Internal Revenue

bulletin

Bulletin No. 2002–22
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2002–53, page 1063.
Annual accounting periods; approval. This announcement discusses some of the more significant issues raised in connection with finalizing Notice 2001–34, 2001–23 I.R.B. 1302, and Notice 2001–35, 2001–23 I.R.B. 1314, which proposed procedures for obtaining the Commissioner's approval to adopt, change, or retain an annual accounting period under sections 441 and 442 of the Code.

INCOME TAX

Rev. Rul. 2002–31, page 1023.
Contingent convertible debt instruments. This ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more cash contingent payments.

T.D. 8993, page 1026.
Final regulations under section 1275 of the Code provide guidance on the treatment of annuity contracts issued by an insurance company subject to tax under subchapter L.

REG–154920–01, page 1060.
Proposed regulations under section 954 of the Code provide that gain or loss arising from certain commodities hedging transactions and currency gain or loss arising from certain interest-bearing liabilities do not constitute (or are not netted against) foreign personal holding company income.

EXEMPT ORGANIZATIONS

Announcement 2002–51, page 1063.
Crisis at Home Intervention Center, of San Bruno, CA, no longer qualifies as an organization to which contributions are deductible under section 170 of the Code.

ADMINISTRATIVE

Notice 2002–36, page 1029.
Contingent convertible debt instruments. This notice requests comments and suggestions for change in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments. Rev. Rul. 2002–31 sets forth the tax treatment of contingent convertible debt instruments under current law.

Rev. Proc. 2002–37, page 1030.
Changes in accounting periods; automatic approval for corporations. Procedures are provided by which certain corporations may obtain automatic approval of the Commissioner to change their annual accounting period under section 442 of the Code. Rev. Proc. 2000–11 modified, amplified, and superseded.

Rev. Proc. 2002–38, page 1037.
Changes in accounting periods; automatic approval for flowthrough entities. Procedures are provided by which partnerships, S corporations, electing S corporations, and personal service corporations may obtain automatic approval of the Commissioner to adopt, change, or retain an annual accounting period under sections 441 and 442 of the Code. Rev. Proc. 87–32 clarified, modified, amplified, and superseded.

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Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–39, page 1046.

Annual accounting periods; prior approval. Procedures are provided under sections 441 and 442 of the Code to establish a business purpose and request the prior approval of the Commissioner to adopt, change, or retain an annual accounting period. Rev. Procs. 85–16 and 74–33 superseded.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 163(*l*).—Disallowance of Deduction on Certain Debt Instruments of Corporations

The revenue ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. See Rev. Rul. 2002–31, on this page.

Section 249.—Limitation on Deduction of Bond Premium on Repurchase

26 CFR 1.249–1: Limitation on deduction of bond premium on repurchase.

The revenue ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. See Rev. Rul. 2002–31, on this page.

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441–1: Period for computation of taxable income.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What significant issues were raised in connection with finalizing Notice 2001–34 and Notice 2001–35, which provided procedures for taxpayers to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period? See Announcement 2002–53, page 1063.

Section 442.—Change of Annual Accounting Period

26 CFR 1.442–1: Change of annual accounting period.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What significant issues were raised in connection with finalizing Notice 2001–34 and Notice 2001–35, which provided procedures for taxpayers to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period? See Announcement 2002–53, page 1063.

Section 444.—Election of Taxable Year Other Than Required Taxable Year

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Section 706.—Taxable Years of Partner and Partnership

26 CFR 1.706–1: Taxable years of partner and partnership.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

Section 898.—Taxable Year of Certain Foreign Corporations

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–4: Contingent payment debt instruments.
(Also §§ 163, 249; 1.249–1.)

Contingent convertible debt instruments. This ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more cash contingent payments.

Rev. Rul. 2002–31

ISSUES

Does the noncontingent bond method described in § 1.1275–4(b) of the Income Tax Regulations apply to a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments? If so, how is the comparable yield determined, and does either § 163(*l*) or § 249 of the Internal Revenue Code affect the issuer's ability to deduct the interest that accrues on the instrument under the noncontingent bond method?

FACTS

On January 1, 2002, Corporation *X* issues for $625*x* a 20-year debt instrument with a stated principal amount of $1,000*x*. Except for the contingent interest payments described below, the debt instrument does not provide for any stated interest. The debt instrument is convertible at any time into a number of shares of Corporation *X* common stock having a value, on the date of issue of the debt instrument, that is significantly less than $625*x*. The debt instrument is part of an issue that is not marketed or sold in substantial part to persons for whom the inclusion of interest from the instruments in the issue is not expected to have a substantial effect on their U.S. tax liability.

The debt instrument provides that, beginning after January 1, 2005, interest ("contingent interest") is payable for any six-month period ending on June 30 or December 31 if the average market price of the instrument for a measurement period before the applicable six-month period is greater than 120 percent of the instrument's accreted value. Under the terms of the debt instrument, accreted value is defined as the issue price of the instrument plus the economic accrual to any date of determination of a portion of the difference between the issue price and the stated principal amount at maturity. The amount of contingent interest that is payable is equal to the greater of (1) the regular cash dividend per share of Corporation *X* common stock for the six-month period multiplied by the number of shares into which the debt instrument may be converted, or (2) *y* percent of the average market price of the debt instrument for the measurement period. The contingent interest is neither a remote nor an incidental contingency within the meaning of § 1.1275–2(h).

On or after January 1, 2005, Corporation *X* has the option to redeem the debt instrument for cash in an amount equal to the instrument's accreted value as of the date the instrument is redeemed. In addition, the holder of the debt instrument has the option to put the debt instrument to Corporation *X* on January 1, 2005, or January 1, 2012, for an amount equal to the instrument's accreted value as of each such date. If the holder exercises this option, Corporation *X* can satisfy its obligation with cash, shares of Corporation *X* common stock, or a combination of cash and shares of Corporation *X* common stock, in each case having a total value equal to the instrument's accreted value. Taking into account both the likelihood of conversion of the debt instrument and the likelihood that the instrument will be put by the holder, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of the issuer.

Corporation *X* takes the position that the noncontingent bond method applies to the debt instrument and that the comparable yield for the instrument is 7 percent, compounded semiannually. (To determine the comparable yield under § 1.1275–4(b), Corporation *X* used the yield at which it would issue a comparable fixed-rate, nonconvertible debt instrument.) In preparing the projected payment schedule required by the noncontingent bond method, Corporation *X* projects payments of contingent interest and a payment at maturity (based on a projected exercise of the conversion privilege) in an amount sufficient to cause the yield on the debt instrument to equal 7 percent, compounded semiannually. When the debt instrument was issued, the long-term applicable Federal rate (AFR) was 5.39 percent, compounded semiannually.

LAW AND ANALYSIS

Section 1.1275–4 provides rules for the treatment of contingent payment debt instruments. In general, if a contingent payment debt instrument is issued for cash or publicly traded property, the noncontingent bond method applies to the instrument. *See* § 1.1275–4(b). Under the noncontingent bond method, interest accrues on the debt instrument as if it were a fixed-payment debt instrument. This fixed-payment debt instrument is constructed by using the instrument's comparable yield and a projected payment schedule.

In general, under § 1.1275–4(b)(4)(i), the comparable yield for a contingent payment debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. Relevant terms and conditions include the level of subordination, term, timing of payments, and general market conditions. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the AFR. In certain situations, the comparable yield is presumed to be the AFR. *See* § 1.1275–4(b)(4)(i)(B).

The projected payment schedule for a debt instrument includes each noncontingent payment and a projected amount for each contingent payment. *See* § 1.1275–4(b)(4)(ii). In general, if a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment as of the issue date. If the projected payment schedule and the instrument's issue price do not produce the comparable yield, then the schedule must be adjusted to produce the comparable yield. In most cases, the issuer's determination of the projected payment schedule will be respected unless it was set with a principal purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. *See* § 1.1275–4(b)(4)(v).

If the actual amount of a contingent payment is different from the projected payment, then the difference is taken into account as either a positive or negative adjustment. A positive adjustment results when the actual amount is greater than the projected amount. In general, a net positive adjustment is treated as interest and is includible in income by the holder and deductible by the issuer in the taxable year in which the adjustment occurs. A negative adjustment results when the actual amount is less than the projected amount. In general, a net negative adjustment (1) reduces interest accruals on the debt instrument for the taxable year, (2) to the extent of any excess, is treated as an ordinary loss by a holder and ordinary income by the issuer, but only to the extent of prior accruals on the debt instrument by the holder or issuer, and (3) to the extent of any further excess, is a carryforward to the next taxable year. *See* § 1.1275–4(b)(6) for the specific rules that apply to negative and positive adjustments.

Except as provided in § 1.1275–4(a)(2), § 1.1275–4 applies to any debt instrument that provides for one or more contingent payments. A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. *See* § 1.1275–2(h) for rules relating to remote and incidental contingencies.

In addition, a debt instrument does not provide for contingent payments merely because it provides for an option to convert the instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. Section 1.1275–4(a)(4). However, this exception does not apply when the debt instrument provides for contingent payments other than the conversion feature and those contingent payments are neither remote nor incidental.

Although the debt instrument issued by Corporation *X* provides for an option described in § 1.1275–4(a)(4), the debt instrument also provides for one or more contingent payments (the contingent interest) that are neither remote nor incidental. As a result, the debt instrument is a contingent payment debt instrument subject to the noncontingent bond method described in § 1.1275–4(b). Although a conversion feature alone does not cause a convertible debt instrument to be subject to the noncontingent bond method, the possibility of a conversion is nevertheless a contingency. Therefore, the comparable yield for a convertible debt instrument subject to the noncontingent bond method is determined under § 1.1275–4(b) by reference to comparable fixed-rate nonconvertible debt instruments. Moreover, the projected payment schedule is determined by treating the stock received upon a conversion of the debt instrument as a contingent payment.

Under § 1.163–7, the amount of interest that is deductible each year on a contingent payment debt instrument is determined under § 1.1275–4. Therefore, for purposes of § 163(a), Corporation *X* computes its interest deductions for each year the debt instrument is outstanding based on the comparable yield of 7 percent, compounded semiannually. Based on the facts set forth above, the original issue discount anti-abuse rule in § 1.1275–2(g) does not apply because the result reached is not unreasonable in light of the purposes of § 163(e), §§ 1271 through 1275, or any related section of the Code. The anti-abuse rule, therefore, does not affect Corporation *X*'s ability to compute its interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Certain provisions of the Internal Revenue Code, such as § 163(*l*) and § 249, may affect an issuer's ability to deduct the interest computed under the noncontingent bond method.

Section 163(*l*), which was added to the Internal Revenue Code by the Taxpayer Relief Act of 1997, § 1005, 1997–4 (Vol. 1) C.B. 125, provides that no deduction is allowed for any interest paid or accrued on a disqualified debt instrument, which is any indebtedness of a corporation that is payable in equity of the issuer or a related party. Under § 163(*l*), indebtedness is payable in equity only if (A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity, (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or (C) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in either (A) or (B) above. Principal or interest is required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

The conference report on the 1997 legislation indicates that an instrument is treated as payable in stock if it is part of an arrangement designed to result in payment with or by reference to such stock, including certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. The conference report further states that it is not expected that § 163(*l*) will affect debt with a conversion feature if the conversion price is significantly higher than the market price of the stock on the issue date of the debt. *See* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523–24 (1997), 1997–4 (Vol. 2) C.B. 1993–94.

Under the terms of the debt instrument issued by Corporation *X*, none of the instrument's principal or interest is required to be determined by reference to the value of Corporation *X*'s stock. Although the value of Corporation *X*'s stock is used in constructing the debt instrument's projected payment schedule, this projected payment is not determinative in applying § 163(*l*) to the instrument. Under the noncontingent bond method, the projected payment schedule is a mechanism for comparing actual payments to projected payments and then applying the rules for negative and positive adjustments.

The debt instrument will be paid in stock on conversion and may be paid in stock, at the option of Corporation *X*, if the holder exercises its put option. Nevertheless, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of Corporation *X*. Therefore, the debt instrument is not a disqualified debt instrument under § 163(*l*), and § 163(*l*) does not bar Corporation *X*'s accrual of interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Section 249 provides that no deduction is allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note or certificate or other evidence of indebtedness that is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness that are not convertible. However, § 249 does not apply to the extent the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature. *See* § 1.249–1. For purposes of § 249, a conversion is a repurchase. *See Clark Equipment Company v. United States,* 912 F.2d 113 (6th Cir. 1990). *See also* §§ 1.61–12(c)(2) and 1.163–7(c).

Section 249 was added to the Internal Revenue Code in 1969 because, in the case of a premium paid upon a corporation's repurchase of its convertible indebtedness, Congress believed that the amount of the premium in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense. Instead, the amount is paid in a capital transaction analogous to a corporation's repurchase of its common stock and, therefore, is not deductible. H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 1, 110 (1969), 1969–3 C.B. 200, 269; S. Rep. No. 552, 91st Cong., 1st Sess. 1, 149 (1969), 1969–3 C.B. 423, 518.

Section 249 applies only to a premium paid to repurchase a convertible debt instrument. Therefore, § 249 does not affect Corporation *X*'s ability to deduct accruals of interest based on the comparable yield. However, § 249 applies to a conversion of the debt instrument into stock having a value in excess of the debt instrument's adjusted issue price. *See Clark Equipment; National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982); and § 1.249–1. Therefore, this excess is not deductible by Corporation *X*, except to the extent the excess does not exceed a normal call premium under § 1.249–1(d) or Corporation *X* can demonstrate that the excess is attributable to the cost of borrowing and not to the conversion feature.

HOLDINGS

The noncontingent bond method described in § 1.1275–4(b) applies to the convertible debt instrument issued by Corporation *X*. The yield at which Corporation *X* would issue a comparable fixed rate nonconvertible debt instrument is used to determine the instrument's comparable yield and, therefore, the accruals of interest on the instrument. In addition, the debt instrument is not a disqualified debt instrument under § 163(*l*). Moreover, § 249 does not affect Corporation *X*'s ability to deduct periodic interest accruals on the debt instrument. However, if the debt instrument is converted into Corporation *X* stock having a value in excess of the debt instrument's adjusted issue price, Corporation *X* may not be able to deduct this excess under § 249.

DRAFTING INFORMATION

The principal authors of this revenue ruling are William E. Blanchard and Dale S. Collinson of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Blanchard at (202) 622–3950 and Mr. Collinson at (202) 622–3900 (not toll-free calls).

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26 CFR 1.1275–1: Definitions.

T.D. 8993

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Debt Instruments With Original Issue Discount; Annuity Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the federal income tax treatment of annuity contracts issued by certain insurance companies. The regulations provide guidance on whether certain annuity contracts are excluded from the definition of a debt instrument under the original issue discount provisions of the Internal Revenue Code.

DATES: *Effective Date*: These regulations are effective June 6, 2002.

Applicability Dates: For dates of applicability, see § 1.1275–1(k)(3).

FOR FURTHER INFORMATION CONTACT: Patrick E. White, (202) 622–3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Sections 163(e) and 1271 through 1275 of the Internal Revenue Code (Code) provide rules for the treatment of debt instruments with original issue discount (OID). Section 1275(a)(1)(A) defines the term *debt instrument* to include a bond, debenture, note, or certificate or other evidence of indebtedness. Sections 1275(a)(1)(B)(i) and (ii), however, exclude certain annuity contracts from the definition of a debt instrument. This document contains rules concerning the exception for annuities described in section 1275(a)(1)(B)(ii). A notice of proposed rulemaking (REG–125237–00, 2001–12 I.R.B. 919) was published in the **Federal Register** (66 FR 2852) on January 12, 2001. One individual commented anonymously on the proposed regulations. The individual primarily expressed concern that the proposed guidance should not limit the investment options of U.S. investors. No public hearing was requested or held. The proposed regulations are adopted as proposed.

Explanation of Provisions

In general, the OID provisions apply to issuers and holders of debt instruments. The term debt instrument generally means any instrument or contractual arrangement that constitutes indebtedness under general principles of income tax law. See section 1275(a)(1)(A) and § 1.1275–1(d) of the Income Tax Regulations.

If a contract is a debt instrument with OID, section 1272 generally requires the holder of the contract to include OID in income currently on a constant yield basis, regardless of the holder's overall method of accounting. By contrast, the holder of an annuity contract to which section 72 applies generally is allowed to defer recognizing economically earned income until distributions are made on the contract.

Section 1275(a)(1)(B) excepts two types of annuity contracts from the definition of a debt instrument. First, section 1275(a)(1)(B)(i) excepts an annuity contract to which section 72 applies if the contract "depends (in whole or in substantial part) on the life expectancy of 1 or more individuals." Second, section 1275(a)(1)(B)(ii) excepts an annuity contract to which section 72 applies under certain circumstances if the contract "is issued by an insurance company subject to tax under subchapter L (or by an entity described in section 501(c) and exempt from tax under section 501(a) which would be subject to tax under subchapter L were it not so exempt)...."

The regulations provide that an annuity contract issued by a foreign insurance company is treated under section 1275(a)(1)(B)(ii) as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract. The IRS and Treasury conclude that this is the most appropriate application of the language of section 1275(a)(1)(B)(ii) and is consistent with the use of that phrase elsewhere in the Code and regulations. See, *e.g.*, sections 953(e)(3)(C) and 1297(b)(2)(B); § 1.848–2(h).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Patrick E. White, Office of the Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1271–0 is amended by adding entries for paragraphs (k) through (k)(3) to § 1.1275–1 to read as follows:

§ 1.1271–0 Original issue discount; effective dates; table of contents.

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§ 1.1275–1 Definitions.

* * * * *

(k) Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code.
(1) Rule.
(2) Examples.
(3) Effective date.

* * * * *

Par. 3. Section 1.1275–1 is amended by adding paragraph (k) to read as follows:

§ 1.1275–1 Definitions.

* * * * *

(k) *Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code*—(1) *Rule*. For purposes of section 1275(a)(1)(B)(ii), an annuity contract issued by a foreign insurance company is considered as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract.

(2) *Examples*. The following examples illustrate the rule of paragraph (k)(1) of this section. Each example assumes that the annuity contract is a contract to which section 72 applies and was issued in a transaction where there is no consideration other than cash or another qualifying annuity contract, pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party, or in a transaction involving a qualified pension or employee benefit plan. The examples are as follows:

Example 1. Company X is an insurance company that is organized, licensed and doing business in Country Y. Company X does not have a U.S. trade or business and is not, under section 842, subject to U.S. income tax under subchapter L with respect to income earned on annuity contracts. A, a U.S. taxpayer, purchases an annuity contract from Company X in Country Y. The annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 2. The facts are the same as in *Example 1*, except that Company X has a U.S. trade or business. A purchased the annuity from Company X's U.S. trade or business. Under section 842(a), Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Under these facts, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 3. The facts are the same as in *Example 2*, except that there is a tax treaty between Country Y and the United States. Company X is a resident of Country Y for purposes of the U.S.-Country Y tax treaty. Company X's activities in the U.S. do not constitute a permanent establishment under the U.S.-Country Y tax treaty. Because Company X does not have a U.S. permanent establishment, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 4. The facts are the same as in *Example 1*, except that Company X is a foreign insurance corporation controlled by a U.S. shareholder. Company X does not make an election under section 953(d) to be treated as a domestic corporation. The controlling U.S. shareholder is required under sections 953 and 954 to include income earned on the annuity contract in its taxable income under subpart F. However, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 5. The facts are the same as in *Example 4*, except that Company X properly elects under section 953(d) to be treated as a domestic corporation. By reason of its election, Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

(3) *Effective date*. This paragraph (k) is applicable for interest accruals on or after June 6, 2002. This paragraph (k) does not apply to an annuity contract that was purchased before January 12, 2001. For purposes of this paragraph (k), if any additional investment in a contract purchased before January 12, 2001, is made on or after January 12, 2001, and the additional investment is not required to be made under a binding written contractual obligation that was entered into before that date, then the additional investment is treated as the purchase of a contract after January 12, 2001.

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved April 26, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 6, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 7, 2002, 67 F.R. 30547)

Section 1378.—Taxable Year of S Corporation

26 CFR 1.1378–1: Taxable year of S corporation.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Section 1502.—Regulations

26 CFR 1.1502–76: Taxable year of members of group.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Part III. Administrative, Procedural, and Miscellaneous

Contingent Convertible Debt Instruments—Request for Comments

Notice 2002–36

Rev. Rul. 2002–31, 2002–22 I.R.B., dated June 3, 2002, provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments (contingent convertible debt instruments). The revenue ruling holds that, in the described circumstances, the noncontingent bond method described in § 1.1275–4(b) of the Income Tax Regulations applies to these debt instruments. In addition, the revenue ruling addresses how an issuer determines the comparable yield used to determine the interest accruals, the effect of § 163(*l*) of the Internal Revenue Code on the accruals, and the consequences of a conversion of the instrument, including the application of § 249. See Rev. Rul. 2002–31 for a discussion of these issues.

The Internal Revenue Service and the Treasury Department are aware that the contingent convertible debt instruments described in the revenue ruling have been the subject of considerable comment within the tax bar and the media regarding whether the applicable tax rules are those generally governing contingent debt instruments or those generally governing convertible debt instruments. Existing regulations dealing with contingent debt instruments establish a general rule that issuers of such instruments are required to accrue interest expense (and holders are required to accrue interest income) as if the debt instruments bore a yield equal to the rate at which an issuer would issue a comparable debt instrument. However, certain convertible debt instruments are generally excluded from the application of the noncontingent bond method.

Specifically, § 1.1275–4(a)(4) provides that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. Because of this exclusion from the noncontingent bond method for straight convertible debt (that is, debt with no contingencies other than the conversion privilege described in § 1.1275–4(a)(4)), issuers and holders of such instruments accrue interest expense and income at a yield that assumes the instrument will not be converted (the nonconversion yield). That yield generally is considerably less than the yield for a comparable nonconvertible debt instrument. By contrast, if a convertible debt instrument providing for the possible payment of additional interest upon the occurrence of particular contingencies is eligible for the application of the noncontingent bond method, relatively insignificant changes in the investment economics of a convertible debt instrument can effect a dramatic change in the amount of interest accruals.

Some commentators have argued that the general approach of the noncontingent bond method, which requires issuers and holders of contingent debt instruments to accrue interest income and expense based on the yield of comparable debt instruments, is economically sound. They argue that the exclusion of straight convertible debt from this general approach simply reflects the historical treatment of convertible debt instruments but is otherwise inconsistent with the economic rationale for the general rule. Accordingly, these commentators argue for limited application of the exclusion for straight convertible debt and assert that sound policy supports the application of the comparable yield methodology to contingent convertible debt instruments.

Other commentators support the exclusion for straight convertible debt (or have assumed its continued existence) and have questioned whether contingent convertible debt instruments should be subject to the comparable yield methodology, particularly if the result is to permit an issuer to deduct interest accruals based on the yield of comparable nonconvertible debt instruments. These commentators have suggested that the discontinuity between the treatment of straight convertible debt and the treatment of contingent convertible debt instruments could be eliminated, or substantially ameliorated, by requiring use of the nonconversion yield on a straight convertible debt instrument as the comparable yield for accruals on contingent convertible debt instruments under the noncontingent bond method.

Several commentators have focused attention on the rule that only remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument. See §§ 1.1275–4(a)(5) and 1.1275–2(h). To the extent that § 1.1275–4 takes into account contingent payments that are relatively unlikely to occur (but not so unlikely as to be remote) and relatively insignificant in amount (but not so insignificant as to be incidental), the narrow scope of the exception tends to make largely elective the exclusion of straight convertible debt from the noncontingent bond method. That is, through changes in the terms of debt instruments that result in relatively small economic differences, issuers can trigger the application of the comparable yield methodology. Critics of this result have suggested an expansion of the universe of contingent payments that are disregarded in determining whether debt is contingent debt.

As a policy matter, the Service and the Treasury are concerned whenever significantly different tax results obtain for economically similar financial instruments, such as (1) straight convertible debt and (2) convertible debt that provides for contingent payments that, while not remote or incidental, are relatively insignificant in amount or in likelihood of occurrence. Such inconsistencies create market inefficiencies and increased transactional expense.

Disparate tax treatment for economically similar financial instruments exists in other instances, however, and the means for achieving equivalent tax treatment may not be clear or acceptable. With respect to contingent convertible debt instruments, for example, differing considerations support competing answers to the question of whether the comparable yield used for interest accruals should be based on a comparable nonconvertible debt instrument or a comparable convertible debt instrument.

Referring to nonconvertible debt instruments to ascertain the comparable yield is more consistent with the economic rationale underlying the comparable yield methodology, although using the nonconversion yield of convertible debt instruments would minimize the cliff effect and discontinuity in tax treatment that result when a contingent convertible debt instrument ceases to be eligible for the exclusion and becomes subject to the comparable yield methodology.

Similarly, changing the rule disregarding remote and incidental contingencies, which applies to nonconvertible debt instruments as well as convertible debt instruments, could have broader effects than simply reducing the cliff effect of adding contingent interest to a convertible debt instrument. The rule generally simplifies administration by avoiding the necessity of applying the comparable yield methodology (and the associated requirements for payment projections and adjustments for differences between projected payments and actual payments) to instruments having contingent payments that are insignificant in amount or unlikely to occur. Any expansion of the rule could cause the universe of instruments to which the comparable yield methodology is inapplicable to include cases in which the possibility of contingent payments has a significant depressing effect on the noncontingent yield on the instrument. The result would be the accrual of income and deduction in amounts less than the true economic yield on the instrument.

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The Service and the Treasury are concerned whenever issuers and their counsel are uncertain about the tax consequences of new financial instruments that are widely used and broadly traded in the capital markets. The capital markets operate most efficiently when the tax treatment of various financial instruments is clear. To resolve the existing controversy and to eliminate confusion in the marketplace, Rev. Rul. 2002–31 sets forth the position of the Service and the Treasury regarding the tax treatment of contingent convertible debt instruments under current law and regulations. This notice invites comments and suggestions for changes in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments to eliminate or reduce the disparity in treatment of these instruments.

The Service and the Treasury invite comments and suggestions for the use of existing regulatory authority (including regulatory authority under § 1275(d)), as well as other administrative measures, to modify the rules governing the tax treatment of straight convertible debt instruments and contingent convertible debt instruments. Specifically, comments and suggestions are invited on whether the exclusion from the noncontingent bond method for straight convertible debt instruments should be eliminated, expanded, or modified; whether the rules for determining a comparable yield for purposes of applying the noncontingent bond method to a contingent convertible debt instrument should be revised to require comparison with a straight convertible debt instrument; and whether the rule that remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument should be modified.

As part of the discussion of the tax treatment of contingent convertible debt instruments, some commentators also have raised issues regarding whether it is appropriate as a matter of public policy to allow issuers deductions for interest accruals on convertible debt instruments to the extent that payment of the accrued interest can ultimately be effected only by the issuance of the issuer's stock. Sections 163(*l*) and 249 contain restrictions on the deductibility of amounts based on the value of an issuer's stock, but those restrictions have limited scope. See the discussion of §§ 163(*l*) and 249 in Rev. Rul. 2002–31. Persons responding to this request for comments may want to include a discussion of how the policies underlying §§ 163(*l*) and 249 relate to suggestions they may make for changes in regulations or other administrative measures.

The Service and the Treasury note that in Notice 2000–29, 2000–1 C.B. 1241, they had previously requested comments on certain federal tax consequences of options to acquire partnership interests and partnership debt instruments convertible into partnership interests. Persons responding to this invitation for comments and suggestions may want to include a discussion of whether a suggested treatment of convertible debt instruments issued by corporations also should apply to similar instruments issued by partnerships.

Please submit all comments by August 30, 2002. Written comments should be sent to:

Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2002–36" in the subject line. All comments will be available for public inspection and copying in their entirety.

The principal authors of this notice are Dale S. Collinson and William E. Blanchard of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Collinson at (202) 622–3900 and Mr. Blanchard at (202) 622–3950 (not toll-free calls).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 442, 706, 898, 1502; 1.442–1, 1.706–1, 1.1502–76.)

Rev. Proc. 2002–37

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedures for certain corporations to obtain automatic approval to change their annual accounting period under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 2000–11, 2000–3 C.B. 309. A corporation complying with all 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 change 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 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. See § 1.441–1(b)(2) for examples of taxpayers, including certain corporations, with required taxable years.

.02 *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 the approval of the Commissioner.

(2) *Annualization of short period return*. Section 443(b) and § 1.443–1(b)(1)(i) generally provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period 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, §§ 1.852–3(e), 1.857–2(a)(4), and 1.1502–76 for exceptions to this general rule for a regulated investment company (RIC), a real estate investment trust (REIT), and a subsidiary corporation 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.

.03 *Approval of a Change*. Section 1.442–1(b) provides, in part, that in order to secure the approval of the Commissioner to change 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, a change 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 change.

SECTION 3. SIGNIFICANT CHANGES

Significant changes to Rev. Proc. 2000–11 made by this revenue procedure include:

.01 Section 4.01(1) of this revenue procedure provides that this revenue procedure is the exclusive procedure for corporations within its scope to change their annual accounting period;

.02 Section 4.01(2) of this revenue procedure waives only certain scope restrictions for changes to (or from) a 52–53-week taxable year that references the same calendar month;

.03 Section 4.01(3) of this revenue procedure provides that a corporation 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, may do so under this revenue procedure notwithstanding certain of the limitations imposed under section 4.02;

.04 Section 4.02(1) 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;

.05 Section 4.02(1) of this revenue procedure also adds to the list of accounting period changes that will not be considered prior changes for purposes of the 48-month rule: (a) a change to comply with § 1.1502–75, (b) any prior change made by a corporation whose majority shareholder has changed its taxable year within the last 12 months if the corporation wants to change to that shareholder's taxable year in order to file consolidated financial statements, and (c) a change to a required taxable year or an ownership taxable year;

.06 Section 4.02(2) of this revenue procedure adds to the list of corporations with certain pass-through interests that are ineligible to use this revenue procedure certain shareholders of a closely-held REIT;

.07 Section 4.02(2) of this revenue procedure also incorporates into this list of potentially prohibited pass-through interests an interest in a controlled foreign corporation (CFC), foreign personal holding company (FPHC), or passive foreign investment company (PFIC) and, as a result, allows an exception for *de minimis* interests in these entities;

.08 Section 4.02(2)(b) of this revenue procedure provides that, in certain cases in which a partnership is owned 50-percent by each of two partners, the corporate partner's interest in the partnership will be disregarded;

.09 Section 4.02(8) of this revenue procedure provides an exception to the scope restrictions for a CFC or FPHC that wants to change to its required taxable year;

.10 Section 4.02(12) of this revenue procedure adds to the list of corporations ineligible to use this revenue procedure a corporation not otherwise described in this revenue procedure that has a required taxable year, unless that corporation is changing to its required taxable year;

.11 Section 6.04 of this revenue procedure now provides certain exceptions to the record keeping/book conformity rule; and

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

SECTION 4. SCOPE

.01 *Applicability*. (1) *In general*. Except as provided in section 4.02, this revenue procedure, which is the exclusive procedure for corporations within its scope, applies to a corporation requesting automatic approval to change its annual accounting period.

(2) *Certain 52–53-week taxable years*. This revenue procedure applies to a corporation (including a member of a consolidated group) that wants to change to (or from) a 52–53-week taxable year, subject to the provisions of section 4.02 of this revenue procedure. However, notwithstanding sections 4.02(1), (2), (3), (6), (8), and (11) of this revenue procedure, this revenue procedure applies to a corporation (including a member of a consolidated group) that wants to change from a 52–53-week taxable year that references a particular month to a non–52–53-week taxable year that ends on the last day of that month, and vice versa.

(3) *Natural business year*. Notwithstanding sections 4.02(2) and (3) of this revenue procedure, this revenue procedure applies to a corporation that wants to change to a natural business year that satisfies the 25-percent gross receipts test described in section 5.

(4) *Section 898 election*. Notwithstanding section 4.02 of this revenue procedure, this revenue procedure applies to a CFC (as defined in § 957) that wants to revoke its one-month deferral election under § 898(c)(1)(B) and change its taxable year to the majority U.S. shareholder year (as defined in § 898(c)(1)(C)).

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

(1) *Prior change*. A corporation that 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 will not be considered a change in annual accounting period:

(a) a prior change in accounting period by a corporation in order to comply with the common taxable year requirement of either § 1.1502–75(d)(3)(v) or 1.1502–76(a)(1). See § 1.442–1(d);

(b) a prior change in accounting period by a corporation either acquired within the last 12 months, or whose majority shareholder changed its taxable year within the last 12 months, if that corporation currently wants to change to the taxable year of its majority shareholder with which it does not file consolidated tax returns in order to file consolidated financial statements. For purposes of this section 4.02(1)(b), "majority shareholder" means ownership that satisfies the test of § 1504(a)(2), substituting "more than 50 percent" for "at least 80 percent;"

(c) a prior change from a 52–53-week taxable year that references a particular month to a non–52–53-week taxable year that ends on the last day of that month, and vice versa; or

(d) a prior change in accounting period to a required taxable year or an ownership taxable year.

(2) *Interest in a pass-through entity*. A corporation that has an interest in a pass-through entity as of the end of the short period. However, an interest in a pass-through entity will be disregarded for this purpose if any of the following conditions are met:

(a) the pass-through entity would be required under the Code or regulations to change its taxable year to the new taxable year of the corporation (or, if applicable in the case of a CFC or FPHC, to a taxable year that begins one month-earlier than the new taxable year of the corporation). See section 6.10 of this revenue procedure for a special term and condition related to this exception;

(b) the pass-through entity is a partnership that is owned 50-percent by each of two partners and the corporation and the partnership both want to change to the taxable year of the other 50-percent partner. See section 6.10 of this revenue procedure for a special term and condition related to this exception;

(c) the new taxable year of the corporation would result in no change in or less deferral (as described in § 1.706–1(b)(3)) from the pass-through entity than the present taxable year of the corporation. If the pass-through entity is a partnership, CFC, or FPHC, the corporation should compare the existing deferral period (between the pass-through entity's and the corporation's current taxable years) with the new deferral period (between the new required taxable year of the pass-through entity and the corporation's new taxable year). See section 4.04 of this revenue procedure for an example of this rule; or

(d) for pass-through entities not qualifying for the exceptions in either section 4.02(2)(a) or (b) of this revenue procedure, the pass-through entity in which the corporation has an interest has been in existence for at least 3 taxable years and the interest is *de minimis*. For this purpose, an interest in a pass-through entity is *de minimis* only if:

(i) for each of the prior 3 taxable years of the corporation, the amount of income (including ordinary income or loss, capital gains or losses, rents, royalties, interest, dividends and deduction equivalents of credits) from such pass-through entity is less than or equal to (A) 5 percent of the corporation's gross receipts (or, in the case of a member of a consolidated group, the consolidated group's gross receipts) for those taxable years, and (B) $500,000; and

(ii) the amount of income from all such pass-through entities in the aggregate is less than or equal to the amounts described in (A) and (B) above. See section 4.04 of this revenue procedure for an example of this rule;

(3) *Shareholder of certain FSCs or IC-DISCs*. A corporation that is a shareholder of a foreign sales corporation (FSC) or interest charge domestic international sales corporation (IC-DISC), as of the end of the short period. However, an interest in a FSC or IC-DISC is disregarded if either of the following conditions is met:

(a) the FSC or IC-DISC in which the corporation is the principal shareholder (*i.e.*, the shareholder with the highest percentage of voting power as defined in § 441(h)) would be required to change its taxable year pursuant to §§ 1.921–1T(b)(4) and (b)(6) to the new taxable year of the corporation. See section 6.10 of this revenue procedure for a special term and condition related to this exception; or

(b) the new taxable year of the corporation would result in no change in or less deferral of income (as determined under the principles of § 1.706–1(a)(3)) from the FSC or IC-DISC than the present taxable year of the corporation;

(4) *FSC or an IC-DISC*. A corporation that is a FSC or an IC-DISC. See § 1.921–1T(b)(4) for rules regarding automatic changes of the annual accounting period of a FSC or IC-DISC to the taxable year of its principal shareholder;

(5) *S corporation*. A corporation that is an S corporation (as defined in § 1361). See Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, for procedures to follow for certain automatic changes in the annual accounting period of an S corporation;

(6) *Electing S corporation*. A corporation that attempts to make an S corporation election for the taxable year immediately following the short period, unless the change is to a permitted taxable year;

(7) *PSC*. A corporation that is a personal service corporation (PSC) (as defined in § 441(i)). See Rev. Proc. 2002–38 for procedures to follow for certain automatic changes in the annual accounting period of a PSC;

(8) *CFC or FPHC*. A corporation that is a CFC (as defined in § 957), including a CFC that is also a PFIC (as defined in § 1297(a)), or a FPHC (as defined in § 552), unless the CFC or FPHC either does not have a required taxable year under final regulations under § 898, or is changing to its required taxable year or to a 52–53-week taxable year that references its required taxable year;

(9) *Tax-exempt organization*. A corporation that is a tax-exempt organization, other than an organization exempt from federal income tax under §§ 521, 526, 527, or 528. See Rev. Proc. 85–58, 1985–2 C.B. 740, for procedures to follow in changing an annual accounting period of a tax-exempt organization that is not within the scope of this revenue procedure;

(10) *Possessions corporation*. A corporation that has in effect an election under § 936;

(11) *Cooperative association*. A corporation that is a cooperative association (within the meaning of § 1381(a)) with a loss in the short period required to effect the change of annual accounting period, unless the patrons of the cooperative association are substantially the same in the year before the change of annual accounting period, in the short period required to effect the change, and in the year following the change. For purposes of this subsection, "substantially the same" means that ownership of more than 90 percent of the cooperative association's stock is owned by the same members; or

(12) *Corporation with a required taxable year*. A corporation that is not described in sections 4.02(1) through (11) of this revenue procedure that has a required taxable year (*e.g.*, a REIT, or a qualified settlement fund or designated settlement fund as defined in § 1.468B),

unless the corporation is changing to its required taxable year.

.03 *Nonautomatic Changes*. Corporations that are unable to obtain automatic approval for a change in accounting period under this revenue procedure, the applicable regulations, or any other revenue procedure must secure prior approval from the Commissioner for a change in an accounting period pursuant to § 442 and the regulations thereunder. *See* Rev. Proc. 2002–39, 2002–22 I.R.B. 1046.

.04 *Examples*.

(1) Example 1. (i) Corporations V, W, X, Y, and Z hold equal 20 percent interests in the capital and profits of partnership ABC. V and W are calendar year taxpayers. X and Y have taxable years ending June 30, and Z has a taxable year ending September 30. ABC does not have a business purpose for a particular taxable year, and thus, pursuant to § 1.706–1, ABC is required to use a taxable year ending June 30 because that taxable year results in the least aggregate deferral of income to its partners. Z currently has a 3-month deferral period (the number of months from the end of ABC's taxable year to the end of Z's taxable year). Z wants to change its taxable year to a calendar year.

(ii) If Z changes its taxable year to a calendar year, ABC would be required to change its taxable year under § 706 to its majority interest taxable year, which is the calendar year. As a result of Z's new taxable year and ABC's new taxable year, Z's deferral period would be eliminated. Because Z's new taxable year would reduce Z's deferral, Z may disregard its interest in ABC under section 4.02(2)(c) of this revenue procedure.

(2) *Example 2*. (i) Corporation X, a calendar year taxpayer, wants to change its taxable year to a year ending June 30. X has interests in five partnerships, ABC, DEF, GHI, JKL, and MNO. All of the partnerships have been in existence for over three taxable years. X's interests in each of ABC and DEF is greater than 50 percent. X's interest in GHI, JKL, and MNO is 15 percent, 10 percent, and 5 percent, respectively. GHI uses the majority interest taxable year ending May 31 and JKL and MNO each use their respective majority interest taxable year ending December 31. X's distributive share of income/(loss) from JKL for the prior three taxable years is $300,000, $(100,000), and $200,000, respectively, and from MNO is $300,000, $200,000, and $100,000, respectively. X's gross receipts for each of those same taxable years was $15,000,000.

(ii) X's interests in its pass-through entities will be disregarded only if each pass-through entity satisfies one of the exceptions enumerated under section 4.02(2) of this revenue procedure. In the instant case, X's interests in ABC and DEF each meet the exception in section 4.02(2)(a) because X is the majority interest partner in each partnership. X's interest in GHI meets the exception in section 4.02(2)(c) because X's new taxable year would result in less deferral than its old taxable year (the deferral between May 31 and June 30 of 1 month as compared to the deferral between May 31 and December 31 of 7 months). Because X is not the majority interest partner in JKL and MNO and because its new taxable year would not result in less deferral from these partnerships, X's interests in JKL and MNO may be disregarded only if they satisfy the *de minimis* exception in section 4.02(2)(d). Although the income from JKL and MNO for each of the prior three taxable years is less than 5 percent of X's gross receipts and $500,000, the income for year 1 from JKL and MNO, in the aggregate ($300,000 and $300,000), exceeds the $500,000 amount specified in section 4.02(2)(d)(ii). Consequently, JKL and MNO fail to satisfy the *de minimis* exception in section 4.02(2)(d). Because X's interests in all of its pass-through entities will not be disregarded, X is not within the scope of this revenue procedure.

SECTION 5. DEFINITIONS

The following definitions apply solely for the purpose of this revenue procedure:

.01 *Corporation*. The term "corporation" includes associations, joint-stock companies, and insurance companies, as provided in § 7701(a)(3), and 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.

.02 *Pass-through Entity*. The term "pass-through entity" means a partnership; a trust; an estate; a common trust fund (as defined in § 584); a CFC (as defined in § 957), but only to the extent the corporation is a U.S. shareholder (as defined in § 951(b)); an FPHC (as defined in § 552), but only to the extent the corporation is a U.S. shareholder (as defined in § 551(a)); a PFIC, but only if the corporation has elected to treat such PFIC as a qualified electing fund (as defined in § 1295); and a closely-held REIT (as defined in § 6655(e)(5)(B)), but only to the extent the corporation is described in § 6655(e)(5)(A).

.03 *Required Taxable Year*. The required taxable year is the particular taxable year that certain taxpayers are required to use under the Code and the regulations thereunder. See § 1.441–1(b)(2) for examples of taxpayers, including certain corporations, with required taxable years.

.04 *Permitted Taxable Year*. A "permitted taxable year" of an electing S corporation is the required taxable year; a taxable year elected under § 444; a natural business year that satisfies the 25-percent gross receipts test described in section 5.06 of this revenue procedure; the ownership taxable year; or a 52–53-week taxable year that references the required taxable year, taxable year elected under § 444, natural business year, or ownership taxable year.

.05 *Ownership Taxable Year*. An "ownership taxable year" of an electing S corporation 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 electing S corporation. Tax-exempt shareholders are not disregarded, however, if the electing S corporation is wholly-owned by such tax-exempt entities. A shareholder in an 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.

.06 *Natural Business Year*. A corporation 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 gross receipts 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) 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.

(c) 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.

(d) 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.

(e) 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.

.07 *First Effective Year*. The first effective year is the first taxable year for which a change in annual accounting period is effective, *e.g.*, the short period required to effect the change. 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 change in annual accounting period.

.08 *Short Period*. A corporation'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.

SECTION 6. TERMS AND CONDITIONS OF CHANGE

.01 *In General*. A change 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 corporation 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 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 corporation secures the approval of the Commissioner to change that taxable year.

.04 *Record Keeping/Book Conformity*. The books of the corporation must be closed as of the last day of the first effective year. Thereafter, the corporation 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 the corporation's required taxable year.

.05 *Changes in Natural Business Year*. If an electing S corporation changes to a natural business year that satisfies the 25-percent gross receipts test under this revenue procedure and that annual accounting period no longer qualifies as a natural business year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner. Certain S corporations may qualify for automatic approval to change their annual accounting period under Rev. Proc. 2002–38. Other taxpayers must request approval under Rev. Proc. 2002–39.

.06 *Changes in Ownership Taxable Year*. An electing S corporation that changes to an ownership taxable year under this revenue procedure must change to a permitted taxable year or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner, or request approval to retain its current taxable year, if, as of the first day of any taxable year, its ownership taxable year changes. Certain S corporations may qualify for automatic approval to change or retain their annual accounting period under Rev. Proc. 2002–38. Other taxpayers must request approval under Rev. Proc. 2002–39.

.07 *52–53-week Taxable Years*. If applicable, the corporation 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 ends with reference to the same calendar month as one or more of its owners).

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

.09 *Creation of General Business Credits*. If there is an unused general business credit or any other unused credit generated in the short period, the corporation must carry that unused credit forward. An unused credit from the short period may not be carried back.

.10 *Concurrent Change for Related Entities*. If a corporation's interest in a pass-through entity, FSC, or IC-DISC (related entity) is disregarded pursuant to section 4.02(2)(a), 4.02(2)(b), or 4.02(3)(a) of this revenue procedure because the related entity is required to change its taxable year to the corporation's new taxable year (or, if applicable in the case of a CFC or FPHC, to a taxable year beginning one month earlier than the corporation's new taxable year), the related entity must change its taxable year concurrently with the corporation's change in taxable year, either under Rev. Proc. 2002–38, Rev. Proc. 2002–39, or this revenue procedure, whichever is applicable. This related party change is required 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).

SECTION 7. GENERAL APPLICATION PROCEDURES

.01 *Approval*. Approval is hereby granted to any corporation within the scope of this revenue procedure to change its annual accounting period, provided the corporation complies with all the applicable provisions of this revenue procedure. Approval is granted beginning with the first effective year. A corporation granted approval under this revenue procedure to change its annual accounting period is deemed to have established a business purpose for the change to the satisfaction of the Commissioner.

.02 *Filing Requirements*.

(1) *Where to file*. Any corporation (including the common parent of a consolidated group) that wants to change its annual accounting period pursuant to the provisions of this revenue procedure must complete and file a Form 1128 with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the corporation files its federal income tax return. No copies of Form 1128 are required to be sent to the national office. The corporation also must attach a copy of the Form 1128 to the federal income tax return filed for the short period required to effect the change. Any corporation completing and filing a Form 1128 on behalf of a CFC or FPHC must file the Form 1128 where the corporation files its federal income tax return.

(2) *When to file*. A Form 1128 filed pursuant to this revenue procedure will be considered timely filed for purposes of § 1.442–1(b)(1) only if it is filed on or before the due date (including extensions) for filing the federal income tax return for the short period required to effect such change.

(3) *Label*. In order to assist in the processing of the change in annual accounting period, reference to this revenue procedure must be made a part of the Form 1128 by either typing or legibly printing the following statement at the top of page 1 of the Form 1128: "FILED UNDER REV. PROC. 2002–37." For a CFC that is revoking a § 898(c)(1)(B) election under section 4.01(4) of this revenue procedure, the label at the top of page 1 of the Form 1128 should read "REVOCATION OF § 898(c)(1)(B) ELECTION FILED UNDER REV. PROC. 2002–37."

(4) *Signature requirements*. The Form 1128 must be signed on behalf of the corporation requesting the change of annual accounting period by an individual with authority to bind the corporation in such matters. If the corporation is a member of a consolidated group, the Form 1128 must be signed by a duly authorized officer of the common parent. If an agent is authorized to represent the corporation 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 corporation, a power of attorney reflecting such authorization(s) should be attached to the application. A corporation's representative without a power of attorney to represent the corporation will not be given any information about the application.

(5) *No user fee*. A user fee is not required for an application filed under this revenue procedure and, except as provided in section 8.01 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 corporation changing to a natural business year that satisfies the 25–percent gross receipts test described in section 5.06 of this revenue procedure, the corporation must supply the gross receipts for the most recent 47 months for itself (or any predecessor) in compliance with the instructions to Form 1128.

(7) *Consolidated application*. A common parent must file a single application to change the annual accounting period of its consolidated group, even if one or more of the subsidiaries of the group are requesting to use a 52–53-week taxable year that ends with reference to the common parent's requested taxable year or the subsidiaries are requesting to use a taxable year consisting of 12 calendar months that coincides with the reference month of the common parent's requested 52–53-week taxable year. *See* § 1.1502–76(a)(1) (common parent must attach a statement to its tax return as required by Rev. Proc. 89–56, 1989–2 C.B. 643, and comply with Rev. Rul. 72–184, 1972–1 C.B. 289). On the Form 1128 filed on behalf of a common parent and its subsidiaries, the common parent corporation must clearly indicate which corporations in the consolidated group (if any) are requesting a 52–53-week taxable year, and which (if any) are requesting a taxable year consisting of 12 calendar months. In addition, the common parent must answer all relevant questions on the Form 1128 for each member of the consolidated group.

SECTION 8. REVIEW OF APPLICATION

.01 *Service Center Review*. A Service Center may deny a change of annual accounting period under this revenue procedure only if (a) the Form 1128 is not filed timely, or (b) the corporation fails to meet the scope or any term and condition of this revenue procedure. If the change is denied, the Service Center will return the Form 1128 with an explanation for the denial.

.02 *Review of Director*. The appropriate director may ascertain if the change in annual accounting period was made in compliance with all the applicable provisions of this revenue procedure. Corporations changing 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 change in annual accounting period without the approval of the Commissioner. Upon examination, a corporation that has initiated an unauthorized change of annual accounting period may be denied the change. For example, the corporation may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

SECTION 9. EFFECTIVE DATE AND TRANSITION RULE

.01 *Effective Date*. This revenue procedure generally is effective for all changes in 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 with respect to a taxable year set forth in section 7.02(2) of this revenue procedure has not yet expired, a corporation 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 and by satisfying the other procedural requirements of section 7.

.02 *Transition Rule*. If a corporation 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 corporation 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 change, the corporation notifies the national office that it wants to use this revenue procedure. If the corporation timely notifies the national office that it wants to use this revenue procedure, the national office will require the corporation 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 corporation.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–11 is modified, amplified, and superseded.

SECTION 11. 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 change its annual accounting period. The information in section 10 is required in order to allow a corporation to apply the provisions of this revenue procedure to a pending application. The likely respondents are corporations.

The estimated total annual reporting burden for the requirements contained in section 7 of this revenue procedure is reflected in the burden estimates for Form 1128. 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 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 Roy A. Hirschhorn and Martin Scully, Jr. of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Hirschhorn or Mr. Scully at (202) 622–4960 (not a toll-free call).

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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

CONTENTS

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 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 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).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 441, 442, 444, 706, 1378, 1502; 1.441–1, 1.441–3, 1.442–1, 1.706–1, 1.1378–1, 1.1502–76.)

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SECTION 1. PURPOSE

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

SECTION 2. BACKGROUND

.01 *Taxable Year Defined*.

(1) *In general*. Section 441(b) and § 1.441–1(b)(1) 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 circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. *See also* H.R. Rep. No. 99–841, 99th Cong., 2d Sess., II–318, 1986–3 (Vol. 4) C.B. 319.

(2) *Sufficient business purposes*. Section 1.442–1(b)(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 taxpayer's annual accounting period is an item included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the government counsel.

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

.01 *In General*.

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

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

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

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

Part IV. Items of General Items

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding the Definition of Foreign Personal Holding Company Income

REG–154920–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide that gain or loss arising from certain commodities hedging transactions and currency gain or loss arising from certain interest-bearing liabilities do not constitute (or are not netted against) foreign personal holding company income. This treatment is proposed because the applicable commodities hedging transactions and interest-bearing liabilities typically offset transactions that do not generate foreign personal holding company income. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 21, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for September 11, 2002, at 10 a.m. must be submitted by August 21, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–154920–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU, REG–154920–01, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kenneth Christman or Ted Setzer at (202) 622–3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 954(c)(1)(C) of the Internal Revenue Code provides that *foreign personal holding company income* of a *controlled foreign corporation* (a CFC) generally includes the excess of gains over losses from transactions in commodities. An exception to this treatment is provided, however, for gains and losses that arise out of "*bona fide* hedging transactions" entered into by a producer, processor, merchant or handler of commodities. Section 954(c)(1)(C)(i). On September 7, 1995, final regulations (T.D. 8618, 1995-2 C.B. 89) were published in the **Federal Register** (60 FR 46500, as corrected at 60 FR 62024) under section 954 governing the definition of a CFC and the definitions of *foreign base company income* and *foreign personal holding company income* of a CFC. These regulations address, among other matters, the circumstances in which income from transactions in commodities will be treated as foreign personal holding company income. In particular, the regulations provide that income from a "qualified hedging transaction" is excluded from the definition of foreign personal holding company income. § 1.954–2(f)(1)(ii). A qualified hedging transaction is defined in the regulations generally as a *bona fide* hedging transaction with respect to a sale of commodities in the active conduct of a commodities business by a CFC if substantially all of the CFC's business is as an active producer, processor, merchant or handler of commodities. §§ 1.954–2(f)(2)(iii) and (iv).

Following the publication of the final regulations, some taxpayers have commented that the regulations inappropriately characterize as foreign personal holding company income any gain arising from hedging transactions entered into by a manufacturer to protect itself from fluctuations in the prices of commodities associated with the products that it manufactures. Because the manufacturer would not be considered to be selling the commodities in the active conduct of a commodities business, transactions entered into by the manufacturer could not qualify for the "qualified hedging transaction" exception under the regulations.

The regulations also address the treatment of currency gain or loss for purposes of subpart F. Although the regulations provide that foreign personal holding company income generally includes the excess of foreign currency gains over foreign currency losses, an exception is provided for foreign currency gain or loss "directly related to the business needs of the controlled foreign corporation." § 1.954–2(g)(2)(ii). Notwithstanding this "business needs" exception, the regulations provide that currency gain or loss arising from an interest-bearing liability must be allocated and apportioned between subpart F and non-subpart F income in the same manner that interest expense associated with the liability is allocated and apportioned between subpart F and non-subpart F income under §§ 1.861–9T and 1.861–12T. § 1.954–2(g)(2)(iii).

Some taxpayers have commented that the final regulations inappropriately characterize a portion of foreign currency gain on certain interest-bearing liabilities as foreign personal holding company income. In particular, these taxpayers have noted that securities dealers commonly utilize a technique known as "match funding" to manage currency exposures associated with their dealer assets. Rather than borrowing in their functional currency to meet their business needs, dealers who utilize this technique attempt to manage their exposure to foreign currencies on their dealer assets by borrowing the funds needed for their business in the currency in which the dealer assets are denominated. As a result, the foreign currency exposure on the dealer assets is offset economically by the foreign currency exposure on the interest-bearing liabilities incurred by the dealer. Under the regulations, foreign currency gain on the dealer assets would qualify for the "business needs" exception and therefore would not be classified as foreign personal holding company income. If the foreign currency gain arose on the offsetting interest-bearing liabilities, however, a portion of the foreign currency gain likely would be treated as subpart F income under the regulations.

Explanation of Provisions

The proposed regulations address each of these issues by refining the relevant exceptions to foreign personal holding company income.

Commodities Hedging Transactions

Section 1.954–2(f)(2)(v), as proposed, would provide that a hedging transaction entered into by a CFC with respect to its business as a producer, processor, merchant or handler of commodities may be a qualified hedging transaction although the hedging transaction is not a hedge with respect to a sale of commodities in the active conduct of a commodities business by a CFC substantially all of whose business is as an active producer, processor, merchant or handler of commodities. The proposed regulation also provides that, for purposes of satisfying the qualified hedging transaction requirements, a producer, processor, merchant or handler of commodities includes (but is not limited to) a CFC that regularly uses commodities in a manufacturing, construction, utilities, or transportation business. Similar to the regulations currently in effect, the proposed regulations provide that a corporation is not a producer, processor, merchant or handler of commodities (and therefore cannot satisfy the qualified hedging transaction requirements) if its business is primarily financial.

Foreign Currency Gain or Loss on Interest-bearing Liabilities

Section 1.954–2(g)(2)(ii)(C)(*2*), as proposed, would provide that interest-bearing liabilities of a CFC will be treated as dealer property if the liabilities are denominated in a currency so as to manage the CFC's currency risk with respect to dealer property held by the CFC. This provision would apply only to interest-bearing liabilities identified on the date the liability is incurred. The result of the proposed rule would be to exclude currency gain or loss on interest-bearing liabilities that manage the CFC's currency risk with respect to dealer property from the computation of foreign personal holding company income.

Proposed Effective Dates

Section 1.954–2(f)(2)(v) is proposed to apply to gain or loss realized by a CFC with respect to a qualified hedging transaction entered into on or after the date proposed § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**. Section 1.954–2(g)(2)(ii)(C)(*2*) is proposed to apply to gain or loss from an interest-bearing liability entered into by a CFC on or after the date proposed § 1.954–2(g)(2)(ii)(C)(*2*) is published as a final regulation in the **Federal Register**.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 11, 2002, at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 21, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Kenneth Christman and Ted Setzer of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.954–0, paragraph (b) is amended by:

1. Removing the entry for § 1.954–2(f)(2)(iii)(E).

2. Revising the entry for § 1.954–2(f)(2)(iv).

3. Adding entries for § 1.954–2(f)(2)(iv)(C), (f)(2)(v) and (f)(2)(vi).

4. Revising the entry for § 1.954–2(g)(2)(ii)(C).

The additions and revisions read as follows::

§ 1.954–0 Introduction.

* * * * *

(b) * * *

§ 1.954–2 Foreign personal holding company income.

* * * * *

(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

* * * * *

(C) Effective date.

(v) Qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(A) In general.

(B) Exception.

(C) Examples.

(D) Effective date.

(vi) Financial institutions not a producer, etc.

(g) * * *

(2) * * *

(ii) * * *

(C) Regular dealers.

(*1*) General rule.

(*2*) Certain interest-bearing liabilities treated as dealer property.

(i) In general.

(ii) Failure to identify certain liabilities.

(iii) Effective date.

* * * * *

Par. 3. Section 1.954–2 is amended by:

1. Removing paragraph (f)(2)(iii)(E).

2. Revising the heading of paragraph (f)(2)(iv).

3. Adding paragraphs (f)(2)(iv)(C), (f)(2)(v), and (f)(2)(vi).

4. Revising paragraphs (g)(2)(C) and (g)(2)(iii).

The revisions and additions read as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

* * * * *

(C) *Effective date*. This paragraph (f)(2)(iv) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(v) *Qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the* ***Federal Register***—(A) *In general*. The term *qualified hedging transaction* means a *bona fide* hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others. For purposes of this paragraph (f)(2)(v), a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business.

(B) *Exception*. The term *qualified hedging transaction* does not include a transaction described in section 988(c)(1) (without regard to section 988(c)(1)(D)(i)).

(C) *Examples*. The following examples illustrate the provisions of this paragraph (f)(2)(v):

Example 1. CFC1 is a controlled foreign corporation located in country A. CFC1 manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. CFC1 conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aluminum used in the machinery it manufactures, CFC1 enters into futures purchase contracts for the delivery of aluminum. These futures purchase contracts are *bona fide* hedging transactions. As CFC1 purchases aluminum and component parts containing significant amounts of aluminum in the spot market for use in its business, it closes out an equivalent amount of aluminum futures purchase contracts by entering into offsetting aluminum futures sales contracts. The aluminum futures purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the computation of foreign personal holding company income.

Example 2. CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are *bona fide* hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

(D) *Effective date*. This paragraph (f)(2)(v) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(vi) *Financial institutions not a producer, etc*. For purposes of this paragraph (f), a corporation is not a producer, processor, merchant or handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(C) *Regular dealers*—(1) *General rule*. Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(2) *Certain interest-bearing liabilities treated as dealer property*—(*i*) *In general*. For purposes of this paragraph (g)(2)(ii)(C), an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency shall be treated as dealer property if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

(*ii*) *Failure to identify certain liabilities*. If a controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property under the previous paragraph but fails to so identify other interest-bearing liabilities that manage its currency risk with respect to assets held that constitute dealer property, the Commissioner may treat such other liabilities as dealer property if the Commissioner determines that the failure to identify such other liabilities had as one of its principal purposes the avoidance of federal income tax.

(*iii*) *Effective date*. This paragraph (g)(2)(ii)(C)(*2*) applies only to gain or loss from an interest-bearing liability entered into by a controlled foreign corporation on or after the date § 1.954–2(g)(2)(ii)(C)(2) is published as a final regulation in the **Federal Register**.

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(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability*. Except as provided in paragraph (g)(2)(ii)(C)(*2*) or (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 10, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 13, 2002, 67 F.R. 31995)

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2002–51

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on March 18, 2002, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428 (c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Crisis at Home Intervention Center
San Bruno, CA

Changes in Annual Accounting Period

Announcement 2002–53

PURPOSE

This announcement discusses some of the more significant issues raised in connection with finalizing Notice 2001–34, 2001–23 I.R.B. 1302, and Notice 2001–35, 2001–23 I.R.B. 1314, which proposed procedures for obtaining the Commissioner's approval to adopt, change, or retain an annual accounting period under §§ 441 and 442 of the Internal Revenue Code and the regulations thereunder.

BACKGROUND

Notice 2001–34 proposed procedures for obtaining the Commissioner's prior approval to adopt, change, or retain an annual accounting period, applicable to a taxpayer that is not within the scope of any automatic approval procedure. Notice 2001–35 proposed new automatic approval procedures for partnerships, S corporations, electing S corporations, and personal service corporations (PSCs). Both notices requested comments from the public in connection with the proposed procedures. At the same time that the Service published these notices, it also issued new proposed regulations (REG–106917–99, 2001–27 I.R.B. 4) under §§ 441, 442, 706, and 1378, relating to annual accounting periods, which also requested public comments.

Rev. Proc. 2002–39, finalizing Notice 2001–34, and Rev. Proc 2002–38, finalizing Notice 2001–35, appear elsewhere in this Bulletin, along with Rev. Proc. 2002–37, which provides updated automatic approval procedures for corporations. These revenue procedures, together with final regulations (T.D. 8996, published in the May 17, 2002, Federal Register (67 FR 35009)) under §§ 441, 442, 706, and 1378, issued concurrently, are intended to provide comprehensive guidance on the adoption, change, and retention of an annual accounting period. The most significant comments received in connection with Notice 2001–34 and Notice 2001–35, along with certain other changes to the proposed procedures, are discussed below. Comments specific to the proposed regulations are discussed in the preamble to the final regulations.

CHANGES TO NOTICE 2001–34 (PRIOR APPROVAL PROCEDURES)

A. *Natural Business Year*

One commentator suggested that the final revenue procedure clarify the terms "peak and nonpeak periods," "at or soon after," and "insignificant gross receipts," in connection with the annual business cycle and seasonal business tests. Rev. Proc. 2002–39 provides clarification by including safe harbor rules for administrative convenience, as well as examples. One safe harbor provides that 1 month will be deemed to be "soon after" the end of a peak period (in the case of the annual business cycle test) or the close of operations (in the case of the seasonal business test). Under a second safe harbor, gross receipts will be deemed to be "insignificant" for purposes of the seasonal business test if they are less than 10 percent of the taxpayer's total gross receipts for the year. The examples illustrate the application of these safe harbor rules. Taxpayers that do not meet the safe harbor rules nevertheless may establish that their requested taxable year meets the annual business cycle test or seasonal business test using all of the facts and circumstances.

Notice 2001–34 provided that a taxpayer seeking to establish a natural business year under section 5.03 must provide information about its gross receipts for the three taxable years immediately preceding the first effective year. Although Rev. Proc. 2002–39 continues to require this information, and to require that the annual business cycle, seasonal business, or 25-percent gross receipts test be met for each of the three preceding years for taxpayers that have been in existence for that length of time, the Service and Treasury realize that newly formed taxpayers may be uncertain about whether and how they can establish a natural business year under these tests. Accordingly, Rev. Proc. 2002–39 clarifies that a taxpayer that has not been in existence for 3 taxable years may satisfy the annual business cycle or seasonal business test by providing information other than prior years' gross receipts, such as a description of its business and reasonable estimates of its gross receipts. However, the Service and Treasury believe that the more objective 25-percent gross receipts test should continue to apply only to established taxpayers that can produce actual gross receipts information for the required 3-year period.

B. *Additional Acceptable Business Purposes*

Section 5.02(1)(b) of Notice 2001–34 provides that a taxpayer, including a partnership, S corporation, electing S corporation, or PSC, may establish a business purpose for a requested taxable year for purposes of section 5.02(1) (to which only general terms and conditions apply) based on all of the facts and circumstances. A commentator requested that the Service provide examples of the kinds of facts and circumstances that would be sufficient for a taxpayer to demonstrate a sufficient business purpose. The commentator further suggested that the final revenue procedure explain whether and how facts such as a taxpayer's gross receipts would be evaluated to determine whether the taxpayer has demonstrated a sufficient business purpose under the facts and circumstances test of section 5.02(1)(b). The Service and Treasury intend for the facts and circumstances test of section 5.02(1)(b) to apply only in rare and unusual circumstances. Rev. Proc. 2002–39 has been clarified to that effect. Accordingly, examples such as those suggested by the commentator have not been included in Rev. Proc. 2002–39.

It should be noted that, if a taxpayer (other than a taxpayer with a required taxable year) fails to satisfy one of the three alternative tests for showing a natural business year (annual business cycle, seasonal business, or 25-percent gross receipts), then the taxpayer still may obtain approval for the change if it demonstrates some nontax reason for the change and accepts additional terms and conditions that are necessary to eliminate substantial distortion created by the change. Under Rev. Proc. 2002–39, this nontax reason can be a reason not heretofore accepted by the Service as a sufficient business purpose in cases where substantial distortion is present, and can be based on criteria, such as gross receipts, that are also the focus of the natural business year tests. For example, such a business purpose could include having significant gross receipts in the last months of the requested taxable year, albeit less than 25 percent of the taxpayer's annual gross receipts.

C. *Changes Within 48 Months*

Some taxpayers have expressed concern that the Service will deny most, or even all, applications to change or retain an annual accounting period under the final prior approval procedures if the taxpayer made a change within the previous 48 months ("prior change"). Although a prior change may disqualify a taxpayer for automatic approval of a change or retention, the Service expects that, for the vast majority of applications under Rev. Proc. 2002–39, approval will not be denied because of a prior change. However, in certain cases, approval may be denied because of the taxpayer's accounting period history (for example, where there exists a pattern of prior changes). *See generally* section 7.01 of Rev. Proc. 2002–39.

D. *Director Consent/Audit Protection*

Notice 2001–34 proposed to offer audit protection to all taxpayers that received prior approval under the final revenue procedure to retain or change an annual accounting period. Consistent with procedures of the Service in the accounting method area, taxpayers under examination were required to secure the consent of the Director to the change or retention. One commentator argued that the requirement to obtain the Director's consent was burdensome, particularly for corporate taxpayers for whom an annual accounting period ordinarily would not be an issue under consideration. The commentator suggested either that all taxpayers under examination be permitted to provide a representation (under penalties of perjury) that their annual accounting period is not an issue under consideration, in lieu of a letter of consent from the Director, or that audit protection be limited to taxpayers that provide the letter of consent.

After carefully weighing the benefits of audit protection against the burden of obtaining the requisite Director consent, the Service and Treasury Department have determined that it is appropriate to extend audit protection only to certain taxpayers with required taxable years, namely, partnerships, S corporations, electing S corporations, and PSCs. Accordingly, other corporate taxpayers, and taxpayers with required taxable years other than those identified above, that are under examination or before an area office or a federal court will not be required to obtain Director consent as a prerequisite to applying for a change under Rev. Proc. 2002–39, and will not be offered audit protection. Similarly, no consent letter is required, and no audit protection is offered, by Rev. Proc. 2002–37, which provides automatic consent procedures for corporations.

E. *Failure to Satisfy Natural Business Year Test in Future Years*

Notice 2001–34 provides that if a partnership, S corporation, electing S corporation, or PSC changes to a natural business year, and that year later fails to qualify as a permitted year, the taxpayer must then change to a permitted year. One commentator objected to this condition, arguing that it effectively mandates annual monitoring of the taxpayer's continued compliance with the natural business year requirement, and as such is overly burdensome. The commentator suggested that the final procedures instead adopt a 3-year testing period.

The Service and Treasury Department believe that a 3-year testing period is inconsistent with the statutory framework imposing required years on such taxpayers, and that the taxpayer's year must continue to be a permitted year in order for the taxpayer to retain it. It should be noted, however, that even if the requested taxable year fails in some later year to qualify as a permitted year under the original test for which approval was granted (for example, the 25-percent gross receipts test), the taxpayer need not change its existing taxable year if the taxpayer can demonstrate that the year is a permitted year under some other test (for example, the annual business cycle test). The same would be true for a taxpayer that changed to or retained a natural business year under one of the automatic approval revenue procedures.

F. *Substantial Distortion of Income*

Notice 2001–34 provides that, for purposes of determining whether the additional terms and conditions of section 5.05 apply, distortion of income resulting from the requested taxable year change will not be considered substantial if the amount of the distortion is less than both: (1) 5 percent of the taxpayer's estimated gross receipts for its current taxable year; and (2) $500,000. The amount of the distortion or deferral is the taxpayer's allocable share of income from a pass-through entity, including ordinary income or loss, rents, royalties, interest, dividends, and deduction equivalents of credits. A similar *de minimis* rule is provided in Rev. Proc. 2000–11 (applied to each of the 3 prior taxable years) for determining whether a corporation with an interest in a pass-through entity is within the scope of that automatic approval revenue procedure.

One commentator suggested that the final prior approval procedures eliminate the $500,000 floor. The commentator believes that, in the case of prior approval applications processed by the national office, it is more appropriate for the Service to determine on a case-by-case basis whether an estimated amount of distortion is *de minimis*.

The Service and Treasury Department believe that the $500,000 floor is appropriate in order to promote consistency of results and facilitate the administration of prior approval applications. Thus, the $500,000 floor is retained in Rev. Proc. 2002–39. Similarly, the $500,000 floor contained in Rev. Proc. 2000–11 is retained in Rev. Proc. 2002–37.

The commentator also recommended that, regardless of the *de minimis* distortion test, the additional terms and conditions of section 5.05 of Notice 2001–34 not apply if the taxpayer's interest in the pass-through entity is less than 5 percent of the entity's profits and capital. The Service and Treasury do not believe that such a rule would be appropriate, as even a 1 percent interest in profits and capital can potentially result in a significant amount of distortion.

CHANGES TO NOTICE 2001–35 (AUTOMATIC APPROVAL PROCEDURES FOR PASS-THROUGH ENTITIES)

A. *Natural Business Year*

One commentator suggested that the final procedures for obtaining automatic approval by a pass-through entity clarify whether a taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is required to recompute the 25-percent gross receipts test. Section 7.02(6) of Rev. Proc. 2002–38 requires only a taxpayer changing to a natural business year using the 25-percent gross receipts test to provide the gross receipts information with its application, in compliance with the instructions for Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. A taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is not required to provide this information. However, as discussed above, for a taxpayer with a required year to continue to use a fiscal year, that year must continue to be a permitted year.

B. *Ownership Taxable Year*

Notice 2001–35 provided that, for purposes of determining the ownership tax year of an S corporation or electing S corporation, 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. One commentator suggested that tax-exempt shareholders should not be disregarded if the S corporation is wholly owned by such shareholders. This suggestion has been adopted in Rev. Proc. 2002–38.

C. *Certain Minor Changes in Ownership of Partnerships*

To alleviate taxpayer burden associated with temporary and minor changes in ownership of a partnership that result in a new required year under § 706(b), a new rule has been added to Rev. Proc. 2002–38. The rule provides that a partnership required under § 706(b) to change its taxable year due to a change of less than 10 percent of the aggregate interests of all partners in the partnership's profits and capital may continue to use its current taxable year for one taxable year if it is foreseeable that the change in ownership will be reversed after one taxable year.

CHANGES TO REV. PROC. 2000–11

A. *Automatic Changes to Natural Business Year*

Rev. Proc. 2000–11 did not allow corporations with disqualifying interests in pass-through entities to change automatically to a natural business year under the 25-percent gross receipts test. Under the final prior approval procedures of Rev. Proc. 2002–39, a corporation qualifying to change to a natural business year based on the 25-percent gross receipts test generally would receive approval to do so (subject only to general terms and conditions) notwithstanding any resulting deferral or distortion attributable to an interest in a pass-through entity. Accordingly, the Service and Treasury Department believe that it is appropriate to provide automatic approval for corporations to change to a natural business year, based on the 25-percent gross receipts test, notwithstanding their interest in a pass-through entity. Rev. Proc. 2002–37 reflects this change.

B. *Conforming Changes*

Certain conforming changes have been made to Rev. Proc. 2002–37, consistent with the rules set forth in the final regulations, Rev. Proc. 2002–38, and Rev. Proc. 2002–39. For example, the limitation on changes within 6 years has been reduced to the most recent 48 months, corporations that are shareholders of a closely-held real estate investment trust are considered to have an interest in a pass-through entity for purposes of the scope limitations of Rev. Proc. 2002–37, and certain scope limitations are waived for changes to (or from) certain 52–53-week taxable years that reference the same calendar month. In addition, Rev. Proc. 2002–37 has been modified to provide that a *de minimis* interest in a controlled foreign corporation, foreign personal holding company, or passive foreign investment company may be disregarded under section 4 of that revenue procedure for purposes of determining whether a corporation is within the scope of Rev. Proc. 2002–37, similar to the treatment of *de minimis* interests in partnerships.

FURTHER INFORMATION

For further information regarding this announcement, contact Martin Scully, Jr. or Michael F. Schmit of the Office of the Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4960 (not a toll-free call).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as“rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

EMPLOYEE PLANS

EMPLOYEE PLANS—Cont.

EMPLOYMENT TAX

EXEMPT ORGANIZATIONS

EXEMPT ORGANIZATIONS—Cont.

GIFT TAX

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

INCOME TAX—Cont.

SELF-EMPLOYMENT TAX