

26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also Part I, §§ 441, 442, 444, 706, 1378; 1.441-1, 1.441-3, 1.442-1, 1.706-1, 1.1378-1.)

Rev. Proc. 2002-38

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SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedures for certain partnerships, S corporations, electing S corporations (as defined in section 5.02), and personal service corporations (PSCs) to obtain automatic approval to adopt, change, or retain their annual accounting period under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations. This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 87–32, 1987–2 C.B. 396. A partnership, S corporation, electing S corporation, or PSC complying with the applicable provisions of this revenue procedure will be deemed to have established a business purpose and obtained the approval of the Commissioner of the Internal Revenue Service to adopt, change, or retain its annual

accounting period under § 442 and the regulations thereunder.

SECTION 2. BACKGROUND

.01 *Taxable Year Defined.*

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

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

(3) *Required taxable year.*

(a) *In general.* Section 1.441–1(b)(2) provides that certain taxpayers must use the particular taxable year that is required under the Code and the regulations thereunder. For example, as described below, a partnership, S corporation, or PSC has a required taxable year that generally conforms to the taxable year of its owners. H.R. Rep. No. 99–841 (Conf. Rep.), 99th Cong., 2d Sess., II–318 (1986), 1986–3 (Vol. 4) C.B. 319. Exceptions are provided for certain taxpayers, including a partnership, S corporation, or PSC, that make an election under § 444, elect to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under § 444, or establish a business purpose for having a different taxable year and obtain approval under § 442.

(b) *Partnerships.* Section 706(b) and § 1.706–1(b)(2) generally provide that a partnership’s taxable year must be its required taxable year. However, a partnership may have a taxable year other than its required taxable year if it makes an election under § 444, elects to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under § 444, or establishes a business purpose for having a different taxable year and obtains the approval of the Commissioner under § 442. The required taxable year for a partnership is:

(i) the taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50 percent;

(ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership (*i.e.*, all the partners having an interest of 5 percent or more in partnership profits or capital); or

(iii) if there is no taxable year described in clause (i) or (ii), the taxable year that results in the least aggregate deferral of income to the partners.

(c) *S corporations.* Section 1378 and § 1.1378-1(a) provide that the taxable year of an S corporation must be a permitted year. The term “permitted year” means (1) the required taxable year (*i.e.*, a taxable year ending on December 31), (2) a taxable year elected under § 444, (3) a 52-53-week taxable year ending with reference to the required taxable year or a taxable year elected under § 444, or (4) any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Commissioner.

(d) *PSCs.* Section 441(i)(1) and § 1.441-3 provide that the taxable year of a PSC must be the calendar year unless the PSC makes an election under § 444, elects to use a 52-53-week taxable year that ends with reference to the calendar year or a taxable year elected under § 444, or establishes, to the satisfaction of the Commissioner, a business purpose for having a different period for its taxable year.

.02 *Adoption of a Taxable Year.* A newly-formed partnership, S corporation, or PSC may adopt its required taxable year, a taxable year elected under § 444, or a 52-53-week taxable year ending with reference to its required taxable year or a taxable year elected under § 444 without the approval of the Commissioner pursuant to § 441. If, however, a partnership, S corporation, or PSC wants to adopt any other taxable year, it must establish a business purpose and obtain approval under § 442. *See* § 1.441-1(c).

.03 *Change in Taxable Year.*

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

(2) *Annualization of short period return.* Section 443(b) and § 1.443-1(b)(1)(i) provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443-1(b)(2) apply, the tax for the short period generally is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. But see §§ 1.706-1(b)(8)(i)(B) and 1.1378-1(c)(2) for exceptions to this general rule for partnerships and S corporations, respectively.

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

.04 *Retention of a Taxable Year.* In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it establishes a business purpose and obtains the approval of the Commissioner under § 442, or makes an election under § 444, to retain its current taxable year. *See* § 1.441-1(d). For example, a corporation on a June 30 fiscal year that either becomes a PSC or elects to be an S corporation, and as a result is required to use the calendar year, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year generally must obtain the approval of the Commissioner to retain that taxable year if its required taxable year changes as a result of a change in ownership. *But see* § 706(b)(4)(B). However, a partnership that has previously established a business purpose to the satisfaction of the Commissioner to use a particular fiscal year is not required to obtain the approval of the Commissioner to retain such fiscal year if its required taxable year changes.

.05 *Approval of an Adoption, Change, or Retention.* Section 1.442-1(b) provides that in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer

must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner. In general, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner’s prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention.

.06 *Business Purpose.*

(1) *Sufficient business purposes.* Section 1.442-1(b)(2) provides that generally the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer’s required taxable year, ownership taxable year, or natural business year. Section 1.442-1(b)(2) also provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners, will not be treated as a business purpose.

(2) *Natural business year.* A taxpayer is deemed to have established a natural business year if it satisfies the “25-percent gross receipts test.” *See* Rev. Proc. 83-25, 1983-1 C.B. 689, superseded by Rev. Proc. 87-32. The Conference Report to the Tax Reform Act of 1986 states that the Secretary may prescribe other tests in addition to the 25-percent gross receipts test to be used to establish the existence of a business purpose if, in the discretion of the Secretary, such tests are desirable and expedient towards the efficient administration of the tax laws. *See* H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess., II-318 (1986), 1986-3 (Vol. 4) C.B. 319.

.07 *Section 444 Elections.* A partnership, S corporation, electing S corporation, or PSC generally can elect under § 444 to use a taxable year other than its required taxable year, but only if the deferral period of the taxable year elected is not longer than the shorter of 3 months or the deferral period of the taxable year being changed. A partnership and an S corporation with a § 444 election must

make required payments under § 7519 that approximate the amount of deferral benefit and a PSC with a § 444 election is subject to the minimum distribution requirements of § 280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted under § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year*. A taxpayer that wants to terminate its § 444 election must follow the automatic procedures under § 1.444-1T(a)(5) to change to its required taxable year or establish a business purpose for using a different taxable year pursuant to § 442, the regulations thereunder, and Rev. Proc. 2002-39, 2002-22 I.R.B. 1046, or this revenue procedure (whichever is applicable).

SECTION 3. SIGNIFICANT CHANGES

Significant changes to Rev. Proc. 87-32 made by this revenue procedure include:

.01 Section 4.01(1) of this revenue procedure clarifies that a partnership, S corporation, electing S corporation, or PSC may change automatically to its required taxable year;

.02 Section 4.01(2) of this revenue procedure allows a partnership, S corporation, electing S corporation, or PSC to change automatically to a natural business year that satisfies the 25-percent gross receipts test, regardless of whether such year results in more deferral of income than its present taxable year;

.03 Sections 4.01(1), (2), and (3) of this revenue procedure allow, in appropriate circumstances, a partnership, S corporation, electing S corporation, or PSC to adopt, change to, or retain a 52-53-week taxable year ending with reference to the required taxable year, natural business year, or ownership taxable year;

.04 Section 4.01(4) of this revenue procedure allows any partnership, S corporation, electing S corporation, or PSC to automatically change from a 52-53-week taxable year to a non-52-53-week taxable year that ends with reference to the same calendar month, and vice versa;

.05 Section 4.01(5) of this revenue procedure allows a partnership that would be required to change its taxable year because of a minor percentage change in

ownership to retain its current taxable year for one year, subject to certain circumstances;

.06 Section 4 of this revenue procedure allows a PSC to automatically change its taxable year even if the PSC makes an S corporation election for the taxable year immediately following the short period;

.07 Sections 4.02(1)-(4) of this revenue procedure generally prevent a partnership, S corporation, electing S corporation, or PSC from using this revenue procedure to change its annual accounting period if the taxpayer is under examination and does not obtain consent from the appropriate director, or is before an area office or before a federal court and its annual accounting period is an issue under consideration;

.08 Section 4.02(5) of this revenue procedure reduces the period of time required between a prior accounting period change and a change effected under this revenue procedure from 6 calendar years to 48 months, and provides that a change to a required or ownership taxable year, and a change to (or from) a 52-53-week taxable year from (or to) a non-52-53-week taxable year ending with reference to the same calendar month, will not be considered changes within the most recent 48-month period;

.09 Section 5.06 of this revenue procedure has been expanded to disregard the interests of certain tax-exempt entities for purposes of determining the ownership taxable year of an S corporation or electing S corporation, unless the S corporation or electing S corporation is wholly owned by such tax-exempt entities;

.10 Section 6.04 of this revenue procedure adds a term and condition requiring the taxpayer to compute its income and keep its books and records (including financial statements) on the basis of the requested taxable year, except in certain circumstances;

.11 Section 6.08 of this revenue procedure adds a term and condition to prevent the carryback of certain capital losses generated in the short period;

.12 Section 7.02(2) of this revenue procedure extends the filing requirements for filing a Form 1128 to the due date of the taxpayer's federal income tax return (including extensions) for the first effective year; and

.13 Section 8.01 provides audit protection for partnerships, S corporations, electing S corporations, or PSCs that change their annual accounting period under this revenue procedure.

SECTION 4. SCOPE

.01 *Applicability*. Except as provided in section 4.02, this revenue procedure, which is the exclusive procedure for taxpayers within its scope to secure the Commissioner's approval, applies to:

(1) *Required taxable year*. A partnership, S corporation, electing S corporation, or PSC that wants to change to its required taxable year (as defined in section 5.03 of this revenue procedure), or to a 52-53-week taxable year ending with reference to such taxable year;

(2) *Natural business year*. A partnership, S corporation, electing S corporation, or PSC (other than a member of a tiered structure as defined in § 444 and § 1.444-2T) that wants to change to or retain a natural business year that satisfies the 25-percent gross receipts test described in section 5.05 of this revenue procedure, or to a 52-53-week taxable year ending with reference to such taxable year;

(3) *Ownership taxable year*. An S corporation or electing S corporation that wants to adopt, change to, or retain its ownership taxable year (as defined in section 5.06 of this revenue procedure), or a 52-53-week taxable year ending with reference to such taxable year;

(4) *Certain 52-53-week taxable years*. A partnership, S corporation, electing S corporation, or PSC that wants to change from a 52-53-week taxable year that references a particular calendar month to a non-52-53-week taxable year that ends on the last day of the same calendar month, and vice versa; and

(5) *Certain changes in ownership of partnerships*. A partnership that is required to change its taxable year under § 706(b)(1)(B) because of a change in its ownership may continue to use its current taxable year for a period of one taxable year, provided that:

(A) the change in ownership is less than 10 percent of all partners' aggregate interests in partnership profits and capital; and

(B) it is reasonably foreseeable that, at the end of one taxable year, the

change in ownership will be reversed. If, at the end of one taxable year, the partnership cannot meet either section 4.01(1) or (3) of this revenue procedure for its current taxable year, then it must change to its required or permitted taxable year under section 4.01(1) of this revenue procedure.

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

(1) *Under examination.* A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is under examination, unless it obtains consent of the appropriate director as provided in section 7.03(1) of this revenue procedure;

(2) *Before an area office.* A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is before an area office with respect to any income tax issue and its annual accounting period is an issue under consideration by the area office;

(3) *Before a federal court.* A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is before a federal court with respect to any income tax issue and its annual accounting period is an issue under consideration by the federal court;

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

(5) *Prior change.* A change to, or retention of, a natural business year as described in section 4.01(2) of this revenue procedure if the partnership, S corporation, electing S corporation, or PSC has changed its annual accounting period at any time within the most recent 48-month period ending with the last month of the requested taxable year. For this purpose, the following changes are not considered prior changes in annual accounting period:

(a) a change to a required taxable year or ownership taxable year;

(b) a change from a 52–53-week taxable year to a non-52–53-week taxable year that ends with reference to the same calendar month, and vice versa; or

(c) a change in accounting period by an S corporation, electing S corporation, or PSC, in order to comply with the common taxable year requirements of §§ 1.1502–75(d)(3)(v) and 1.1502–76(a)(1).

.03 *Nonautomatic Changes.* Any partnership, S corporation, electing S corporation, or PSC that wants to adopt, change to, or retain an annual accounting period that cannot do so automatically under this revenue procedure (because the requested taxable year is not described in section 4.01, or because of a prior change as described in section 4.02(5)) or pursuant to a provision in the Code, regulations, or other published administrative procedures, must obtain the approval of the Commissioner. See § 1.442–1(b) and Rev. Proc. 2002–39 for rules relating to nonautomatic changes of annual accounting periods by partnerships, S corporations, electing S corporations, and PSCs.

SECTION 5. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure:

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

.02 *Electing S Corporations.* “Electing S corporations” are corporations attempting to make an S election for the short period described in section 5.09 of this revenue procedure. See Rev. Proc. 2002–37, 2002–22 I.R.B. 1030, superseding Rev. Proc. 2000–11, 2000–3 I.R.B. 309, for procedures for automatic approval to change an annual accounting period by corporations attempting to make an S election for the taxable year immediately following the short period.

.03 *Required Taxable Year.* The “required taxable year” is the taxable year determined under § 706(b) in the case of a partnership, § 1378 in the case of an S corporation or an electing S corporation, or § 441(i) in the case of a PSC, without

taking into account any taxable year that is allowable by reason of a business purpose (including a grandfathered fiscal year) or a § 444 election.

.04 *Permitted Taxable Year.* A “permitted taxable year” is the required taxable year; a natural business year; the ownership taxable year; a taxable year elected under § 444; a 52–53-week taxable year that references the required taxable year, natural business year, ownership taxable year, or a taxable year elected under § 444; or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner.

.05 *Natural Business Year.* A partnership, S corporation, electing S corporation, or PSC establishes a “natural business year” under this revenue procedure by satisfying the following “25-percent gross receipts test”:

(1) *Prior three years gross receipts.*

(a) Gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested annual accounting period are totaled and then divided into the amount of gross receipts from sales and services for the last 2 months of this 12-month period.

(b) The same computation as in (1)(a) above is made for the two preceding 12-month periods ending with the last month of the requested annual accounting period.

(2) *Natural business year.*

(a) Except as provided in (b) below, if each of the three results described in (1) equals or exceeds 25 percent, then the requested annual accounting period is deemed to be the taxpayer's natural business year.

(b) The taxpayer must determine whether any annual accounting period other than the requested annual accounting period also meets the 25-percent test described in (2)(a). If one or more other annual accounting periods produce higher averages of the three percentages (rounded to 1/100 of a percent) described in (1) than the requested annual accounting period, then the requested annual accounting period will not qualify as the taxpayer's natural business year.

(3) *Special rules.* (a) To apply the 25-percent gross receipts test for any particular year, the taxpayer must compute

its gross receipts under the method of accounting used to prepare its federal income tax returns for such taxable year.

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

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

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

.06 Ownership Taxable Year. For an S corporation or electing S corporation, an “ownership taxable year” is the taxable year (if any) that, as of the first day of the first effective year, constitutes the taxable year of one or more shareholders (including any shareholder that concurrently changes to such taxable year) holding more than 50-percent of the corporation’s issued and outstanding shares of stock. For this purpose, under principles similar to § 1.706–3T for determining the taxable year of a partnership, a shareholder that is tax-exempt under § 501(a) is disregarded if such shareholder is not subject to tax on any income attributable to the S corporation. Tax-exempt shareholders are not disregarded, however, if the S corporation is wholly-owned by such tax-exempt entities. A shareholder in an S corporation or electing S corporation that wants to concurrently change its taxable year must follow the instructions generally applicable to taxpayers changing their taxable years contained in § 1.442–1(b), Rev. Proc. 2002–39, or any other applicable administrative procedure published by the Commissioner.

.07 Grandfathered Fiscal Year. A grandfathered fiscal year is a fiscal year (other than a year that resulted in a three-month or less deferral of income) that a partnership or an S corporation received

permission to use on or after July 1, 1974, by a letter ruling (*i.e.*, not by automatic approval).

.08 First Effective Year. The first effective year is the first taxable year for which an adoption, change, or retention in annual accounting period is effective. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in this revenue procedure necessary to effect the adoption, change, or retention in annual accounting period.

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

.10 Field Office, Area Office, Director. The terms “field office,” “area office,” and “director” have the same meaning as those terms have in Rev. Proc. 2002–1, 2002–1 I.R.B. 1 (or any successor).

.11 Under Examination.

(1) *In general.*

(a) Except as provided in section 5.11(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

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

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

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by an area officer that the case has been referred to an area office from a field office, the date the taxpayer files a peti-

tion in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to an area office under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575, or Rev. Proc. 99–28, 1999–2 C.B. 109.

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

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

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

(b) in a case in which no formal notice is given, on the date on which the period under § 6229 expires;

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

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

.12 Issue Under Consideration.

(1) *During an examination.* A taxpayer’s annual accounting period is an issue under consideration for the taxable years under examination if the taxpayer

receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the taxpayer's annual accounting period as an issue under consideration. For example, a taxpayer's annual accounting period is an issue under consideration as a result of an examination plan that identifies the propriety of the taxpayer's annual accounting period as a matter to be examined. The question of whether the taxpayer's annual accounting period is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002-2, 2002-1 I.R.B. 82 (or any successor).

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

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

.13 *Personal Service Corporation.* For purposes of this revenue procedure, a PSC does not include a corporation that has a required taxable year under a provision of the Code other than § 441(i) (e.g., a specified foreign corporation as defined in § 898(b)(1)).

SECTION 6. TERMS AND CONDITIONS

.01 *In General.* An adoption, change, or retention in annual accounting period filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Short Period Tax Return.* The taxpayer generally must file a federal income tax return for the short period required to effect a change by the due date of that return, including extensions, in accordance with § 1.443-1(a). In the case of a PSC, the corporation's taxable income for the short period must be annualized and the tax must be computed in accordance with the provisions of § 443(b) and § 1.443-1(b). However, for changes to (or from) a 52-53-week taxable year referencing the same month as the current (or requested) taxable year, see special rules in § 1.441-2.

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

.04 *Record Keeping/Book Conformity.* The books of the taxpayer must be closed as of the last day of the first effective year. Thereafter, the taxpayer must compute its income and keep its books and records (including financial statements and reports to creditors) on the basis of the requested taxable year, except that this requirement shall not apply (1) to books and records maintained solely for foreign law purposes (e.g., foreign tax reporting purposes), or (2) if the requested taxable year is either the taxpayer's required taxable year or ownership taxable year.

.05 *Changes in Natural Business Year.* If a partnership, S corporation, electing S corporation, or PSC changes to or retains a natural business year under this revenue procedure and that year no longer qualifies as a permitted taxable year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year. Taxpayers qualifying under section 4 of this revenue procedure may request automatic approval for the change under the provisions of this revenue procedure. Other taxpayers must request approval under Rev. Proc. 2002-39.

.06 *Changes in Ownership Taxable Year.* An S corporation or electing S corporation that adopts, changes to, or retains an ownership taxable year under this revenue procedure must change to a

permitted taxable year, or request approval to retain its current taxable year, if, as of the first day of any taxable year, its ownership taxable year changes. S corporations qualifying under section 4 of this revenue procedure may request automatic approval for the change or retention under the provisions of this revenue procedure. Other taxpayers must request approval under Rev. Proc. 2002-39.

.07 *52-53-week Taxable Years.* If applicable, the taxpayer must comply with § 1.441-2(e) (relating to the timing of taking items into account in those cases where the taxable year of a pass-through entity or PSC ends with reference to the same calendar month as one or more of its partners, shareholders, or employee-owners).

.08 *Creation of Net Operating Loss or Capital Loss.* In the case of a PSC changing to a natural business year, if the PSC generates a net operating loss (NOL) or capital loss (CL) in the short period required to effect the change in annual accounting period, the PSC may not carry the NOL or CL back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, except as provided in § 280H and the regulations thereunder, the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either (a) \$50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

.09 *Creation of General Business Credits.* In the case of a PSC changing to a natural business year, if there is an unused general business credit or any other unused credit generated in the short period, the PSC must carry that unused credit forward. An unused credit from the short period may not be carried back.

SECTION 7. GENERAL APPLICATION PROCEDURES

.01 *Approval.* Approval is hereby granted to any partnership, S corporation, electing S corporation, or PSC within the scope of this revenue procedure to adopt, change, or retain its annual accounting period, provided the taxpayer complies with all the applicable provisions of this

revenue procedure. Approval is granted beginning with the first effective year. A partnership, S corporation, electing S corporation, or PSC granted approval under this revenue procedure to adopt, change to, or retain an annual accounting period other than its required year is deemed to have established a business purpose for the adoption, change, or retention to the satisfaction of the Commissioner.

.02 Filing Requirements.

(1) *Where to file.* A taxpayer within the scope of this revenue procedure that wants to adopt, change, or retain its annual accounting period under this revenue procedure must complete and file an application (*i.e.*, a current Form 1128 or Form 2553, *Election by a Small Business Corporation*, in the case of an electing S corporation) with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the taxpayer files its federal income tax return. No copies of Form 1128 (or Form 2553) are required to be sent to the national office. The taxpayer also must attach a copy of the Form 1128 (or Form 2553) to the federal income tax return filed for the first effective year.

(2) *When to file.* The Form 1128 must be filed no earlier than the day following the end of the first effective year and no later than the due date (including extensions) for filing the federal income tax return for the first effective year. For electing S corporations, the Form 2553 must be filed when the election to be an S corporation is filed pursuant to § 1362(b) and § 1.1362-6. Generally, such election must be filed at any time during (a) the taxable year that immediately precedes the taxable year for which the election is to be effective, or (b) the taxable year for which the election is to be effective, provided the election is made before the 16th day of the third month of the taxable year.

(3) *Label.* In order to assist in the processing of the adoption, change, or retention in annual accounting period, taxpayers should write at the top of page 1 of the Form 1128 (Form 2553): "FILED UNDER REV. PROC. 2002-38."

(4) *Signature requirements.* In the case of a partnership, the Form 1128 must be signed on behalf of the partnership by a general partner. In the case of a limited liability company that elects to be treated

as a partnership, the Form 1128 must be signed by a member-manager who has personal knowledge of the facts. In all other cases, the Form 1128 (Form 2553) must be signed by an authorized corporate officer. If an agent is authorized to represent the taxpayer before the Service, to receive the original or a copy of correspondence concerning the application, or to perform any other act(s) regarding the application on behalf of the taxpayer, a power of attorney reflecting such authorization(s) should be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer will not be given any information about the application.

(5) *No user fee.* A user fee is not required for applications filed under this revenue procedure and, except as provided in section 9.01 of this revenue procedure, the receipt of an application filed under this revenue procedure may not be acknowledged.

(6) *Additional information.* In the case of a taxpayer changing to a natural business year that satisfies the 25-percent gross receipts test described in section 5.05 of this revenue procedure, the taxpayer must supply the gross receipts for the most recent 47 months for itself (or any predecessor) in compliance with the instructions to Form 1128 (or Form 2553).

.03 Additional Procedures If Under Examination, Before an Area Office, or Before a Federal Court.

(1) Taxpayers under examination.

(a) A taxpayer under examination may request approval to change or retain its annual accounting period under this revenue procedure only if the appropriate director consents to the change or retention. The director will consent to the change or retention unless, in the opinion of the director, the taxpayer's annual accounting period ordinarily would be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the director will consent to a change where the taxpayer is using a permissible annual accounting period. The director also will consent to a change from an impermissible annual accounting period where the period became impermissible (*e.g.*, due to a change in ownership or a change in the taxpayer's business) subsequent to the

years under examination. The question of whether the taxpayer's annual accounting period from which the taxpayer is changing is permissible or became impermissible subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002-2.

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

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

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

SECTION 8. EFFECT OF APPROVAL

.01 Audit Protection.

(1) *In general.* Except as provided in section 8.01(2) of this revenue procedure, a taxpayer that files an application in compliance with all the applicable provisions of this revenue procedure will not be required by the Service to change its

annual accounting period for a taxable year prior to the first effective year.

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

(a) the taxpayer fails to implement the change;

(b) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure; or

(c) there was a misstatement or omission of material facts.

.02 Subsequently Required Changes.

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

(a) the enactment of legislation;

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

(c) the issuance of temporary or final regulations;

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

(e) the issuance of written notice to the taxpayer that the change in annual accounting period was not in compliance with all the applicable provisions of this revenue procedure or is not in accord with the current view of the Service; or

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

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

(a) the taxpayer complied with the applicable provisions of this revenue procedure;

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

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

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

(e) the taxpayer to which the approval was granted acted in good faith

in relying on the approval, and applying the change retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW OF APPLICATION

.01 Service Center Review. A Service Center may deny an adoption, change, or retention of an annual accounting period under this revenue procedure only if (1) the Form 1128 (or Form 2553) is not filed timely, or (2) the taxpayer fails to meet the scope or any term and condition of this revenue procedure. If the application is denied, the Service Center will return the application with an explanation for the denial. In the case of a denial of an accounting period request filed on Form 2553, the corporation will be required to use the calendar year or, if applicable, make a § 444 election, if it chooses to be an S corporation.

.02 Review of Director. The appropriate director may ascertain if the adoption, change, or retention of annual accounting period was made in compliance with all the applicable provisions of this revenue procedure. Taxpayers adopting, changing, or retaining their annual accounting period pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the adoption, change, or retention of annual accounting period without the approval of the Commissioner. Upon examination, a taxpayer that has initiated an unauthorized adoption, change, or retention of annual accounting period may be denied the adoption, change, or retention. For example, the taxpayer may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

SECTION 10. EFFECTIVE DATE AND TRANSITION RULE

.01 Effective Date. This revenue procedure generally is effective for adoptions, changes, or retentions of annual accounting periods for which the first effective year ends on or after May 10, 2002. However, if the time period for filing Form 1128 (or Form 2553) with respect to a taxable year set forth in section 7.02(2) of this revenue procedure has not yet

expired, a taxpayer within the scope of this revenue procedure may elect early application of the revenue procedure by providing the notification set forth in section 7.02(3) on the top of page 1 of Form 1128 (or Form 2553) and by satisfying the other procedural requirements of section 7.

.02 Transition Rule. If a taxpayer within the scope of this revenue procedure filed an application with the national office and the application is pending with the national office on May 10, 2002, the taxpayer may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless by the later of June 25, 2002, or the issuance of the letter ruling granting or denying approval for the adoption, change, or retention, the taxpayer notifies the national office that it wants to use this revenue procedure. If the taxpayer timely notifies the national office that it wants to use this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application will be refunded to the taxpayer.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-32 is clarified, modified, amplified, and superseded.

SECTION 12. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1786. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are found in sections 7 and 10. The information in section 7 is required in order to determine whether the taxpayer properly obtained automatic

approval to adopt, change, or retain its annual accounting period. The information in section 10 is required in order to allow a taxpayer to apply the provisions of this revenue procedure to a pending application. The likely respondents are the following: partnerships, S corporations, electing S corporations, and PSCs.

The estimated total annual reporting burden for the requirements contained in section 7 of this revenue procedure is reflected in the burden estimates for Forms 1128 and 2553. The estimated total annual reporting burden for the requirement contained in section 10 of this revenue procedure is 50 hours: the estimated annual burden per respondent is 30 minutes; the estimated number of respondents is 100; and the estimated annual frequency of response is once.

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

DRAFTING INFORMATION

The principal authors of this revenue procedure are Michael F. Schmit and Roy A. Hirschhorn of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Schmit or Mr. Hirschhorn at (202) 622-4960 (not a toll-free call).