

## Rev. Proc. 2002-39

### CONTENTS

#### SECTION 1. PURPOSE

#### SECTION 2. BACKGROUND

- .01 *Taxable Year Defined*
  - (1) *In general*
  - (2) *Annual accounting period*
  - (3) *Required taxable year*
- .02 *Adoption of Taxable Year*
- .03 *Change in Taxable Year*

- (1) *In general*
- (2) *Annualization of short period return*
- (3) *No retroactive change in annual accounting period*
- .04 *Retention of Taxable Year*
- .05 *Approval of an Adoption, Change, or Retention*
  - (1) *In general*
  - (2) *Automatic approval*
- .06 *Business Purpose*
  - (1) *In general*
  - (2) *Sufficient business purposes*
  - (3) *Insufficient business purposes*
- .07 *Section 444 Elections*

#### SECTION 3. SCOPE

- .01 *Applicability*
- .02 *Inapplicability*
  - (1) *Automatic approval*
  - (2) *Under examination*
  - (3) *Before an area office*
  - (4) *Before a federal court*
  - (5) *Partnerships and S corporations*

#### SECTION 4. DEFINITIONS

- .01 *Taxpayer*
- .02 *Corporation*
- .03 *Pass-through Entity*
- .04 *Required Taxable Year*
- .05 *Permitted Taxable Year*
- .06 *First Effective Year*
- .07 *Short Period*
- .08 *Field Office, Area Office, Director*
- .09 *Under Examination*
  - (1) *In general*
  - (2) *Partnerships and S corporations subject to TEFRA*
- .10 *Issue Under Consideration*
  - (1) *During an examination*
  - (2) *Before an area office*
  - (3) *Before a federal court*

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

- .01 *In General*
  - (1) *Approval of requests*
  - (2) *Exceptions*
- .02 *Business Purpose*
  - (1) *Taxpayers that establish a business purpose*
  - (2) *Taxpayers that are deemed to have established a business purpose*
- .03 *Natural Business Year*
  - (1) *Annual business cycle test*
  - (2) *Seasonal business test*

- (3) *25-percent gross receipts test*
- .04 *General Terms and Conditions*
  - (1) *Short period tax return*
  - (2) *Subsequent year tax returns*
  - (3) *Record keeping/book conformity*
  - (4) *Changes in natural business year*
  - (5) *52-53-week taxable years*
  - (6) *Creation of net operating loss or capital loss*
  - (7) *Creation of general business credits*
  - (8) *Concurrent change for related entities*
- .05 *Additional Terms, Conditions, and Adjustments*

- (1) *Substantial distortion*
- (2) *Deferral of substantial pass-through income*
- (3) *Special rule for certain pass-through entities*
- (4) *Use of expiring NOLs, CLs, and credits*
- (5) *Other terms, conditions, and adjustments*
- .06 *Examples*

#### SECTION 6. GENERAL APPLICATION PROCEDURES

- .01 *What to File*
  - (1) *Application*
  - (2) *Signature requirement*
  - (3) *Additional information regarding prior applications*
  - (4) *Additional information for section 5.03 (1) and (2)*
  - (5) *Additional information for section 5.03 (3)*
  - (6) *Additional information for section 5.04*
  - (7) *Additional information for section 5.05*
- .02 *When to File*
  - (1) *In general*
  - (2) *Electing S corporations*
- .03 *Where to File*
  - (1) *In general*
  - (2) *Electing S corporations*
  - (3) *Exempt organizations*
- .04 *User Fee*
- .05 *Consolidated Groups — Separate Forms 1128 Not Required*
- .06 *Additional Procedures If Under Examination, Before an Area Office, or Before a Federal Court*
  - (1) *Certain taxpayers under examination*

- (2) *Certain taxpayers before an area office*
- (3) *Certain taxpayers before a federal court*

## SECTION 7. PROCESSING OF APPLICATION

- .01 *Service Discretion*
- .02 *Applicability of Rev. Proc. 2002-1, Rev. Proc. 2002-4, and Any Successor Revenue Procedures*
- .03 *Incomplete Application - 21 Day Rule*
- .04 *Conference in the National Office*
- .05 *Letter Ruling*
- .06 *Effect of Noncompliance*
- .07 *Effect on Other Offices of the Service*

## SECTION 8. EFFECT OF APPROVAL

- .01 *Audit Protection*
  - (1) *In general*
  - (2) *Exceptions*
- .02 *Subsequently Required Changes*
  - (1) *In general*
  - (2) *Retroactive change or modification*

## SECTION 9. REVIEW BY DIRECTOR

- .01 *In General*
- .02 *National Office Consideration*

## SECTION 10. EFFECTIVE DATE AND TRANSITION RULE

- .01 *In General*
- .02 *Transition Rule for Pending Applications*

## SECTION 11. EFFECT ON OTHER DOCUMENTS

## SECTION 12. PAPERWORK REDUCTION ACT

## DRAFTING INFORMATION

### SECTION 1. PURPOSE

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

conditions, and adjustments that the Commissioner may deem necessary to effect the adoption, change, or retention.

## SECTION 2. BACKGROUND

### .01 *Taxable Year Defined.*

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

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

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

.02 *Adoption of Taxable Year.* Generally, a taxpayer may adopt any taxable year that satisfies § 441 and the regulations thereunder without the approval of the Commissioner. However, a partnership, electing S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under § 444, or a 52-53-week

taxable year that references its required taxable year or a taxable year elected under § 444 must establish a business purpose and obtain approval under § 442. *See* § 1.441-1(c).

### .03 *Change in Taxable Year.*

(1) *In general.* Section 1.442-1(a)(1) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain approval 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, for example, §§ 1.706-1(b)(8)(i)(B), 1.852-3(e), 1.857-2(a)(4), 1.1378-1(c)(2), and 1.1502-76 for exceptions to this general rule for a partnership, a regulated investment company (RIC), a real estate investment trust (REIT), an S corporation, and a subsidiary ceasing to be a member of a consolidated group, 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 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 using 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.*

(1) *In general.* 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.

(2) *Automatic approval.* Under the Code and regulations, certain taxpayers are allowed to change their annual accounting periods without approval or with automatic approval (*see, e.g.,* §§ 444, 859(b), and § 1.442-1(c) and (d)). In addition, the Service has issued revenue procedures that enable certain taxpayers to obtain automatic approval to adopt, change, or retain their annual accounting periods. *See, for example,* Rev. Proc. 2002-37, 2002-22 I.R.B. 1030 (or any successor) for corporations; Rev. Proc. 2002-38, 2002-22 I.R.B. 1037 (or any successor) for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66-50, 1966-2 C.B. 1260 (or any successor) for individuals.

#### .06 *Business Purpose.*

(1) *In general.* Section 1.442-1(b) provides that in determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and cir-

cumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. *See also* H.R. Rep. No. 99-841, 99th Cong., 2d Sess., II-318, 1986-3 (Vol. 4) C.B. 319.

#### (2) *Sufficient business purposes.*

Section 1.442-1(b)(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. A taxpayer generally 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, 1987-2 C.B. 396, superseded by Rev. Proc. 2002-38, 2002-22 I.R.B. 1037. In Rev. Rul. 87-57, 1987-2 C.B. 117, the Service determined that a partnership, S corporation, or PSC established, to the satisfaction of the Secretary, a business purpose for adopting, retaining, or changing its taxable year in the following four situations:

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

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

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

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

#### (3) *Insufficient business purposes.*

Section 1.442-1(b) provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a

business purpose for using a taxable year other than its required taxable year. In addition, the legislative history to the Tax Reform Act of 1986 provides that the following reasons ordinarily will not be sufficient for a partnership, S corporation, or PSC to establish that the business purpose requirement for a particular taxable year has been met:

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

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

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

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

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

.07 *Section 444 Elections.* 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 the 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 by § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year*. A taxpayer that wants to terminate its § 444 election must follow the automatic procedures under § 1.444-

1T(a)(5) to change to its required taxable year or establish a business purpose for using a different taxable year pursuant to § 442, the regulations thereunder, and Rev. Proc. 2002–38 or this revenue procedure (whichever is applicable).

### SECTION 3. SCOPE

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

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

(1) *Automatic approval.* An adoption, change, or retention of annual accounting period that is permitted to be made pursuant to a provision of the Code or regulations or a published automatic approval procedure. Before submitting an application pursuant to this revenue procedure, taxpayers are encouraged to review the automatic approval procedures referenced in § 1.442–1 and the following revenue procedures: Rev. Proc. 2002–37 (for corporations); Rev. Proc. 2002–38 (for partnerships, S corporations, electing S corporations, and PSCs); Rev. Proc. 66–50, as modified by Rev. Proc. 81–40, 1981–2 C.B. 604 (for individuals); Rev. Proc. 85–58, 1985–2 C.B. 740, and Rev. Proc. 76–10, 1976–1 C.B. 548, as modified by Rev. Proc. 79–3, 1979–1 C.B. 483 (for exempt organizations); Rev. Proc. 87–27, 1987–1 C.B. 769 (for employee retirement plans and employee trusts); and Rev. Proc. 85–15, 1985–1 C.B. 516 (for changes to comply with § 441(g)).

(2) *Under examination.* A taxpayer with a required taxable year that is under examination, unless the taxpayer obtains the consent of the appropriate director as provided in section 6.06(1) of this revenue procedure.

(3) *Before an area office.* A taxpayer with a required taxable year that is before an area office with respect to any income tax issue if its annual accounting period is an issue under consideration by the area office.

(4) *Before a federal court.* A taxpayer with a required taxable year that is before a federal court with respect to any income tax issue if its annual accounting

period is an issue under consideration by the federal court.

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

### SECTION 4. DEFINITIONS

.01 *Taxpayer.* The term “taxpayer” has the same meaning as the term “person” as defined in § 7701(a)(1) (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 *Corporation.* The term “corporation” includes each member of a consolidated group. However, the common parent of a consolidated group may change the group’s annual accounting period under this revenue procedure if every member of the consolidated group meets all the requirements and complies with all the conditions of this revenue procedure.

.03 *Pass-through Entity.* For purposes of this revenue procedure, the term “pass-through entity” means a partnership; an S corporation (as defined in § 1361); an electing S corporation (i.e., a corporation attempting to make an S election for the first effective year); a trust; an estate; a common trust fund (as defined in § 584); a controlled foreign corporation (CFC) (as defined in § 957), but only to the extent the taxpayer is a U.S. shareholder (as defined in § 951(b)); a foreign personal holding company (FPHC) (as defined in § 552), but only to the extent the taxpayer is a U.S. shareholder (as defined in § 551(a)); a passive foreign investment company (PFIC), but only to the extent the taxpayer has elected to treat the PFIC as a qualified electing fund (as defined in § 1295); a closely-held REIT (as defined in § 6655(e)(5)(B)), but only if the taxpayer is described in § 6655(e)(5)(A)); or any other similar entity.

.04 *Required Taxable Year.* The “required taxable year” is the particular taxable year that certain taxpayers are

required to use under the Code or regulations thereunder. For example, 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, and § 441(i) in the case of a PSC, without taking into account any taxable year that is allowable by reason of a § 444 election. See generally § 1.441–1(b)(2) (providing examples of other entities with required taxable years).

.05 *Permitted Taxable Year.* The term “permitted taxable year” means 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 taxable year elected under § 444; or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner.

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

.07 *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.

.08 *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).

.09 *Under Examination.*

(1) *In general.*

(a) Except as provided in section 4.08(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for

the purpose of scheduling any type of examination of the return. An examination ends:

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

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, a Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the “closing” letter (for example, Letter 891(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 appeals officer that the case has been referred to an area office from a field office, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to an area office under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575, 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 an S corporation that is subject to the TEFRA unified audit and litigation provisions (note that an S corporation is not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996, see Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996)), an examination begins on the date of the notice of the beginning of an administrative proceeding sent or personally delivered to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in the case in which the Service accepts the partnership or S corporation return as filed, on the date of the “no adjustments” letter or the “no change”

notice of the final administrative adjustment sent to the TMP;

(b) in a 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 or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires.

#### .10 *Issue Under Consideration.*

(1) *During an examination.* A taxpayer’s annual accounting period is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining officer(s) specifically citing the taxpayer’s annual accounting period as an issue under consideration. For example, a taxpayer’s annual accounting period is an issue under consideration as a result of an examination plan that identifies the propriety of the taxpayer’s annual accounting period as a matter to be examined. The question of whether the taxpayer’s annual accounting period is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002–2, 2002–1 I.R.B. 82 (or any successor), or, for exempt organizations, Rev. Proc. 2002–5, 2002–1 I.R.B. 173 (or any successor).

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

(3) *Before a federal court.* A taxpayer’s annual accounting period is an issue under consideration for the taxable years before a federal court if the taxpay-

er’s annual accounting period is an item included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the government counsel.

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

### .01 *In General.*

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

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

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

(2) *Exceptions.* Notwithstanding the general rule of section 5.01(1)(a) of this revenue procedure, a taxpayer with a required taxable year (other than a partnership, S corporation, electing S corporation, or PSC) will not be granted approval under this revenue procedure to adopt, change, or retain a taxable year other than its required taxable year or, in appropriate circumstances, a 52–53-week taxable year that ends with reference to its required taxable year. In addition, a partnership, S corporation, electing S corporation, or PSC will be granted approval to adopt, change, or retain an annual accounting period only if it establishes a business purpose under section 5.02(1) for that annual accounting period. Notwithstanding the general rule of section 5.01(1)(b) of this revenue procedure, the Service may determine that, based on the unique facts of a particular case and in the interest of sound tax administration, terms, conditions, and adjustments that differ from those provided in this revenue procedure are more appropriate for an adoption, change, or retention made under this revenue procedure.

## .02 Business Purpose.

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

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

(b) *Facts and circumstances.* A taxpayer (including a partnership, S corporation, electing S corporation, or PSC) may establish a business purpose for the requested taxable year based on all the relevant facts and circumstances. However, the Service anticipates that a taxpayer will be granted permission to adopt, change, or retain an annual accounting period under this facts and circumstances test only in rare and unusual circumstances. For this purpose, deferral of income to owners will not be treated as a business purpose. In addition, administrative and convenience business reasons such as those described in Rev. Rul. 87-57 and the following will not be sufficient to establish a business purpose under this section:

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

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

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

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

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

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

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

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

### (1) Annual business cycle test.

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

information for the three immediately preceding taxable years may provide information other than gross receipts to demonstrate a peak and non-peak period of business, such as a description of its business and/or reasonable estimates of future gross receipts.

(b) *Safe harbor.* For purposes of section 5.03(1)(a) of this revenue procedure, 1 month will be deemed to be "soon after" the close of the highest peak period of business.

(c) *Example.* A, a corporation, operates a retail business. The highest peak of A's annual business cycle occurs in December each year. In January, a significant amount of the merchandise that was purchased by A's customers in December is either returned or exchanged. A's natural business year is deemed to end at (December 31st), or soon after (January 31st), the close of the highest peak period of business in December. Accordingly, under the provisions of this revenue procedure, a request by A for a taxable year ending either December 31st or January 31st would be granted, subject to the general terms and conditions of section 5.04 of this revenue procedure.

### (2) Seasonal business test.

(a) *In general.* If the taxpayer's gross receipts from sales and services for the short period and the three immediately preceding taxable years indicate that the taxpayer's business is operational for only part of the year (*e.g.*, due to weather conditions) and, as a result, the taxpayer has insignificant gross receipts during the period the business is not operational, the taxpayer's natural business year is deemed to end at, or soon after, the operations end for the season. A taxpayer that has not been in existence for a sufficient period to provide gross receipts information for the three immediately preceding taxable years may provide information other than gross receipts to demonstrate that it satisfies the requirements of a seasonal business, such as a description of its business and/or reasonable estimates of future gross receipts.

(b) *Safe Harbor.* For purposes of section 5.03(2)(a) of this revenue procedure, an amount equal to less than 10 percent of the taxpayer's total gross receipts for the year will be deemed to be "insignificant," and 1 month will be deemed to be "soon after" the close of operations.

(c) *Example.* B, a partnership, operates a ski resort from November

through March of each year. During September and October, and during April, employees prepare the resort for the ski season, and close it down for the season, respectively. The resort earns less than 10 percent of its annual gross receipts during the period of April through October, when it is closed to guests. B's natural business year is deemed to end at (March 31st), or soon after (April 30th), the close of the resort operations. Accordingly, under the provisions of this revenue procedure, a request by B for a taxable year ending either March 31st or April 30th would be granted, subject to the general terms and conditions of section 5.04 of this revenue procedure.

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

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

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

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

(b) *Natural business year.*

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

(ii) The taxpayer must determine whether any annual accounting period other than the requested annual accounting period also meets the 25-percent gross receipts test of paragraph (b)(i). If one or more annual accounting periods produce higher averages of the three percentages (rounded to the 1/100 of a percent) described in (a) than the requested annual accounting period, then the requested annual accounting period will not qualify

as the taxpayer's natural business year under the 25-percent gross receipts test.

(c) *Special rules.*

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

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

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

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

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

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

(1) *Short period tax return.* The taxpayer must file a federal income tax return for the short period required to effect a change in annual accounting period by the due date of that return, including extensions pursuant to § 1.443-1(a). The taxpayer's taxable income for the short period generally 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. See also,

for example, §§ 1.706-1(b)(8)(i)(B), 1.852-3(e), 1.857-2(a)(4), 1.1378-1(c)(2), and 1.1502-76 for exceptions to the annualization rule for a partnership, RIC, REIT, S corporation, and subsidiary corporation ceasing to be a member of a consolidated group, respectively.

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

(3) *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.

(4) *Changes in natural business year.* If a partnership, S corporation, electing S corporation, or PSC changes to or retains a natural business year under this revenue procedure and that annual accounting period no longer qualifies as a permitted taxable year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year. Certain partnerships, S corporations, electing S corporations, and PSCs may qualify for automatic approval to change their annual accounting period under Rev. Proc. 2002-38. Other taxpayers must request approval under this revenue procedure.

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

(6) *Creation of net operating loss or capital loss.* If the taxpayer generates a net operating loss (NOL) or capital loss

(CL) in the short period required to effect a change in annual accounting period, the taxpayer may not carry the NOL or CL back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, except as otherwise provided in the Code or regulations (e.g., § 280H and the regulations thereunder in the case of a PSC) the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either: (a) \$50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

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

(8) *Concurrent change for related entities.* In appropriate cases, if a taxpayer owns a majority interest in a pass-through entity, the entity will be required to concurrently change its annual accounting period as a term and condition of the approval of the taxpayer's request to change its annual accounting period, notwithstanding the testing date provisions in §§ 706(b)(4)(A)(ii), 898(c)(1)(C)(ii), § 1.921-1T(b)(6), and the special provision in § 706(b)(4)(B). If this condition applies, the pass-through entity must comply with the appropriate procedures to obtain approval for the change. See, e.g., Rev. Proc. 2002-37 and Rev. Proc. 2002-38.

.05 *Additional Terms, Conditions, and Adjustments.* The additional terms, conditions, and adjustments described in this section 5.05 apply to taxpayers that obtain approval under this revenue procedure to change an annual accounting period and that establish a business purpose under section 5.02(2) of this revenue procedure. These additional terms, conditions, and adjustments are necessary to neutralize the tax effects of a substantial distortion of income that otherwise would result from the change, including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial

portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary of an estate; the creation of a short period in which there is a substantial NOL, CL, or credit (including a general business credit), or the creation of a short period in which there is a substantial amount of income to offset an expiring NOL, CL, or credit.

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

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

(ii) \$500,000.

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

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

determined by comparing the taxable year of the next lower-tier indirectly-owned pass-through entity with the taxpayer's taxable year until either: (1) an increase in the deferral period is found or (2) the next lower-tier entity either does not exist or is not a pass-through entity.

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

(c) *Adjustment.* If the deferral of income computed in section 5.05(2)(b) of this revenue procedure represents a substantial distortion of income (as defined in section 5.05(1)), the taxpayer must include the entire amount of the distortion (and not merely the excess over the amounts specified in section 5.05(1)) as ordinary income for the first effective year. The taxpayer also must report its allocable share of income from the pass-through entity in the taxable year following the first effective year in accordance with general tax principles (e.g., § 706). The taxpayer must establish a suspense account for the amount included in ordinary income for the first effective year and deduct this amount ratably over the

four taxable years immediately succeeding the first effective year. Notwithstanding the preceding sentence, if all or a portion of the suspense account is attributable to an interest in a pass-through entity that is subsequently disposed of, any amount so attributable that remains in the suspense account in the year of the disposition may be deducted in that year. In all cases, the deduction under this paragraph will be treated as an ordinary deduction. The adjustments described in this section do not affect the taxpayer's basis in the pass-through entity (such as basis in a partnership determined under § 705). See Examples 1, 2, and 3, section 5.06 of this revenue procedure.

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

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

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

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

*Example 1.* P, a foreign corporation, maintains its books and files its foreign country tax returns on the basis of a taxable year ending on May 31st. In 2001, P acquires all the stock of S, a domestic corporation, that maintains its books and files its tax returns on the calendar year. S has a minority interest in a partnership that uses the calendar year. In order to facilitate the filing of consolidated financial statements for P and S, S applies for approval to change its taxable year to a taxable year ending on May 31st beginning on May 31, 2002. The change will create a substantial distortion of income as a result of increasing the deferral of S's distributive share of income from its partnership interest. Consequently, S will be required, under section 5.05(2) of this revenue procedure, to report the partnership income that accrues between January 1 and May 31, 2002, as an ordinary income adjustment on its short period tax return as a term, condition, and adjustment of the change. Thereafter, on subsequent tax returns filed for its taxable year ending on May 31st (beginning May 31, 2003), S must report the partnership income for the partnership's taxable year ending December 31 based on the Schedule K-1 in accordance with § 706. To take into account S's double inclusion of the 5 months of partnership income from January 1 to May 31, 2002, S must recognize an ordinary deduction adjustment in each of the four taxable years following the first effective year equal to one-fourth of the ordinary income adjustment amount included on S's short period tax return. Neither adjustment will affect S's basis in the partnership.

*Example 2.* D is a domestic corporation that currently maintains its books and files its tax returns on the calendar year, but applies in 2002 for approval to change its taxable year to a year ending on May 31st. D owns a majority interest in a partnership, PS1, which in turn owns a minority interest in another partnership, PS2. PS1 and PS2 have taxable years ending on December 31st and September 30th, respectively, as required by the majority interest rule of § 706(b)(1)(b)(i). If D changes its annual accounting period to May 31st, and the first effective year ends on May 31, 2002, PS1 will be

required to conform its taxable year with D using a first effective year of May 31, 2002, as required under section 5.04(8) of this revenue procedure. Accordingly, D's requested change in its taxable year would not increase the deferral of D's distributive share of income or gain from PS1. However, PS2 will retain its September 30th taxable year; thus, D's requested change will increase the deferral of D's distributive share of income and gain from PS2, which is passed through to D from PS1. Assuming the deferral results in a substantial distortion of income, D will be required, under section 5.05(2) of this revenue procedure, to report its distributive share of PS2's income and gain accruing between January 1, 2002, and May 31, 2002, as an ordinary income adjustment on its tax return for the short period ending May 31st as a term and condition of the change in D's taxable year.

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

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

## SECTION 6. GENERAL APPLICATION PROCEDURES

### .01 What to File.

(1) *Application.* To request the Commissioner's approval to adopt, change, or retain an annual accounting period under this revenue procedure, a taxpayer (other than an electing S corporation) must complete, sign, and file a

current Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. An electing S corporation requesting to adopt, change, or retain an annual accounting period must complete the appropriate section of, and sign and file, a current Form 2553, *Election by a Small Business Corporation*.

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

(3) *Additional information regarding prior applications*.

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

(b) *Accounting period not changed*. If a prior application (filed under either an automatic change procedure or a procedure requiring prior approval) was withdrawn, not perfected, or denied, or if the change in annual

accounting period was not made, and the taxpayer files another application to change its annual accounting period within the most recent 48-month period ending with the last month of the requested taxable year, a copy of the earlier application, together with any related correspondence from the Service, must be attached to the application filed for the requested taxable year. An explanation must be furnished stating why the earlier application was withdrawn or not perfected or why the change in annual accounting period was not made. The Service will consider the explanation in determining whether the subsequent request for a change in the taxpayer's annual accounting period will be granted.

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

(5) *Additional information for section 5.03(3)*. In the case of a taxpayer requesting to change to a natural business year that satisfies the 25-percent gross receipts test described in section 5.03(3) 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.

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

(7) *Additional information for section 5.05*. If a taxpayer requests to change an annual accounting period and establishes a business purpose under section 5.02(2) of this revenue procedure, the taxpayer must provide the following additional information necessary to determine whether a substantial distortion of income (within the meaning of section 5.05(1)) exists and, thus, whether the additional terms, conditions, and adjustments of section 5.05 apply:

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

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

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

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

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

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

.02 *When to File*.

(1) *In general*. Except as provided in section 6.02(2) of this revenue procedure, a taxpayer must file a Form 1128 no earlier than the day following the end of the first effective year and no later than the due date (not including extensions) of the federal income tax return for the first effective year. However, the Service recommends that the Form 1128 be filed as early as possible to provide the Service adequate time to respond to the request prior to the due date (including extensions) of the taxpayer's federal income tax return for the first effective year. In the case of a change that results in a short period of six days or less, the Form 1128 also must be filed no earlier than the day following the end of the short period and no later than the due date (not including extensions) of the federal income tax return for the short period, even though the short period is not treated as a separate taxable year under § 1.441-2(b)(2). A taxpayer that fails to file a Form 1128

within the time period prescribed in this section 6.02(1) may request an extension of time to file under § 301.9100 of the Procedure and Administration Regulations. Under § 301.9100-3, a Form 1128 filed within 90 days after the time period prescribed in this section 6.02(1) may be considered as timely filed if the taxpayer establishes that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. If a Form 1128 is filed more than 90 days after this period, prejudice to the interests of the government will be presumed and such requests will be approved only in unusual and compelling circumstances. See § 301.9100-3(c)(3).

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

*.03 Where to File.*

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

(2) *Electing S corporations.* An electing S corporation requesting to adopt, change, or retain an annual accounting period pursuant to this revenue procedure must file its Form 2553 with the appropriate Service Center designated in the instructions to the Form 2553. The taxpayer should not include the user fee with the Form 2553 mailed to the

Service Center. The Service Center will send the Form 2553 to the national office of the Service, which will then notify the taxpayer that the fee is due.

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

*.04 User Fee.* Taxpayers are required to pay user fees for requests to adopt, change, or retain an annual accounting period under this revenue procedure. Rev. Proc. 2002-1 and, for tax-exempt organizations, Rev. Proc. 2002-8, 2002-1 I.R.B. 259 (or any successors) contain the schedule of user fees and provide guidance for complying with the user fee requirements.

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

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

(1) *Certain taxpayers under examination.*

(a) A partnership, S corporation, electing S corporation, or PSC that is under examination may apply for approval to change or retain its annual accounting period under this revenue procedure only if the appropriate director

consents to the change or retention. The director will consent to the change or retention unless in the opinion of the director, such entity's annual accounting period ordinarily would be included as an item of adjustment in the year(s) for which the entity is under examination. For example, the director will consent to a change where the entity 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 entity's business) subsequent to the years under examination. The question of whether the annual accounting period from which the entity 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 (or any successor) or, for tax-exempt organizations, Rev. Proc. 2002-5 (or any successor).

(b) A partnership, S corporation, electing S corporation, or PSC 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 partnership, S corporation, electing S corporation, or PSC must provide a copy of the application to the director at the same time it files the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

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

(3) *Certain taxpayers before a federal court.* A partnership, S corporation,

electing S corporation, or PSC that is before a federal court must attach to the application a separate statement signed by an appropriate person certifying that, to the best of that person's knowledge, the entity's annual accounting period is not an issue under consideration by the federal court. The entity must provide a copy of the application to the government counsel at the same time it files the application with the national office. The application must contain the name and telephone number of the government counsel.

## SECTION 7. PROCESSING OF APPLICATION

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

.02 *Applicability of Rev. Proc. 2002-1, Rev. Proc. 2002-4, and Any Successor Revenue Procedures.* Rev. Proc. 2002-1 or, for tax-exempt organizations, Rev. Proc. 2002-4, 2002-1 I.R.B. 127 (or any successors) will apply to any request made under this revenue procedure to adopt, change, or retain an annual accounting period.

.03 *Incomplete Application — 21 Day Rule.* If the Service receives an application that is not completed properly in accordance with the instructions on the Form 1128 (or Form 2553) and the provisions of this revenue procedure, or if supplemental information is needed, the Service will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 21 days from the date of the notification to furnish the necessary information. The Service reserves the right to impose shorter reply periods if subsequent requests for additional information are made. If the required information is not submitted to the Service within the reply period, the application will not be processed. A reasonable additional

period to furnish information may be granted to a taxpayer. Any request for an extension of time to furnish necessary information must be made in writing and submitted within the 21-day period. If the extension request is denied, there is no right of appeal.

.04 *Conference in the National Office.* The taxpayer must complete the appropriate line on the Form 1128, or attach a statement to the Form 2553, to request a conference of right if an adverse response is contemplated by the Service. If the taxpayer does not complete the appropriate line on the Form 1128, attach a statement to the Form 2553, or request a conference in a later written communication, the Service will presume that the taxpayer does not desire a conference. If requested, a conference will be arranged in the national office prior to the Service's formal reply to the taxpayer's application. For taxpayers other than exempt organizations, see section 11 of Rev. Proc. 2002-1 (or any successor). For exempt organizations, see section 12 of Rev. Proc. 2002-4 (or any successor).

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

.06 *Effect of Noncompliance.* If a taxpayer adopts, changes, or retains an annual accounting period without authorization or without complying with all of the provisions of this revenue procedure and the letter ruling granting permission for the change, the taxpayer has initiated an adoption, change, or retention of annual accounting period without obtaining the approval of the Commissioner as required by §§ 441(i), 442, 706(b), and 1378. Upon examination, a taxpayer that has initiated an unauthorized adoption, change, or retention of annual accounting

period may be denied the adoption, change, or retention. For example, the taxpayer may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

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

## SECTION 8. EFFECT OF APPROVAL

### .01 *Audit Protection.*

(1) *In general.* Except as provided in section 8.01(2) of this revenue procedure, a partnership, S corporation, electing S corporation, or PSC 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 the annual accounting period of a taxpayer described in section 8.01(1) of this revenue procedure for a prior taxable year if:

- (a) the taxpayer withdraws or does not perfect its request;
- (b) the national office denies the request;
- (c) the taxpayer declines to implement the change;
- (d) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure and the letter ruling granting permission for the change; or
- (e) the national office modifies or revokes the ruling because there has been a misstatement or omission of material facts.

### .02 *Subsequently Required Changes.*

(1) *In general.* A taxpayer described in section 8.01(1) of this revenue procedure 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 accounting period was granted in error or is not in accord with the current views of the Service; or

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

(2) *Retroactive change or modification.* Except in rare or unusual circumstances, if a taxpayer described in section 8.01(1) of this revenue procedure adopted, changed, or retained its annual accounting period under this revenue procedure and is subsequently required under section 8.02(1) of this revenue procedure to change its annual accounting period, the required change will not be applied retroactively provided that:

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

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

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

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

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

## SECTION 9. REVIEW BY DIRECTOR

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

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

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

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

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

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

.02 *National Office Consideration.* If a director recommends that the ruling (other than the amount of the adjustments required to effect the change) should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2002-2 or, for tax-exempt organizations, Rev. Proc. 2002-5 will be followed.

## SECTION 10. EFFECTIVE DATE AND TRANSITION RULE

.01 *In General.* Except as provided in section 10.02 of this revenue procedure, this revenue procedure is effective for applications filed on or after May 10, 2002.

.02 *Transition Rule for Pending Applications.* If a taxpayer filed an application before May 10, 2002, and the application is pending with the national office on May 10, 2002, the taxpayer may request that the application be processed in accordance with this revenue procedure. However, the national office will process applications filed before May 10, 2002, in accordance with prior authorities unless, prior to the later of June 25, 2002, or the issuance of the letter ruling granting or denying consent to the adoption, change, or retention, the taxpayer notifies the national office that it requests that its

application be processed in accordance with this revenue procedure.

## SECTION 11. EFFECT ON OTHER DOCUMENTS

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

## SECTION 12. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been 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 6, 7, and 10. The information in section 6 is required in order to determine whether the taxpayer's annual accounting period will result in a distortion of income. This information will be used by the Service to determine which terms, conditions, and adjustments will be necessary to effect the adoption, change, or retention of annual accounting period. The information in section 7 is required in order to determine whether the taxpayer desires a conference of right if an adverse response to its application is contemplated. 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: individuals, corporations, associations, trusts, estates, partnerships, farms, business or other for-profit organizations, non-profit organizations, and small businesses or organizations.

Except for the burdens contained in sections 6.01(5), 6.01(6), 7.04 (Forms 2553 only), and 10.02, the total annual reporting burden for the requirements contained in this revenue procedure is reflected in the burden estimates for Forms 1128 and 2553.

The estimated total annual reporting burden for the requirements contained in sections 6.01(5), 6.01(6), 7.04, and 10.02 of this revenue procedure is 600 hours: the estimated average annual burden per respondent is 1.2 hours; the estimated number of respondents is 500; and the estimated frequency of response is on occasion.

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

## DRAFTING INFORMATION

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