deduction.[21] This decision was recently followed in *General Dynamics Corp. v. United States.*[22]

In *Eastman Kodak Co. v. United States,*[23] the Court of Claims dealt with the issue of "two-step" liability. In this case, the question involved whether a taxpayer could deduct the accrued payroll tax on accrued, but unpaid wages. The taxpayer owed the wages, but was not legally liable for the payroll taxes thereon until the taxpayer actually paid the wages. Nevertheless, the court ruled that since the taxpayer owed the wages, it could accrue the payroll taxes thereon. The court rejected a current deduction for the payroll taxes that attached to unpaid vacation pay and a current profit-sharing plan. On these latter items, the court concluded that because they were paid sufficiently far into the next taxable year, the taxpayer might exceed the FICA limit on other wages and, therefore, might never have to pay FICA taxes on either the vacation pay or the profit-sharing bonuses.

In *Hughes Properties, Inc. v. United States,*[24] the court al-

[20] 518 F.2d 772 (9th Cir. 1975), *rev'g* 59 T.C. 751 (1973).

[21] *See also* Lukens Steel Co. v. Commissioner, 442 F.2d 1131, 1135 (3d Cir. 1971); Crucible, Inc. v. United States, 591 F.2d 643 (Ct. Cl. 1979).

[22] 84–2 U.S. Tax Cas. (CCH) ¶ 9783, 54 A.F.T.R.2d (P-H) ¶ 84,5989 (Ct. Cl. 1984).

[23] 534 F.2d 252 (Ct. Cl. 1976).

[24] 84–2 U.S. Tax Cas. ¶ 9616, 54 A.F.T.R.2d (P-H) ¶ 84,5462 (Ct. Cl. 1984).

lowed an accrual-basis casino to deduct currently the increase in its liability to fund an unpaid progressive slot machine jackpot that was not won prior to year end. The court stated that the taxpayer's liability was fixed under state gaming regulations and the amount of the jackpot was at least the amount accrued, notwithstanding that no one had won the jackpot by year end and the time of eventual payment was thus highly uncertain.

The principal exception to this trend in the case law is *Mooney Aircraft, Inc. v. United States*.[25] In this case, the Fifth Circuit rejected a current accrual for a taxpayer's fixed liability to redeem a bond in the future. The court concluded that since the liability would likely not be paid for as much as fifteen, twenty, or thirty years, it would not clearly reflect the taxpayer's income to allow a current deduction.

Given the foregoing history, the Treasury became increasingly concerned by the trend of the courts to allow currrent deductions for obligations to perform services in the distant future. The Treasury considered two possible alternatives to deal with this problem: (1) allow a deduction for only the present value of the future cost performing the services; or (2) disallow a deduction for a liability to perform services in the future until the services are actually performed. The Treasury opted for the latter alternative, although with a substantially broader scope. The proposal was eventually enacted in 1984 with modifications noted in the succeeding sections.

¶ 1401.2 General Rule—Economic Performance

In the 1984 Act, Congress added a new subsection (h) to section 461 of the Code.[26] This section provides that in applying the all events test, the test shall not be deemed satisfied until economic performance has occurred. If the taxpayer's obligation to pay money arises out of another person's providing either goods, services, or the use of property to the tax-

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[25] 420 F.2d 400 (5th Cir. 1969).

[26] DEFRA, *supra* note 3, § 91(a).

payer, economic performance occurs when such goods, services or the use of property is provided.[27] This rule may be illustrated by the following examples:

(1) If an accrual-basis taxpayer contracts with a maintenance company to provide janitorial services in the taxpayer's office building, amounts owed to the janitorial company are not deemed to satisfy the economic performance requirement until the janitorial services are actually provided.

(2) If an accrual-basis manufacturer contracts with a repair parts company to replace during a warranty period defective parts in the manufacturer's machinery sold to customers, economic performance occurs when such defective parts are replaced.

(3) If an accrual-basis insurance company contracts with a car rental company to provide free rental cars to the insurance company's customers while the customers' cars are being repaired following accidents, economic performance occurs as the rental cars are provided.

If a taxpayer's liability is to provide goods, services or the use of property to others, economic performance occurs when the goods, services or use of the property is provided.[28] This general rule may be illustrated by the following examples:

(1) If an accrual-basis publisher is obligated to furnish purchasers of its encyclopedias with free supplements for three years, economic performance occurs as the supplements are provided.

(2) If an accrual-basis seller of cars is obligated to repair the cars for free for two years, economic performance occurs as the repairs are performed.

(3) If an accrual-basis manufacturer of video recorders agrees to provide one year's free use of certain videotapes

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27 *See* I.R.C. § 461(h)(2)(A), *added by* DEFRA, *supra* note 3, § 91(a).

28 *Id.* § 461(h)(2)(B).

to customers, economic performance occurs as such tapes are provided.

The committee reports provide a number of specific rules governing economic performance in a variety of situations. In the case of interest expense, economic performance is deemed to occur with the passage of time during the term of the loan.[29] For debts incurred in transactions arising after June 8, 1984, interest expense is deductible only on a constant interest basis. Interest on loans originating prior to such date are not subject to this statutory rule; however, no inference should be drawn as to the propriety of noneconomic accruals in such cases.[30]

In the case of payments for nuclear waste disposal, the committee reports state that it is anticipated that the Treasury will issue regulations which will provide that economic performance with respect to amounts payable under the Nuclear Waste Disposal Act of 1982 occurs as payments are made to the Federal Government.[31] A special rule is also provided in the committee reports for natural gas supplier refunds. Under Revenue Ruling 63–182,[32] the Service ruled that a natural gas utility which received refunds from its suppliers because of overcharges and which must refund such amounts to its customers within the next year is entitled to deduct the amount of the refunds in the year in which the refunds are received by the utility, even though this deduction is taken prior to the year in which the refunds are passed through to customers. The committee reports state that the rule may be continued under the 1984 Act provided that the refunds are made to customers within a reasonable period of time in the taxable year following the utility's receipt of the refunds and that adequate interest is paid to the customers and is includible in their income.[33] This latter requirement may prove to be a practical bar to the effective use of this exception.

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[29] H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 874, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 751, 868 [hereinafter CONF. REP. 861].

[30] *Id. See also* Rev. Rul. 83–84, 1983–1 C.B. 97.

[31] CONF. REP. 861, *supra* note 29, at 875.

[32] 1963–2 C.B. 194.

[33] CONF. REP. 861, *supra* note 29, at 875–76.

In the case of a liability for compensation for services, economic performance generally occurs as the employee renders the services.[34] However, under the special rule of section 404(a)(5) of the Code, a liability to pay employee benefits is not deductible prior to the time that such benefits are paid if payment occurs beyond the end of the taxable year.[35] A special rule is also applicable to a taxpayer's liability to pay tort and workmen's compensation claims,[36] and provides that economic performance for these liabilities is not satisfied until the liabilities are paid. This provision effectively reverses the *Crescent Wharf* line of cases discussed above.

If a taxpayer's liability to pay employee benefits is satisfied in a taxable year subsequent to the taxable year in which economic performance occurs, the allowance of the deduction is governed by special deferred compensation rules. Under prior law, a taxpayer's liability to pay compensation to employees pursuant to a plan or similar arrangement that had the effect of deferring the receipt of the compensation was deductible at the time such compensation was includible in the employees' income.[37] In applying this rule, the payment of a liability for employee compensation that was deferred for more than twelve months beyond the end of the taxable year of accrual was generally considered deferred compensation and deferral for a shorter period did not prevent a current deduction of the liability.[38] However, the twelve-month cutoff rule for the definition of deferred compensation was never formalized. In addition, the statute was clarified in the Revenue Act of 1978[39] to eliminate the uncertainty created by the decision in *Latrobe Steel Co. v. Commissioner*,[40] as to what types of deferred payments were subject to the restriction in section 404(a)(5) of the Code.

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[34] I.R.C. § 461(h)(2)(A), *added by* DEFRA, *supra* note 3, § 91(a).

[35] *See* DEFRA, *supra* note 3, § 523(a).

[36] I.R.C. § 461(h)(2)(C), *added by* DEFRA, *supra* note 3, § 91(a).

[37] I.R.C. § 404(a) (1982).

[38] Rev. Rul. 61–127, 1961–2 C.B. 36; Rev. Rul. 57–88, 1957–1 C.B. 88; Letter Ruling 8206170.

[39] Pub. L. No. 95–600, 92 Stat. 2763 (1978).

[40] 62 T.C. 456 (1974), *nonacq.* 1976–2 C.B. 3.

Section 512 of the 1984 Act amends section 404(b) of the Code to provide that any arrangement of employer compensation which has the effect of a stock bonus, pension, profit-sharing plan, annuity plan or other plan which defers the receipt of compensation will be subject to section 404(a). The 1984 Act also adds a paragraph (2) to subsection 404(b) of the Code to provide that any plan providing for deferred benefits other than compensation for employees, their spouses, or their dependents is treated as a plan of deferred compensation.[41] A special exception is made for welfare benefit funds (under section 419(e)) and for vacation plans under section 463.[42] The conference committee added an exception for bonuses and other payments made within two and one-half months after the close of the taxable year in which significant services were performed.[43] In effect, deferred compensation is thus defined as payments of compensation that are deferred for more than two and one-half months beyond the end of the year of accrual.

One question which the statute leaves open is whether prepayment of a liability generally satisfies economic performance in the case of a long-term liability to perform services or deliver goods. The authors submit that payment in such cases does not satisfy economic performance. If Congress had intended the opposite conclusion, the authors believe that Congress would have permitted deductions for the present value of a liability to perform services in the future. Moreover, the legislative changes imposing the premature accrual rules on certain tax shelters with regard to prepaid expenses do not seem logical if payment constitutes economic performance.[44] This conclusion is reinforced by the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.[45]

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[41] DEFRA, *supra* note 3, § 523(a).

[42] I.R.C. § 404(b)(2)(B), *added by* DEFRA, *supra* note 3, § 523(a).

[43] CONF. REP. 861, *supra* note 29, at 1160.

[44] *See* I.R.C. § 461(i), *added by* DEFRA, *supra* note 3, § 91(e).

[45] STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT 262 (Comm. Print 1984).

Another aspect of the special payment rules is that economic performance overrides the special rules of existing section 461(f)[46] of the Code.[47] Thus, contested liabilities must satisfy the economic performance standard in order to be deductible, notwithstanding the payment of funds into a section 461(f) trust. In the case of workmen's compensation or tort liabilities, economic performance is not satisfied until the recipient is ultimately paid.[48]

A final aspect of economic performance is the impact of partial performance. As noted previously, under the new premature accrual provisions economic performance and accrual occur as performance occurs, not necessarily when the performance is completed. This gives rise to the question: when does partial performance result in a partial accrual?

Since deductions under section 461 depend both on economic performance and the satisfaction of the all events test, pre-1984 case law on the right to accrue income or expenses in instances of partial performance should continue to be relevant under current law. While the bulk of the precedents in this area deal with the accrual of income, the principles should be equally applicable to the accrual of deductions. In the absence of specific guidance on this question, it should be noted that section 1.451–1(a) of the regulations provides as follows with respect to the proper time for an accrual method taxpayer to report income:

> Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accura-

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[46] I.R.C. § 461(f), *added by* DEFRA, *supra* note 3, § 91(e).

[47] CONF. REP. 861, *supra* note 29, at 876.

[48] I.R.C. § 461(h)(2)(C), *added by* DEFRA, *supra* note 3, § 91(a).

> cy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.[49]

The Service has in several published rulings expressed the following formulation as to when the all events test for the accrual of income is satisfied: "All the events that fix the right to receive income referred to in section 1.451–1(a) of the regulations occur when either (1) the required performance takes place, or (2) payment is due, or (3) payment is made."[50]

In the case of contracts that specifically provide that billing will occur only when the required performance is completed, payment is not due until these conditions for billing are satisfied. Since payment under such contracts will not occur prior to billing, the Revenue Ruling 79–195 conditions for accrual could be satisfied prior to completion of all of the work only if it were considered that the required performance had taken place prior to completion of all of the work. Since the performance required by the contract is completion of the work, the conditions for accrual would not appear to be met prior to final completion.

This conclusion is confirmed most directly by the Tax Court decision in *Decision, Inc. v. Commissioner*.[51] In that case the Service argued that income accrued upon partial performance by the taxpayer under a contract to provide advertising and resume services, even though the taxpayer was not yet entitled to bill for these services. The Tax Court disagreed: "We cannot accept this argument. . . . Respondent has referred us to no cases holding that income accrues upon part performance of a contract prior to an agreed billing or payment date."[52]

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[49] Treas. Reg. § 1.451–1(a), T.D. 6282, 1958–1 C.B. 221.

[50] Rev. Rul. 79–195, 1979–1 C.B. 177. *See also* Rev. Rul. 77–135, 1977–1 C.B. 133; Rev. Rul. 74–607, 1974–2 C.B. 149.

[51] 47 T.C. 58 (1966).

[52] *Id.* at 63.

The conclusion that compensation not due until completion of the contract does not accrue until completion is also supported by *Craig v. Thompson*,[53] although the court there based its conclusion primarily on a rejection of the argument that the contract in fact called for monthly payments. It is not entirely clear that the court was presented with the argument that the income should be accrued based on partial performance even if the contract did not require payment prior to completion.

There are also a number of precedents holding that retainages do not accrue prior to the time the retainage actually becomes payable. This conclusion also supports the view that partial performance does not permit accrual of income due upon the completion of a contract.[54]

One decision that may support the conclusion that partial performance does provide a basis for accrual is *Dingle-Clark Co. v. Commissioner*.[55] This case held that where, as of the beginning of the taxable year at issue, a contract was 95% complete, the following items were properly accruable in earlier years: (1) retainages attributable to billings in those years; (2) the portion of the base fee attributable to work done in earlier years; and (3) the portion of a bonus fee attributable to work done in earlier years. The court noted that as of the beginning of the year at issue, "there was no substantial contingency . . . which could have prevented petitioner's ultimate receipt"[56] of the retainages and other amounts. In light of the inconsistency that would otherwise result between this decision and the Tax Court's other decisions dealing with retain-

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[53] 177 F.2d 457 (8th Cir. 1949).

[54] *See, e.g.*, Rev. Rul. 69–314, 1969–1 C.B. 139; United States v. Harmon, 205 F.2d 919 (10th Cir. 1953); Marquardt Corp. v. Commissioner, 39 T.C. 443 (1962); Dally v. Commissioner, 20 T.C. 894, 899 (1953), *aff'd on other grounds*, 277 F.2d 724 (9th Cir. 1955). But see Wright Contracting Corp. v. Commissioner, 316 F.2d 249 (5th Cir. 1963), which held that the taxpayer could not change from a method of accounting that accrued retainages to a method that did not without the Commissioner's consent, and suggested that it was proper to accrue retainages.

[55] 26 T.C. 782 (1956), *acq.* 1957–1 C.B. 4.

[56] *Id.* at 791.

ages, it probably should be concluded that the fact that the contract was 95% complete was crucial to the result.

It should be noted that, in contrast to the prevailing weight of authority, the Service has recently taken the position in litigation that accrual of income based on partial performance may be required even though neither billing nor payment has yet occurred. In *Public Service Co. of New Hampshire v. Commissioner*,[57] the Service argued that "under normal accrual concepts the income attributable to consumption of electricity after the December meter reading date to year end clearly is currently accruable."[58] The Tax Court concluded that it need not consider this issue, but gave the following indication of what its conclusion on the merits might have been: "Our conclusion in this regard is reinforced by the fact that the 'billing' requirement to which petitioner was subject may well be critical with respect to the issue of accruability."[59]

Thus, it appears that with respect to those contracts that explicitly provide that billing is to occur upon completion of the contract, accrual of income is not required until the contract is completed.

Applying this rationale to the treatment of deductions, the case law under the all events test seems to support the conclusion of the income accrual cases that absent a specific agreement to the contrary, no accrual is permitted until completion of the services and the rendering of a bill. In the leading case on the deductibility of expenses for services, *Old Colony Trust Associates v. Hassett*,[60] the court held that legal expenses for services rendered in 1933 and 1934 could not be deducted until 1935 when the fee was first determined and billed. A similar conclusion was reached in *Cold Metal Process Co. v. Commissioner*,[61] *Canton Cotton Mills v. United*

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[57] 78 T.C. 445, 453 (1982).

[58] *Id.*

[59] *Id.* at 454.

[60] 55 F. Supp. 629 (D. Mass. 1944), *rev'd on other grounds*, 150 F.2d 179 (1st Cir. 1945).

[61] 17 T.C. 916 (1951), *aff'd.*, 247 F.2d 864 (6th Cir. 1952).

States,[62] and *Kanne v. American Factors, Ltd.*[63] However, in each of these cases, the absence of a prior agreement coupled with the failure to render a bill was held to prevent accrual of legal expenses even where all or substantially all of the services were performed. In *SICO Foundation v. United States,*[64] the taxpayer's lack of knowledge as to the amount of the accrual for legal services prior to the submission of a bill was held to prevent accrual.

It is interesting to note that in each of these cases, there was no prearranged agreement as to the precise billing. This gives rise to a question as to whether, if there is a precise agreement to bill on an hourly basis, the rendering of a bill is a mere formality rather than a prerequisite to accrual. It seems doubtful that accrual would be permitted in these circumstances because even with agreement to bill on an hourly basis, there may be a disagreement as to the number of hours, the rates to apply, or the particular attorneys who should have performed the services.

Based on the foregoing case law, it seems unlikely that partial performance gives rise to a partial accrual. However, in those cases where under prior law accrual was proper prior to even the commencement of performance, partial performance under the economic performance rules may give rise to a partial deduction. In such a case, the all events test case law will be of little help and taxpayers will have to look elsewhere for guidance. One possibility is to presume deductibility on a straight-line basis over the expected term of performance. Another possibility would be to follow a percentage of completion methodology, based either on the percentage of physical completion or the percentage of costs incurred compared to estimated total costs to complete.[65]

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[62] 94 F. Supp. 561 (Ct. Cl. 1951).

[63] 190 F.2d 155 (9th Cir. 1951).

[64] 295 F.2d 924 (Ct. Cl. 1961).

[65] For an analogy in the long-term contract area, see Treas. Reg. § 1.451–3(c)(2), T.D. 7397, 1976–1 C.B. 115.

¶ 1401.3 Legislative Exceptions to Economic Performance

Section 461(h)(5) of the Code contains a number of exceptions from the requirement for economic performance. Thus, the accrual of employee benefits under a qualified pension, profit-sharing or stock bonus plan described in sections 404 or 404A and contributions to a funded welfare benefit plan under section 419 need not satisfy the economic performance rules. Similarly, reserves for bad debts under section 166, qualified discount coupon redemption reserves under section 466, and insurance company reserves are also exempted from the economic performance requirement.[66] The final exception from economic performance applies to accruals of vacation pay under section 463.[67]

This latter exception is of considerable significance to taxpayers because the overwhelming majority of taxpayers with vacation pay plans have chosen not to make an election under section 463. However, as a result of the changes made by the 1984 Act, most taxpayers will be forced to make such an election in order to retain current deductions for vacation pay.

The background of section 463 is that under the 1939 Code, the Service had ruled that a taxpayer could deduct accrued vacation pay even though the recipient might forfeit the pay if employment ceased prior to payment.[68] When the 1954 Code was enacted, the Service changed its position and ruled that an employee must be entitled to the vacation pay in all circumstances in order for the employer to be able to accrue it prior to payment.[69]

Congress postponed the implementation of Revenue Ruling 54–608 for several years, until it finally resolved the problem permanently in section 463. Under section 463, a taxpayer could deduct the increase in its liability for accrued vacation despite the fact that such pay is forfeitable if an employee's

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[66] I.R.C. § 461(h)(6), *added by* DEFRA, *supra* note 3, § 91(a).

[67] *Id.*

[68] I.T. 3956, 1949–1 C.B. 78.

[69] Rev. Rul. 54–608, 1954–2 C.B. 8.

employment is terminated prior to payment.[70] While section 463 is theoretically applicable to taxpayers with vested vacation plans, there was no incentive to make an election under section 463 in such a case because the accruals could be deducted currently under the regular section 461 rules.

As a result of the 1984 Act changes, vacation pay for services rendered in a preceding taxable year is considered deferred compensation if it is paid more than two and one-half months after the end of the taxable year of accrual.[71] Accordingly, taxpayers must elect section 463 treatment even for vested vacation pay plans if they wish to continue accruing such amounts currently. Ordinarily, an election under section 463 by a taxpayer who currently accrued a liability for vacation pay under a vested vacation pay plan would not cause any change in tax treatment. However, there is some concern that the Service would use the occasion of a section 463 election to reexamine the propriety of a taxpayer's prior accruals.

Two particular types of vacation pay plans which are prevalent among companies are of concern to the Service. Under the first type of plan, vacation pay is not forfeited if employment is terminated. However, if an employee is too busy to take his or her vacation, the employee's vacation is forfeited without pay. There is a significant risk that such a plan is not vested and, therefore, deductions outside of section 463 would be improper. Under the second type of plan, if the employee fails to take his or her vacation by the end of the year, the vacation is "banked" or carried over to a future year. In this type of plan, there is a serious question whether such a plan was a plan of deferred compensation subject to the restrictions of section 404(a)(5), even prior to the enactment of the 1984 Act. If a taxpayer has either of these types of plans and has been accruing deductions in the year in which the vacation was earned through employment, it is possible that the Service would seek adjustments to reverse such accruals incident to the making of a section 463 election under the 1984 Act.

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[70] I.R.C. § 463(a) (1982).

[71] CONF. REP. 861, *supra* note 29, at 1160.

¶ 1401.4 Conference Committee Exceptions to Economic Performance

In order to qualify for this exception, the following conditions must be satisfied:

(1) the all events test must be satisfied during the taxable year, apart from economic performance;

(2) economic performance must occur no more than eight and one-half months after the close of the taxable year of accrual;

(3) the item must be recurring in nature and the taxpayer must consistently treat items of that type as incurred in the taxable year in which the all events test is met; and

(4) either (i) the item must not be material, or (ii) the accrual of the item in the year in which the all events test is met must result in a better matching of the item with the income to which it relates than would accrual in the year of economic performance.[72]

This class of exceptions is inapplicable to liabilities for worker's compensation, tort liabilities, or liabilities for deferred compensation to employees.[73]

In analyzing these requirements, it should be noted that while the first condition under this class of exceptions (*i.e.*, satisfaction of the all events test) should be self-evident, the enactment of the 1984 Act may cause revenue agents to re-examine their long-standing position towards certain accruals. For example, a large variety of expenses have routinely been deducted and allowed on audit under prior law notwithstanding that they technically failed to comply with the all events test. In these cases, the basis for allowance was often that the expenses overlapped two taxable years.[74] For example, many calendar-year taxpayers deducted currently accrued insur-

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[72] I.R.C. § 461(h)(3), *added by* DEFRA, *supra* note 3, § 91(a).

[73] *Id.* § 461(h)(3)(C).

[74] Treas. Reg. § 1.461–1(a)(3)(i) (1957).

ance which was due and payable at a time prior to the completion of the term of the insurance which extended into the next taxable year. It is unclear what the Service's attitude will be toward these types of accruals subsequent to the enactment of the 1984 Act.

The second condition for this class of exceptions is that economic performance must occur within a reasonable period of time after the end of the taxable year of accrual.[75] The statute limits a reasonable period of time to eight and one-half months.[76] Although it is not specifically covered, it should be presumed that this condition must be satisfied within the specified period of time by the *completion* of economic performance.

The third requirement for this class of exceptions to apply is that the expense to be accrued must be recurring in nature and the taxpayer must consistently accrue the expense in the year that the all events test is satisfied.[77] The conference committee report indicates that consideration should be given to the frequency with which the expense and similar expenses occur or are expected to occur, but it is not necessary that the expense recur every year.[78] In addition, the conference committee report indicates that the conferees intend that this condition not preclude new trades or businesses or new types of expenses from qualifying.[79] Thus, a taxpayer's future expectations with regard to a particular expense, as well as the taxpayer's past history, will affect whether this condition is satisfied. In this regard, it should be noted that since the time when a deduction is taken is a method of accounting,[80] presumably once a taxpayer has begun accounting for the expense in the appropriate taxable year, it can be assumed for purposes of satisfying this condition that such treatment will continue.

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[75] I.R.C. § 461(h)(3)(A)(ii)(I), *added by* DEFRA, *supra* note 3, § 91(a).

[76] *Id.* § 461(h)(3)(A)(ii)(II).

[77] *Id.* § 461(h)(3)(A)(iii).

[78] CONF. REP. 861, *supra* note 29, at 873.

[79] *Id.*

[80] Treas. Reg. § 1.446–1(e)(2)(ii)(a), T.D. 7073, 1970–2 C.B. 98.

The final condition for this class of exceptions has two alternative requirements. The first alternative requirement is that the expense not be material.[81] The factors to be taken into account in determining materiality include the size of the expense and its treatment in the taxpayer's financial statements.[82] The size of the item must be considered in absolute terms and also in relation to the taxpayer's other expenses and income.[83] Moreover, materiality must be determined with respect to the activity to which the expense directly relates, rather than to the taxpayer's activities as a whole.[84] This size test may be applied both at the partnership and partner level (or at both levels of any other type of pass-through entity, such as a trust) in appropriate circumstances.[85] The conference committee report illustrates this approach with the case of an accrual method partnership that makes a special allocation of an expense that is not material at the partnership level, but is material at the partner level.[86] The conference committee report also states that this special rule should not impose significant additional reporting burdens on partnerships and other flow-through entities in the nonabusive cases.[87]

There is no indication of what threshold size test would be applied in determining materiality. In the authors' opinion, a percentage test in the range of 1% to 5% should be applied. However, it is possible that a sliding scale test based on the absolute size of the expense may be appropriate under the conference committee report mandate. Whatever test is adopted should be incorporated into the regulations or frequent audit issues will arise.

The second aspect of the materiality condition is its rela-

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[81] I.R.C. § 461(h)(3)(A)(iv)(I), *added by* DEFRA, *supra* note 3, § 91(a).

[82] CONF. REP. 861, *supra* note 29, at 873–74.

[83] *Id.* at 874.

[84] *Id.*

[85] *Id.*

[86] *Id.* The materiality standard is only applicable for purposes of this Code section and is not to be applied in other areas.

[87] *Id.*

tionship to financial reporting.[88] The conference committee report establishes what amounts to a "one-way street" financial conformity requirement. Thus, if an expense is considered material for financial reporting purposes, it will be treated as failing this condition. However, the converse is not necessarily true; an expense that is not considered material for financial reporting is not necessarily immaterial for purposes of this condition.[89] Thus, if an expense of a taxpayer is immaterial in a taxpayer's consolidated financial statements, but is material taking into account the separate company involved, there is a high likelihood that the expense would be considered material for purposes of this condition. The application of this test may be illustrated with the case of a calendar-year taxpayer who purchases a one-year fire insurance policy on September 1 of each year. If, for financial reporting purposes, the taxpayer prorates the cost of the policy over its term, the taxpayer will fail the materiality test. In contrast, if the item is expensed entirely in the year incurred for financial reporting purposes, it may or may not satisfy the materiality test.

The interpretation of the financial reporting conformity condition will undoubtedly generate issues which are analogous to those in the LIFO area.[90] The Service can be expected to take a position consistent with the 1984 Act that financial conformity for a subsidiary corporation must be satisfied both at the subsidiary and the parent company level.[91]

As an alternative to the materiality standard, a taxpayer may satisfy the final condition for an exception to the economic performance requirement if it can be shown that a current accrual results in a better matching of revenue and expenses than does accrual in the year in which economic performance occurs.[92] The conference committee report con-

[88] I.R.C. § 461(h)(3)(A)(iv)(II), *added by* DEFRA, *supra* note 3, § 91(a).

[89] CONF. REP. 861, *supra* note 29, at 874.

[90] *See* I.R.C. § 472(c), (e) (1982). For a detailed discussion of this subject, see L. SCHNEIDER, FEDERAL INCOME TAXATION OF INVENTORIES ch. 11 (1979).

[91] I.R.C. § 472(g), *added by* DEFRA, *supra* note 3, § 95(a).

[92] I.R.C. § 461(h)(3)(A)(iv)(II), *added by* DEFRA, *supra* note 3, § 91(a).

tains a number of illustrations of the matching concept. For example, if a salesman's commission is earned upon a sale, but is not payable until the revenue from the sale is collected, the expense is better matched with the related income which is accrued in the year of the sales accrual rather than in the year of collection.[93] Similarly, if goods which are sold are in transit at year end, it more clearly matches income and expense to accrue the entire shipping expense in the year of the sale.[94]

Certain kinds of expenses are more appropriately matched to the period to which they relate, rather than to a particular type of income. This is true in the case of rent and insurance expense.[95] Advertising expenses are difficult to match either with particular revenues or with a particular period. In the case of advertising, the conference committee report states that the matching condition will be satisfied if advertising is accrued for tax purposes in the same year in which it is deducted for financial reporting purposes.[96]

Because of the lack of detailed guidance on many of these issues, it should be anticipated that the bulk of the controversies in this area will arise in the qualification of items for one of the exceptions from the economic performance requirement.

¶ 1401.5 Accounting Method Considerations and Effective Date

The economic performance rules are generally effective for amounts incurred after July 18, 1984.[97] Although the economic performance rules are currently in effect, the interplay of these rules with existing regulations and rulings is in question. It is anticipated that the Treasury Department will review existing regulations and rulings to determine whether

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[93] CONF. REP. 861, *supra* note 29, at 874.

[94] *Id.*

[95] *Id.* at 875.

[96] *Id.*

[97] *Id.* at 877.

they are consistent with the policies and principles set forth in the new economic performance rules.[98] As stated by the conferees:

> Until new regulations are issued under these provisions or the existing rulings are revoked or clarified, taxpayers may continue to rely on these rulings to the extent they are not inconsistent with the general principles of economic performance or the generic exception for recurring items. Likewise, the conferees expect that taxpayers may rely on present law with respect to agreements entered into with the Internal Revenue Service (for example, under section 446 or 7121 of the Code or Rev. Proc. 80–51, 1980–2 C.B. 818), until new regulations are issued.[99]

With respect to reliance on existing rulings and regulations, it may be a matter of interpretation as to whether such rules or regulations are consistent with the principles and policies of economic performance, thereby making such reliance vulnerable to challenge by the Service. The conferees, as noted above, also refer to reliance on present law with respect to agreements with the Service under sections 446 or 7121 of the Code and under Revenue Procedure 80–51.[100] I.R.C. § 446 presents the general rules for methods of accounting as well as requirements with respect to changes in accounting methods. I.R.C. § 7121 grants the Secretary the authority to enter into a written agreement with a taxpayer regarding his tax liability for a particular tax period. Revenue Procedure 80–51 sets forth the general procedures for obtaining the consent of the Commissioner for changes in methods of accounting. The conferees indicated that agreements entered into with the Service under the above-mentioned provisions based on present law can be relied upon until new regulations are issued. The precise scope of this pronouncement is unclear. For example, does this mean that if a tax-

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[98] *Id.* at 876.

[99] *Id.*

[100] *Id. See also* Rev. Proc. 80–51, 1980–2 C.B. 818, *as superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

payer has secured the consent of the Commissioner for a change in accounting method pursuant to section 446, that such consent may be withdrawn based on subsequently issued regulations? Similarly, could an agreement with the Commissioner with respect to the taxability of a particular item or transaction be rescinded if the regulations which are subsequently issued in connection with the economic performance rules are inconsistent with such agreement? The answer to both questions is probably (and unfortunately) yes. However, will such agreements be recognized to the extent they affect tax periods prior to issuance of the "economic performance" regulations? The answers to these questions are not readily apparent from the body of the 1984 Act; nor are the answers found in the conference report. The precise scope of the provision of the conference report relating to "Reliance on other existing Rulings and Regulations"[101] is therefore unclear and will most likely remain so until new regulations are issued. While it is likely that subsequently issued regulations will be generally retroactive to July 19, 1984 it is believed that exceptions will be provided, based upon reasonable reliance, if not blanket waivers.

Although, as was noted above, the economic performance rules are generally effective on July 19, 1984, taxpayers are provided with a choice of two transition procedures for applying the economic performance rules.[102] The first choice available to taxpayers is to elect to have the economic performance rules apply only to expenses incurred after the date of enactment, i.e., after July 18, 1984.[103] In other words, a "clean cutoff" method. This election may be made "with respect to each type of deductible item."[104] Under this choice, an adjustment under section 481 would not result. Section 481 provides generally for adjustments to taxable income to prevent items of income or expense from being duplicated or omitted when a taxpayer changes his method of accounting (section 481

[101] CONF. REP. 861, *supra* note 29, at 876.

[102] *Id.* at 877.

[103] *Id.*

[104] *Id.*

adjustment).[105]

The second choice provided to taxpayers with respect to the application of the economic performance rules is the election to apply the economic performance rules to expenses incurred both prior to and after the date of enactment.[106] Under this approach, a section 481 adjustment would result and such adjustment would be amortized over a period of no more than three years.[107] It is understood that the spread period was limited to three years because of revenue considerations. In certain situations, special relief in the form of a longer spread period should be sought.

In general, the section 481 adjustment as noted above, is required when a taxpayer changes his method of accounting. The purpose and nature of section 481 adjustments is summarized in part by Revenue Procedure 84–74 as follows:

> Methods of accounting should clearly reflect income on a continuing basis, and the Internal Revenue Service administers its discretion under sections 446(e) and 481(c) of the Code so that, in general, any distortion of income on an annual basis is minimized. The Service will consider the need for consistency in the accounting area against the taxpayer's reason for desiring to change its method of accounting when the method of accounting from which the taxpayer is changing clearly reflects income. When there is a change in method of accounting, income for the year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following years is determined under the new method of accounting. The section 481(a) adjustment, while necessary to prevent duplications or omission of income or deductions, by its nature is distortive since it does not reflect the economic income of the year. An adjustment period for the section 481(a) adjustments is . . . intended to

[105] I.R.C. § 481(a) (1982).

[106] CONF. REP. 861, *supra* note 29, at 877.

[107] *Id.*

> reduce the possibility of a change in method of accounting from itself creating a material distortion in income in the year of change and to reduce any distortion when it does exist.[108]

Thus, if a taxpayer elects to apply the economic performance rules to expenses incurred *both* prior to and after the date of enactment, a section 481 adjustment is necessary with the total adjustment to be amortized over a period not to exceed three years in order to satisfy the principles and policies of Revenue Procedure 84–74, as summarized in part, above.

It is not clear what the "year of change" is under the method change approach. Typically, method changes are made as of the first day of a taxable year and the section 481 adjustment is computed as of the last day of the year preceding the year of change. If the year of change is the taxable year that includes the date of enactment (July 18, 1984), retroactive application would result. A representative of the national office of the IRS indicated informally that he thought that there would be a hypothetical split of 1984 into two taxable years for method change purposes on an item by item basis, i.e., one year being the period before July 19, 1984, and the second being the period of July 19, 1984 to the end of the year—with the latter being the year of change. It is believed that this approach is not very practical and the taxable year of change should be the taxable year beginning after July 18, 1984, but at a minimum the beginning of a month, e.g., August 1, 1984. What this means is that if there is an item that had been consistently accrued even though economic performance takes place at some uncertain point of time in the future, these amounts accrued through July 18, 1984, with respect to which no performance had taken place as of that date, would be deducted again when performance occurs (sometime after July 18, 1984) resulting in a double-deduction. The positive section 481 adjustment increases income for the double deduction over three taxable years starting with the year of change. The Joint Committee General Ex-

[108] Rev. Proc. 84–74, 1984–44 I.R.B. 15, 17.

planation of the Revenue Provisions of the Deficit Reduction Act of 1984,[109] supports the above-described IRS view and goes on to say that in some cases it may not be possible to determine the amount of the adjustment and the regulations could provide that the method change occurs as of the first day of the taxable year that includes July 19, 1984.

The question then becomes: Under what circumstances is one election more advantageous than the other? If economic performance of a liability will occur in year one or year two of the spread period, it would generally be advantageous to elect the section 481 adjustment approach. The reason for this is that the net increase in taxable income for the period prior to the year of change that arises due to the possible double deduction (accrued amount as of the end of the year preceding the year of change and again when economic performance occurs) will be added to taxable income over three years.[110] In other words, assuming economic performance of the liability will take place early in the spread period, the deduction for the liability will be available before inclusion of the income increasing adjustment. In short, the election to apply the economic performance rules retroactively to certain liabilities can have the effect of accelerating a deduction while deferring income.

If, on the other hand, economic performance will not occur with respect to a liability deducted prior to enactment, within the three year period subsequent to the enactment date, it would not be advantageous to elect to have the economic performance rules apply retroactively to that particular liability. The reason for this is that the net increase in taxable income arising due to the section 481 adjustment would be recognized

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109 STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT 268 (Comm. Print 1984).

110 CONF. REP. 861, *supra* note 29, at 877. Temporary Regulations issued on May 17, 1985 provide the taxpayer with an election to have the method change effective as of the first day of their taxable year that includes July 19, 1984, or the taxpayer may elect a split-year change with the first day of the method change year being July 19, 1984. *See* Q–8 of Temp. Reg. § 1.461–3T (1985).

over three years while the liability could not be deducted for tax purposes until after that three year period, when economic performance occurs. The net effect would be to accelerate income while deferring expenses. It is conceivable, however, that this effect would be attractive if a corporation was in a loss position during the section 481 three year adjustment period and expects to be in a profitable position when economic performance with respect to a particular liability will occur. However, this opportunity would, in part, be reduced if the net operating loss limitation rule of section 5.15 of Revenue Procedure 84–74[111] is made applicable to these changes. Since the election with respect to application of the economic performance rules can be made on an expense by expense basis,[112] the transition period for applying the economic performance rules offers possible tax planning opportunities. Although the election with respect to the timing of the application of the economic performance rules is available on an item by item basis, it is not clear how this choice will be interpreted. The language of the conference report reads in part as follows: "[t]axpayers may elect (with respect to each type of deductible item). . . ."[113] This may not mean there is an expense by expense choice of transition methods but rather a category by category choice. It is unclear how this choice will be interpreted.

¶ 1401.6 Special NOL Rules

The 1984 Act has added a special ten-year net operating loss (NOL) carryback for NOLs attributable to certain liabilities deferred under the provisions of IRC § 461.[114] This special NOL carryback provision applies only to "an amount incurred with respect to a liability which arises under a Federal or

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[111] 1984–44 I.R.B. 15.

[112] CONF. REP. 861, *supra* note 29, at 877.

[113] *Id.* This question has been at least partially resolved by recently issued Temporary Regulations which provide that the taxpayer may elect the change separately for each separate trade or business and for each trade or business may elect the change with respect to one or more types of items.

[114] *See* I.R.C. § 172(b)(1)(K), *added by* DEFRA, *supra* note 3, § 91(d).

State law or out of any tort of the taxpayer. . . ."[115] Second, the liability must result from an act or failure to act, occurring at least three years prior to the taxable year in which the NOL arises.[116] Third, in the case of a liability arising out of a tort, such liability must arise out of a series of actions or inactions occurring over an extended period of time, "a substantial portion of which occurs at least three years before the beginning of such taxable year."[117] Finally, the taxpayer must have used the accrual method of accounting during the period when the act was performed and when the NOL arises.[118] These new rules provide some relief beyond the three-year NOL carryback period to help compensate for the mismatching that arises from the inability to accrue for a reserve during the years when related sales take place. Examples of situations to which this provision will likely apply are pollution control violations, certain product liability problems, and wrongful acts (negligent or otherwise).

The amount of the NOL carryback is limited to the lesser of (1) the NOL reduced by amounts attributable to a foreign expropriation loss, or a product liability loss[119] or (2) the statutory and tort liabilities that are allowed pursuant to this provision.[120] With respect to the carryback period, the code provides that "no deferred statutory or tort liability loss may be carried back to a taxable year beginning before January 1, 1984 . . ."[121] unless such loss could be carried back under prior law. In effect, this makes the provision prospective. Under prior law, NOLs resulting from such events could generally only be carried back three years.[122]

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[115] *Id.* § 172(k)(1)(B)(ii).

[116] *Id.* § 172(k)(1)(B)(ii)(I).

[117] *Id.* § 172(k)(1)(B)(ii)(II).

[118] *Id.* § 172(k)(1)(B).

[119] *Id.* § 172(k)(1)(A)(i).

[120] *Id.* § 172(k)(1)(A)(ii).

[121] *Id.* § 172(k)(4).

[122] I.R.C. § 172(b)(1)(A) (1982).

¶ 1401.7 Special Premature Accrual Rules

A complex set of provisions were added by the 1984 Act dealing with the accrual and deduction of costs associated with decommissioning nuclear facilities, and mine and solid-waste reclamation facilities. With respect to nuclear power plant decommissioning expenses, a special rule has been provided under IRC § 172(k)(2) permitting a NOL arising due to such expenses to be carried back to a period beginning with the taxable year in which the plant was placed in service and ending with the taxable year preceding the year of loss. The 1984 Act also added sections 88 and 468A relating to deductions in connection with nuclear power plant decommissioning. Under present law it is unclear when nuclear power plant decommissioning expenses are properly deductible.[123] Decommissioning expenses are incurred by a utility company at the end of the useful life of a nuclear power plant in order to make the plant site safe in accordance with federal and state laws.[124] Section 468A sets forth the rules for the timing, amount, and methods for deducting decommissioning costs. Although a detailed analysis of this provision is beyond the scope of this Article, the general thrust of section 468A is to allow a taxpayer responsible for decommissioning a power plant to establish a separate decommissioning fund and deduct contributions to the fund as they are made, subject to various limitations.[125]

Similarly, section 468(a) was added which relates to the deductibility of mine and solid waste reclamation and closing costs. In general, federal and state laws require reclamation of surface mines and waste disposal sites. Section 468(a) sets forth the rules with respect to the deduction for costs associated with such reclamation. Basically, section 468 allows a taxpayer to establish, and contribute to a sinking fund an amount equal to the estimated costs of reclamation incurred each year. Once again, a detailed analysis of this provision is not within the scope of this Article.

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[123] CONF. REP. 861, *supra* note 29, at 877.
[124] *Id.*
[125] *Id.*

¶ 1402 ACCOUNTING METHODS AND THE PENALTY PROVISIONS—I.R.C. SECTION 446(f)

¶ 1402.1 Background

Section 446(e) provides in part that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary."[126] A change in method of accounting includes a change in the over-all method of accounting for gross income or deductions or a change in the treatment of any material item.[127] A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.[128] As to the consent requirement, the regulations provide that consent from the Commissioner is equally applicable to a change from an improper method of accounting as it is to a change from a proper method.[129]

Neither the Code nor the regulations imposed a *duty* on a taxpayer to apply for a change in accounting method, even if the taxpayer's method was clearly erroneous. To the contrary, section 481(a)(2) provides that if a taxpayer is required to change its method of accounting, any adjustment required by section 481 shall not include any pre-1954 amounts. If, on the other hand, the taxpayer initiates the change in accounting method, the adjustment includes amounts relating to pre-1954 years,[130] which, depending on the taxpayer's particular circumstances, could be a disincentive to change an improper method. The traditional inducement the IRS has used is a multi-year spread of the associated section 481 adjustment.[131]

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126 I.R.C. § 446(e) (1982).

127 Treas. Reg. § 1.446–1(e)(2)(ii)(a), T.D. 7073, 1970–2 C.B. 98.

128 *Id.*

129 Treas. Reg. § 1.446–1(e)(2)(i), T.D. 7073, 1970–2 C.B. 98. *See also* Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975).

130 I.R.C. § 481(a)(2) (1982).

131 *See* Rev. Proc. 64–16, 1964–1 C.B. 677; Rev. Proc. 70–27, 1970–2 C.B. 509; Rev. Proc. 80–51, 1980–2 C.B. 818; Rev. Proc. 84–74, 1984–44 I.R.B. 15.

Under AICPA rules, a CPA must consider whether to proceed with the preparation of the current year's return where he knows of an error in a previously filed return and the client has done nothing to correct the error.[132] However, this rule does not apply where a method of accounting is continued under circumstances believed to require permission to effect a change.[133] After the Supreme Court's *Thor Power Tool Co. v. Commissioner*[134] decision, a dialogue ensued between the AICPA and the Service as to mandatory method changes which resulted in the issuance of Revenue Procedure 80–5[135] which granted blanket permission to taxpayers to switch off *Thor* inventory methods.

Taxpayers using an improper method have argued that there is *no requirement* to request permission from the Service to change to a proper method. Based on this argument, taxpayers have also asserted the lack of permission as a defense to any penalty arising from use of the improper method, including the substantial underpayment penalty under section 6661 and the negligence penalty under section 6653.

¶ 1402.2 New Statutory Provisions

Under the 1984 Act, taxpayers can no longer rely on the accounting method change consent requirement as a defense to any penalty in the Code. The 1984 Act added section 446(f) which provides as follows:

> If the taxpayer does not file with the Secretary a request to change the method of accounting, the absence of the consent of the Secretary to a change in the method of accounting shall not be taken into account—
>
> (1) to prevent the imposition of any penalty, or the addition of any amount to tax, under this title, or

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[132] AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTS, STATEMENT ON RESPONSIBILITIES IN TAX PRACTICE No. 6 (Aug. 1970).

[133] *Id.*

[134] 439 U.S. 522 (1979).

[135] 1980–1 C.B. 582. For a detailed discussion see L. SCHNEIDER, *supra* note 90, at § 7.08.

(2) to diminish the amount of such penalty or addition to tax.[136]

The conference report also states that no inference should be drawn as to whether the accounting method defense was valid under prior law.[137]

The effective date of the IRC § 446(f) is for taxable years beginning after July 18, 1984.[138] A special rule is suggested in the conference report that provides that if a taxpayer has been contacted for an audit and wishes to change from an improper to a proper method for a year that includes July 18, 1984, but is beyond the 180-day filing period (as in the case of a calendar year taxpayer), such taxpayer will have until the extended due date of the return for the taxable year that includes July 18, 1984, to file the method change to avoid penalties.[139] Revenue Procedure 80–51 provides at section 5.03 that an early application may be filed within the six month period before the beginning of the year of change.[140] It is not clear what the year of change will be; probably the taxable year that includes July 18, 1984.

As discussed earlier, a taxpayer whose method of accounting is "involuntarily" changed is entitled to a pre-1954 offset, i.e., a reduction of the section 481 adjustment by amounts applicable to taxable years prior to 1954.[141] This offset right is given up on a "voluntary" change,[142] the quid-pro-quo being a spread of the resulting adjustment. Those taxpayers with old erroneous practices are now forced to seek permission to change those practices in order to avoid penalties and will also be forced to give up pre-1954 balances. The Service should modify their rules and, in fact, taxpayers should re-

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136 I.R.C. § 446(f), *added by* DEFRA, *supra* note 3, § 161(a).

137 CONF. REP. 861, *supra* note 29, at 1002.

138 DEFRA, *supra* note 3, § 161(b).

139 CONF. REP. 861, *supra* note 29, at 1002.

140 Rev. Proc. 80–51, 1980–2 C.B. 818. *See also* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

141 I.R.C. § 481(a)(2) (1982).

142 *Id.*

quest pre-1954 offsets, notwithstanding the spread of the resulting section 481 adjustment. The Service has allowed a pre-1954 offset and a spread in the case of changes to full-absorption accounting for inventories during a special transition period.[143]

¶ 1402.3 Interplay with Internal Revenue Service Administrative Procedures

In 1964, the IRS issued Revenue Procedure 64–16[144] which granted a ten-year spread to those taxpayers that voluntarily sought method changes, corrective or otherwise. Such spread procedures also applied to method issues raised under examination, albeit starting in a different taxable year. The spread amount (section 481(a) adjustment) includes amounts applicable to pre-1954 taxable years because such changes are viewed as "voluntary." This is the case notwithstanding the fact that the spread was elected during an examination.

One of the primary purposes of Revenue Procedure 64–16 was to attempt to resolve the continuing conflict regarding the difference between the mere correction of an error and a change in method of accounting, with the taxpayer conceding the method issue and the government granting a ten-year spread of the impact of the change. Over the years, Revenue Procedure 64–16 has been modified a number of times, with the most recent version being Revenue Procedure 84–74.[145]

In 1980, Revenue Procedure 80–51[146] was issued, the purpose of which was stated as follows:

> This revenue procedure contains several major changes and amplifications in the procedures for obtaining the Commissioner's consent to a change in method of accounting. These changes and amplifications are made to encourage compli-

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[143] Treas. Reg. § 1.471–11(e)(1) (1973).

[144] 1964–1 C.B. 677, *superceded by* Rev. Proc. 70–27, 1970–2 C.B. 509, and Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[145] 1984–44 I.R.B. 15.

[146] 1980–2 C.B. 818, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

> ance with proper methods of accounting when a taxpayer is determining taxable income in accordance with one or more methods of accounting that are proscribed by the Code, regulations, decisions of the Supreme Court of the United States, revenue rulings and revenue procedures.[147]

Under this revenue procedure, the Service drew a distinction for the first time between taxpayers using a clearly erroneous method of accounting and all other taxpayers. In the case of a clearly erroneous method of accounting, the Service held that once a taxpayer was contacted by the Service to commence an audit, the taxpayer was precluded from filing Form 3115—Application for Change in Accounting Method—to request permission to correct such erroneous method.[148] These clearly erroneous methods of accounting labelled "Category A" methods, were defined as those methods of accounting that are specifically not permitted to be used by the taxpayer by the Code, regulations, or a decision of the United States Supreme Court, e.g., *Thor Power Tool*.[149] "Category B" methods, are all methods other than "Category A" methods.[150]

If a method to be changed is a Category A method, Revenue Procedure 84–74 does not apply if the taxpayer has been contacted by a representative of the Service for the purpose of scheduling an examination of its federal income tax return, or returns.[151] Instead, the change in method will be made by the Service, but no spread period for the adjustment would be allowed. (It appears that in light of the reduced spread period and limited applicability of the spread procedures to issues arising during examination, taxpayers will have a renewed incentive to raise correction of error versus method issues.) Thus, a taxpayer using a clearly erroneous Category A method of accounting, who was under constant audit could be

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[147] *Id.* at 819.

[148] *Id.* at 820.

[149] *Id.* at 825.

[150] *Id.*

[151] Rev. Proc. 84–74, 1984–44 I.R.B. 15, 19.

subject to penalties if its method was corrected on audit, but could not request permission to correct such method under Revenue Procedure 80–51, except during a limited ninety-day period following the completion of the audit.[152] Revenue Procedure 80–51 provided that a request for a change from a Category A method could be made but only during the ninety-day period following the issuance of a no-change report or other basic report as long as the Category A method was not included as an adjustment, or placed in suspense.[153] Revenue Procedure 84–74 improves this situation by providing for a thirty-day window period after the beginning of each year under certain circumstances.[154]

Assuming Form 3115—Application for Change in Accounting Method—could be filed, in light of the restrictions and limitations set forth above, such application had to be filed no earlier than six months prior to the beginning of the taxable year of change, and no later than 180 days after the beginning of the taxable year of change.[155] In order to file after the 180 day period a taxpayer had to have met the requirements of Treasury Regulation section 1.9100–1, which in general required a showing of good cause.[156] What this means is that while new section 446(f) applies to taxable years beginning after enactment, various windows will be open in the future to file method changes for "newly discovered" problems other than the first 180 days of a year: no exam—up to six months prior to the beginning of the year of change—exam under way —first thirty days of each taxable year. In light of the significant changes made by the IRS in Revenue Procedure 80–51 when it updated Revenue Procedure 70–27 and the precedential nature of those changes as they carryforward to Revenue Procedure 84–74, a comparison of Revenue Procedures 70–27, 80–51, and 84–74 follows.

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[152] Rev. Proc. 80–51, 1980–2 C.B. 818, 820.

[153] *Id.*

[154] Rev. Proc. 84–74, 1984–44 I.R.B. 15, 20.

[155] Rev. Proc. 80–51, 1980–2, C.B. 818, 821, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15, 21.

[156] Rev. Proc. 84–74, 1984–44 I.R.B. 15, 21.

Comparison of Method Change Revenue Procedures

Revenue Procedure 70–27[157]	Revenue Procedure 80–51[158]	Revenue Procedure 84–74[159]
	DEFINITIONS	
	Category A Any method specifically not permitted by the Code, regulations, or a decision of the Supreme Court.	The definition of Category A has been changed to include methods designated as such by the taxpayer or the IRS if clearly erroneous.
	Category B Includes any method that is not a Category A method.	The method of accounting is clearly erroneous *unless* the method is acceptable under any of the following: • currently recognized pronouncements, opinions, or rules of the accounting profession; • current accounting conventions or practices recognized in the industry; • the materiality doctrine of GAAP; or • a document published by the IRS.

[157] 1970–2 C.B. 509, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[158] 1980–2 C.B. 818, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[159] 1984–44 I.R.B. 15.

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
	TIME FOR FILING FORM 3115	
Form 3115 is filed within 180 days after the beginning of the taxable year of change. Late applications after the 180-day period but within nine months may be considered by the IRS upon a showing of good cause.	Form 3115 must be filed within 180 days after the beginning of the taxable year of change. The requirements of Treasury Regulation section 1.9100–1 have to be met to file application after 180 days but before nine months. Applications filed after nine months are considered to jeopardize the interests of the government except in very unusual and compelling circumstances.	The same rules apply.
	A Form 3115 is considered filed when it is mailed to or hand delivered to the IRS.	The same rules apply.
	A taxpayer may file an application up to six months early. The application must be complete except for the section 481(a) adjustment, and must be perfected within the first ninety days of the year of change.	The time for filing early is specified as after the first 180 days of the taxable year prior to the year of change, and before the beginning of the year of change. Also, if the application is not perfected within the first ninety days, the IRS will so notify the taxpayer. If the application is not then perfected within the first 120 days of the year of change, the IRS will close the case.

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
TIME FOR FILING FORM 3115—CONTINUED		
	Applications filed late and not granted Treasury Regulation section 1.9100–1 relief may be considered for the following year if the taxpayer so elects within thirty days after issuance of a denial of relief by the IRS. This procedure is elected by filing a statement with the IRS.	Basically, the same rules apply, except that a new Form 3115 must be filed for the subsequent tax year. A taxpayer who files an early application which is not perfected, or for which the consent letter, discussed below, is not returned, must attach a copy of such application to any subsequent early application requesting consent to change the same method of accounting for a subsequent tax year. (A similar rule applies to applications not filed early if the consent letter attributable thereto is not returned.)
TIME FOR FILING—ADDITIONAL INFORMATION		
	A request on a Form 3115 is treated as a ruling request. Therefore, a taxpayer has thirty days from notice by the IRS to submit additional information or the IRS will close the case. An additional thirty days is available after the case is closed to have it reopened.	Additional information must be submitted within forty-five days of notice by the IRS. An extension of fifteen days may be granted in unusual or compelling circumstances. Failure to meet these deadlines will result in the permanent closing of the case.

Revenue Procedure 70–27

The section 481(a) adjustment is taken into account over the number of taxable years the old method was used, though not to exceed ten years. However, if an insubstantial portion of the adjustment is attributable to events in early years, the adjustment period may be reduced.

Revenue Procedure 80–51

ADJUSTMENT PERIOD

The section 481(a) adjustment is generally taken into account over the number of taxable years the old method was used, not to exceed ten years. However, where an insubstantial portion of the adjustment is attributable to events in early years, the following rules apply:

- if the entire section 481(a) adjustment is attributable to the taxable year immediately preceding the year of change, the total adjustment is taken into account in one year;
- if the taxpayer has used the old method more than four years, and if 67% or more of the section 481(a) adjustment is attributable to any of the one, two or three years immediately preceding the year of change, the highest portion attributable to such years will be spread over three taxable years. The remaining portion is spread over the remainder of the years the taxpayer used the old method, but not more than ten years.

Revenue Procedure 84–74

For Category B changes, the same general rule applies except that the spread period cannot exceed six years.

If the change is from a Category A method, a negative section 481(a) adjustment is taken into account in the year of change, while a positive adjustment is taken into account over no more than three years.

The three-year spread period for positive Section 481(a) adjustments from Category A changes applies to changes for taxable years beginning on or after October 29, 1986. For taxable years beginning on or after October 29, 1984 but before October 29, 1986, the maximum spread period is six years.

The two-year deferred effective date described above does not apply to *Thor Power*[160] type changes. The maximum spread period for these changes is three years.

[160] Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

	Revenue Procedure 80–51 • if the taxpayer has used the old method for four years, 75% is substituted for 67%. If the taxpayer has been contacted by the IRS for purposes of an examination and if the old method has been designated by a revenue ruling or revenue procedure more than two years prior to filing the Form 3115, the adjustment period cannot exceed five years.	Under the new rules the adjustment period cannot exceed three years.
	FULL ABSORPTION	
Revenue Procedure 74–51[161] provides that the spread provisions of Revenue Procedure 70–27 do not apply to a taxpayer changing to the full-absorption method after the transition period in Treasury Regulation section 1.471–11(e)[162]—that is, while a taxpayer could request a change to full absorption—no spread of the resulting section 481(a) adjustment would be granted for a taxable year beginning after September 19, 1975.	A taxpayer may file a request to change to the full absorption method and the normal spread provisions will apply except that the spread period is limited to five years.	Under the new rules the spread period is limited to three years.

[161] 1974–2 C.B. 507, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[162] Treas. Reg. § 1.471–11(e) (1973).

TRIGGERING OF SECTION 481(A) ADJUSTMENT

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
There were no specific provisions under Revenue Procedure 70–27. However, the IRS used basically the same rules contained in Revenue Procedure 80–51 as terms and conditions which were set forth in the form of a consent letter.	If a change in the method of accounting is granted, the spread period will be terminated, and the remaining portion of the section 481(a) adjustment will be brought into income consistent with the following rules: • If the change in method involves a change in inventory valuation, and if at the end of any taxable year during the spread period the taxcarrying value of the inventory is less than two-thirds of the adjusted-tax-carrying value as of the beginning of the year of change, then the balance of the net section 481(a) adjustment must be taken into account in full in determining taxable income in the year of such inventory reduction. A taxpayer may request a waiver of this rule if the reduction is attributable to a strike, involuntary conversion or involuntary interruption of the availability of goods. Such request must be filed within ninety days after the end of the taxable year in which such reduction takes place.	These rules continue to apply with the following exception: • Temporary reductions will not trigger the section 481(a) adjustment. Now the inventory must also be reduced at least by the applicable percentage as of the end of the following year. Also, the balance of the net section 481(a) adjustment is now taken into account in determining taxable income in the year succeeding the first year of the reduction.

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
TRIGGERING OF SECTION 481(A) ADJUSTMENT—CONTINUED		
	• If the taxpayer ceases to engage in the trade or business (except in a transaction to which section 381 applies) that gave rise to the adjustment, the restoration occurs in the year the taxpayer ceases that business. If the taxpayer elects LIFO, any unamortized section 481(a) adjustment attributable to a change in method of valuing inventory that involved an adjustment considered as coming within the market restoration rule of section 472(d), must be taken into account in the year LIFO is elected.	Section 472(d) now allows taxpayers a three-year spread of any market writedowns. However, if during an adjustment period resulting from a prior change in method of inventory valuation a taxpayer adopts LIFO, section 472(d) shall be applied as if LIFO was elected in the year the earlier method change was made.

LIFO DISCONTINUANCE

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
Under Revenue Procedure 71–16[163] and Revenue Procedure 72–24,[164] a taxpayer could request a spread of up to twice the number of years the LIFO method was used. In the case of changes that qualified under Revenue Procedure 71–16, the adjustment period could have been up to twenty years. Under Revenue Procedure 72–24 the adjustment period was limited to ten years. The positive adjustment resulting from an involuntary termination of LIFO could be spread over up to ten years.	A taxpayer filing an application to discontinue LIFO is subject to the same rules as in any other accounting method change. In addition, the taxpayer must agree not to elect LIFO for a ten year period unless the Commissioner grants consent to reelect at an earlier time, based on "extraordinary circumstances."	In addition to these rules, a Form 3115 requesting permission to discontinue LIFO must include a statement indicating whether a termination event has occurred during an open year. To readopt LIFO, a taxpayer must file Form 3115 requesting such change.[165] If within ten years of the prior discontinuance of LIFO, extraordinary circumstances must be shown.

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[163] 1971–1 C.B. 682, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[164] 1972–1 C.B. 749, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

[165] This rule is of questionable validity since the adoption of LIFO is not a change to which I.R.C. § 446(e) applies.

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
	CASES UNDER EXAMINATION	
Under Revenue Procedure 70–27, as amended by Revenue Procedure 75–18,[166] a taxpayer under examination could request the application of the ten-year spread procedures. The year of transition was generally the most recent taxable year for which a return was filed at the date the examination started. Revenue Procedure 70–27, does not apply where the method of accounting in question was initiated in a year under examination.	Generally, a taxpayer that has been contacted by the IRS for purposes of an examination may obtain consent to change its method of accounting *unless* the method to be changed is a Category A method. If the IRS proposes the change, the year of change is generally the most recent taxable year that is being examined by the IRS, but not later than the most recent taxable year for which a return was filed at the date the examination commenced. If the taxpayer proposes the change, the year of change is the current year.	These rules apply except as indicated below.

[166] Rev. Proc. 75–18, 1975–1 C.B. 687, *superceded by* Rev. Proc. 84–74, 1984–44 I.R.B. 15.

Revenue Procedure 70–27	**Revenue Procedure 80–51**	**Revenue Procedure 84–74**
	If the method to be changed is a Category A method, Revenue Procedure 80–51 does not apply if the taxpayer has been contacted by the IRS for purposes of scheduling an examination. Instead, the change in method is made by the district director without a spread period. An exception from this rule applies during the ninety-day period following the issuance of a no-change report or other basic report form if the Category A method is not included as an adjustment or placed in suspense.	This rule applies except that the ninety-day window has been extended to 120 days. In addition, if a taxpayer has been precluded from changing a Category A method due to a continuous examination for at least eighteen consecutive months and the method to be changed is not an issue under consideration, then *during the first thirty days*, of the taxable year, the *taxpayer can request a change* in the method of accounting. The year of change is the current tax year and the adjustment period cannot exceed three years. This thirty-day rule becomes effective for taxable years beginning in 1985.
	LIMITING TERMS AND CONDITIONS There were no specific provisions under Revenue Procedure 80–51. (However, the same rules detailed in Revenue Procedure 84–74 generally applied in practice.)	The IRS, in consenting to a change in method, imposes terms and conditions to prevent taxpayers from receiving otherwise unavailable tax benefits that might arise from a new method. Specifically listed are terms and conditions pertaining to NOLs and tax credits:

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
LIMITING TERMS AND CONDITIONS—CONTINUED		
		• An NOL resulting from a negative section 481(a) adjustment cannot be carried back to the three years preceding the year of change to which it normally would be carried first. • A consolidated or separate NOL carryforward cannot offset a positive section 481(a) adjustment "in the year of change." (But presumably not so in future years.) • A consolidated or separate credit carryforward cannot offset the income tax arising from a positive section 481(a) adjustment "in the year of change." (But presumably not so in the future years.) These terms and conditions do not apply to changes from Category A methods of accounting.

CONSENT LETTER

Revenue Procedure 70–27	Revenue Procedure 80–51	Revenue Procedure 84–74
No consent letter is required.	No consent letter is required.	If a taxpayer agrees to the terms and conditions specified in a ruling letter granting permission to change an accounting method, the taxpayer must acknowledge such agreement by signing and returning to the national office of the IRS the agreement copy of the ruling letter. This consent *must be filed within forty-five days of the issuance of the ruling letter. Otherwise, the ruling will be null and void.* If a taxpayer does not agree to the terms and conditions specified in the ruling letter, or if the taxpayer otherwise chooses not to effect the change, the unsigned agreement copy of the ruling letter should be returned to the national office of the IRS with an explanation as to why the taxpayer disagrees or chooses not to effect the change.

Revenue Procedure 84–74—*Miscellaneous Provisions*

If a taxpayer has more than one separate and distinct trade or business, a separate Form 3115 is required for each business. The section 481(a) adjustment and the adjustment period will be determined on the basis of the separate books and records for each business.

If the last day for filing a Form 3115 falls on a Saturday, Sunday, or legal holiday, the filing will be considered timely if it is filed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.