INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 446.00-00
CASE-MIS No.: TAM-109116-07

, Appeals Team Case Leader
AP:ATCL:STP

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Corporation A =
X =
Y =
Z =

Investment Banker =
Year 0 =
Year 4 =
Newco =
ABC Securities Exchange =
C =

ISSUE:

The issue presented in this memorandum is whether Corporation A and its subsidiaries ("Taxpayers") obtained "audit protection" by filing a Form 3115 requesting consent to

change their methods of accounting to comply with § 1.263(a)-5 of the Income Tax Regulations. Audit protection is not defined in the Code or Regulations, but is described as follows in Rev. Proc. 2002-9, § 7.01 (and in Rev. Proc. 97-27, § 9.01 in substantially similar terms):

> Except as provided in sections 6.03(5) or 7.02 or in the APPENDIX of this revenue procedure, when a taxpayer timely files a copy of the application with the national office in compliance with all the applicable provisions of this revenue procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

Accordingly, if Taxpayers obtained audit protection as a result of filing their Form 3115, the Service would ordinarily be precluded from requiring Taxpayers to change their methods of accounting for the items covered by the Form 3115 for any taxable year prior to the year of change, although this protection would be subject to certain exceptions.

CONCLUSION(S):

Taxpayers did not obtain audit protection as a result of filing their Form 3115.

FACTS:

Corporation A and its subsidiaries are primarily engaged in the business of providing X to Y located in the United States. Prior to 2000, Corporation A and its subsidiaries also operated lesser business divisions, which provided Z.

The value of the Corporation A's common stock had remained stagnant for several years. In response to this lack of growth, Corporation A engaged Investment Banker to provide advice regarding strategic alternatives for increasing shareholder value. Investment Banker identified three alternatives for consideration: (1) maintenance of the status quo; (2) recapitalization, which would result in either a leveraged recapitalization or a full recapitalization with a spin off of the lesser business divisions; and (3) divestiture of the lesser business divisions by means of either targeted stock, an Initial Public Offering ("IPO") carve out, a split off, or a spin off.

In January of Year 0, the Board of Directors of Corporation A approved a plan of reorganization which called for the division of Corporation A and its subsidiaries into two independent companies. Under the plan, certain lesser business divisions would be combined into a separate, independent, publicly traded company called Newco; the remaining business assets and activities would remain with Corporation A and its subsidiaries.

In March of Year 0, Corporation A contributed various subsidiaries, assets, and liabilities to Newco. In May of Year 0, Corporation A finalized its decision to divest itself of the ownership of Newco through a mechanism involving a IPO and a split off. An IPO of less than 20 percent of the common stock of Newco was completed in June of Year 0, on the ABC Securities Exchange. Thereafter, the outstanding stock of Newco was owned, in part, by Corporation A and, in part, by unrelated public shareholders. Corporation A also took steps to perform the split off, in which certain shareholders of stock in Corporation A would exchange their stock in taxpayer for stock in Newco. However, in October of Year 0, Corporation A abandoned the split off when it became apparent that a split off of Newco would not maximize shareholder value.

Instead, Corporation A ultimately determined that the traditional spin off was the best mechanism to maximize shareholder value. The Board of Directors of Corporation A approved the spin off transaction in November of Year 0. The spin off was effected by the distribution of C share of Newco common stock for each one share of stock of Corporation A. The spin off was completed, and Newco became a wholly separate and independent company from Corporation A in December of Year 0.

In July of Year 4, the Service issued a Form 5701, Notice of Proposed Adjustment, with respect to Newco Corporation proposing to capitalize certain IPO transaction costs. On the same date, the Service issued a Form 5701 with respect to Corporation A proposing to capitalize certain spin-off transaction costs.

In September of Year 4, Taxpayers filed a Form 3115, Application for Change in Accounting Method, under Rev. Proc. 2004-23 for the 2003 calendar year to request an accounting method change in the handling of transaction costs under § 1.263(a)-5.

LAW AND ANALYSIS:

Section 446(a) of the Internal Revenue Code provides that taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income keeping his books. See also § 1.446-1(a)(1).

Clear reflection of income

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also § 1.446-1(b)(1).

The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439

U.S. 522, 532-3 (1979); RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied 457 U.S. 1133 (1982).

Service-imposed accounting method changes

Using professional judgment in accordance with auditing standards, an examining agent will make findings of fact and apply Service position on issues of law to determine whether an issue is an accounting method issue and whether the taxpayer's method of accounting is permissible. For this purpose, the term “accounting method issue” means an issue regarding whether the taxpayer's accounting treatment of an item is proper, but only if changing the taxpayer's treatment of such item could constitute a change in method of accounting. See Rev. Proc. 2002-18, 2002-1 C.B. 678, §§ 3.01 and 5.01.

An examining agent who determines that a taxpayer's method of accounting is impermissible may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting. Except as provided in § 2.06 of Rev. Proc. 2002-18 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under § 446(e)), an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method contrived to reflect the hazards of litigation. See Rev. Proc. 2002-18, §§ 5.02 and 5.03.

Once the Commissioner has determined that the taxpayer’s method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner’s selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970); Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See Rev. Proc. 2002-18, § 5.04(1).

An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See § 1.448-1(c)(3); Rev. Proc. 2002-18, § 5.04(2), (3).

Taxpayer-initiated accounting method changes

Section 446(e) provides that, except as otherwise provided, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Commissioner. Such consent must be secured whether or not the taxpayer's existing method is proper or is permitted under the Internal Revenue Code or the regulations thereunder. See § 1.446 1(e)(2)(i).

Section 1.446-1(e)(3)(i) provides in part that, except as otherwise provided under the authority of § 1.446-1(e)(3)(ii), to secure the Commissioner's consent to a taxpayer's change in method of accounting, the taxpayer must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account.

Section 1.446-1(e)(3)(ii) provides that notwithstanding the provisions of § 1.446-1(e)(3)(i), the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under § 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

Revenue Procedure 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432) provides the general procedures under § 446(e) and § 1.446-1(e) for obtaining the consent of the Commissioner of Internal Revenue to change a method of accounting for federal income tax purposes.

Section 4.01 of Rev. Proc. 97-27 provides that Rev. Proc. 97-27 applies to all taxpayers requesting the Commissioner's consent to change a method of accounting for federal income tax purposes, except as specifically provided in other published guidance or in § 4.02 of Rev. Proc. 97-27.

Section 4.02(1) of Rev. Proc. 97-27 provides that Rev. Proc. 97-27 does not apply if the change in method of accounting is required to be made pursuant to a published automatic change procedure.

Revenue Procedure 2002-9, 2002-1 C.B. 327, (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002- 54, 2002-2 C.B. 432) provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in its appendix. A taxpayer complying with all the applicable provisions of Rev. Proc. 2002-9 has obtained the consent of the Commissioner to change its method of accounting under § 446(e). See Rev. Proc. 2002-9, § 1.

Section 4.01 of Rev. Proc. 2002-9 provides that Rev. Proc. 2002-9 applies to a taxpayer requesting the Commissioner's consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9. Rev. Proc. 2002-9 is the exclusive procedure for a taxpayer within its scope to obtain the Commissioner's consent.

Section 4.02(1) of Rev. Proc. 2002-9 provides that except as otherwise provided in the Appendix of Rev. Proc. 2002-9 (see, for example, section 1.01 of the APPENDIX), Rev. Proc. 2002-9 does not apply if, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is under examination (as provided in § 3.08 of Rev. Proc. 2002-9), except as provided in §§ 6.03(2) (90-day window), 6.03(3) (120-day window), 6.03(4) (director consent), 6.03(5) (changes lacking audit protection), and 6.03(6) (issue pending) of Rev. Proc. 2002-9.

Section 6.01 of Rev. Proc. 2002-9 provides that pursuant to § 1.446-1(e)(2)(i), the consent of the Commissioner is granted to any taxpayer within the scope of Rev. Proc. 2002-9 to change its method(s) of accounting as described in the Appendix to Rev. Proc. 2002-9. This consent is granted only for the change(s) of accounting method and the affected item(s) that are clearly and expressly identified in the taxpayer's application. Further, this consent is granted only to the extent that the taxpayer complies with all the applicable provisions of Rev. Proc. 2002-9 and implements the change in method of accounting for the requested year of change.

Section 6.03(1) of Rev. Proc. 2002-9 provides that except as otherwise provided in the Appendix of Rev. Proc. 2002-9 (see, for example, section 1.01 of the Appendix), a taxpayer that is under examination may file an application to change a method of

accounting under § 6 of Rev. Proc. 2002-9 only if the taxpayer is within the provisions of §§ 6.03(2) (90-day window), 6.03(3) (120-day window), 6.03(4) (director consent), 6.03(5) (changes lacking audit protection), or 6.03(6) (issue pending) of Rev. Proc. 2002-9. A taxpayer that files an application beyond the time periods provided in the 90-day and 120-day windows is not eligible for the automatic extension of time and will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances.

Section 6.03(6)(a) of Rev. Proc. 2002-9 provides that a taxpayer that is under examination with respect to any income tax issue may request to change a method of accounting if the method of accounting to be changed is an issue pending for any taxable year under examination. However, the audit protection provisions of § 7.01 of Rev. Proc. 2002-9 do not apply to a taxpayer changing its method of accounting under § 6.03(6) of Rev. Proc. 2002-9. For this purpose, an issue is pending for taxable years under examination if the Service has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer's method of accounting. This notification normally will occur after the Service has gathered information sufficient to determine that an adjustment is appropriate and justified, although the exact amount of the adjustment may not yet be determined.

Section 7.01 of Rev. Proc. 2002-9 provides that except as provided in §§ 6.03(5) or 7.02 or in the Appendix of Rev. Proc. 2002-9, when a taxpayer timely files a copy of the application with the national office in compliance with all the applicable provisions of Rev. Proc. 2002-9, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

Section 263(a) intangibles regulations

On January 24, 2002, the Internal Revenue Service (“Service”) and Treasury Department published an advance notice of proposed rulemaking (Announcement 2002-9, 2002-1 C.B. 536) announcing an intention to provide guidance on the extent to which § 263(a) requires taxpayers to capitalize amounts paid to acquire, create, or enhance intangible assets.

On December 19, 2002, the Service and Treasury Department published a notice of proposed rulemaking (NPRM) (2003-1 C.B. 373) proposing regulations under § 263(a) (relating to the capitalization requirement), § 167 (relating to safe harbor amortization) and § 446 (relating to the allocation of debt issuance costs). Part IX of the Preamble of the NPRM provided that taxpayers could not change a method of accounting in reliance upon the rules contained in the NPRM until the rules are published as final regulations in the Federal Register. The NPRM further provided that upon publication of the final regulations, taxpayers would be required to follow the applicable procedures for obtaining the Commissioner's automatic consent to a change in accounting method.

On January 5, 2004, the Service and Treasury Department published final regulations ("the final regulations") under § 263 in T.D. 9107, 2004-1 C.B. 447. Section 1.263(a)-4 prescribes the extent to which taxpayers must capitalize amounts paid or incurred to acquire or create (or to facilitate the acquisition or creation of) intangibles. Section 1.263(a)-5 prescribes the extent to which taxpayers must capitalize amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. Section 1.167(a)-3(b) provides a safe harbor useful life for certain intangible assets. The final regulations under §§ 1.263(a)-4 and 1.263(a)-5 are effective for amounts paid or incurred on or after December 31, 2003. The final regulations under § 1.167(a)-3(b) are effective for intangible assets created on or after December 31, 2003.

Section 1.263(a)-5(n)(1) provides that a taxpayer seeking to change a method of accounting to comply with § 1.263(a)-5 must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e). For the taxpayer's first taxable year ending on or after December 31, 2003, the regulation granted a taxpayer consent to change its methods of accounting to comply with §1.263(a)-5, provided the taxpayer followed the administrative procedures issued under § 1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method. In this regard, the regulation referenced Rev. Proc. 2002-9.

Section 1.263(a)-5(n)(2) provides that any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with § 1.263(a)-5 for its first taxable year ending on or after December 31, 2003.

Section 1.263(a)-5(n)(3) provides that the section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer's first taxable year ending on or after December 31, 2003, is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.

Revenue Procedure 2004-23, 2004 C.B. 785, provides in § 1 that Rev. Proc. 2004-23 provides the exclusive administrative procedures under which a taxpayer described in § 3 of Rev. Proc. 2004-23 may obtain automatic consent for the taxpayer's first taxable year ending on or after December 31, 2003, to change to a method of accounting provided in §§ 1.263(a)-4, 1.263(a)-5, and 1.167(a)-3(b).

Section 3.01 of Rev. Proc. 2004-23 provides that Rev. Proc. 2004-23 applies to a taxpayer that seeks, for the taxpayer's first taxable year ending on or after December 31, 2003, to change to a method of accounting provided in the final regulations.

Section 4.01 of Rev. Proc. 2004-23 provides that a taxpayer within the scope of Rev. Proc. 2004-23 is, in accordance with § 6.01 of Rev. Proc. 2002-9, granted the consent of the Commissioner to change to a method of accounting provided in the final regulations provided that the taxpayer follows the automatic change in method of accounting provisions in Rev. Proc. 2002-9, with the following modifications:

(1) The scope limitations in § 4.02 of Rev. Proc. 2002-9 do not apply;

(2) The taxpayer must prepare and file Form 3115, Application for Change in Accounting Method, in accordance with section 4.02 of Rev. Proc. 2004-23;

(3) The copy of Form 3115 must be sent to a specified address;

(4) The taxpayer must compute any applicable § 481(a) adjustment and take such adjustment into account in accordance with § 5 of Rev. Proc. 2004-23; and

(5) A taxpayer described in § 4.03(2) of Rev. Proc. 2004-23 procedure must file one or more amended federal income tax returns in accordance with § 4.03(3), (4), or (5), as applicable, of Rev. Proc. 2004-23.

Section 7.01 of Rev. Proc. 2004-23 provides that Rev. Proc. 2002-9 is modified and amplified to include the automatic changes set forth in Rev. Proc. 2004-23 within § 3 of the APPENDIX of Rev. Proc. 2002-9.

ANALYSIS

The issue presented in this memorandum is whether Taxpayers obtained “audit protection” by filing their Form 3115 requesting consent to change their methods of accounting to comply with § 1.263(a)-5.

Audit protection and § 446

Audit protection is not expressly created by §§ 446 and 481 and the regulations issued thereunder. While § 446(e) requires a taxpayer to obtain the consent of the Commissioner before changing a method of accounting, it does not address whether such a request restricts the authority of the Commissioner to correct an improper accounting method in a prior taxable year. If anything, the Code and Regulations appear to oppose the notion of audit protection by stressing that the Commissioner has the authority, and arguably the duty, to correct improper methods of accounting. In particular, § 446(b) states that if a taxpayer’s existing method of accounting does not clearly reflect income, the computation of income “shall” be made under a method of accounting that does clearly reflect income in the opinion of the Commissioner.

The regulations under § 446 do authorize the Commissioner to prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures include the terms and conditions necessary to obtain the Commissioner's consent to effect the change. See § 1.446-1(e)(3)(ii). The general administrative procedures issued by the Commissioner for voluntary accounting method changes – Revenue Procedures 97-27 and 2002-9 – both establish audit protection, which is part of an overall system of incentives to encourage prompt and voluntary compliance with proper tax accounting principles. See Rev. Proc. 97-27, § 1.02.

The audit protection created by Rev. Procs. 97-27 and 2002-9 is subject to limitations. Audit protection does not apply to certain changes in method of accounting. For example, automatic accounting method changes from sale to lease treatment, and vice verse, are made without audit protection. See Rev. Proc. 2002-9, Appendix § 2.03(3). Where audit protection does apply, such protection is subject to certain enumerated limitations. See Rev. Proc. 97-27, § 9.02 and Rev. Proc. 2002-9, § 7.02.

In sum, §§ 446 and 481 and their associated regulations do not grant audit protection to accounting method changes. The Commissioner, however, has promulgated administrative procedures that extend audit protection to accounting method changes, subject to enumerated exceptions and limitations.

Accounting method changes under Rev. Proc. 2004-23

Taxpayers filed a Form 3115 requesting consent to change to methods of accounting for transactions costs provided in § 1.263(a)-5 for their first taxable year ending on or after December 31, 2003. Accordingly, Taxpayers are within the scope of Rev. Proc. 2004-23, which provides the exclusive administrative procedures under which Taxpayers may obtain consent for their desired accounting method changes. See Rev. Proc. 2004-23, §§ 1, 3.01.

A taxpayer seeking consent pursuant to Rev. Proc. 2004-32 must comply with the automatic change in accounting method provisions in Rev. Proc. 2002-9 as modified by §§ 4.01(1) to 4.01(5). See Rev. Proc. 2004-32, § 7.01. If the taxpayer complies with such provisions, the taxpayer is, in accordance with § 6.01 of Rev. Proc. 2002-9, granted the consent of the Commissioner to change its method of accounting. See Rev. Proc. 2004-32, § 4.01.

A taxpayer that is under examination with respect to any income tax issue may request to change a method of accounting if the method of accounting to be changed is an issue pending for any taxable year under examination, but the audit protection provisions of § 7.01 of Rev. Proc. 2002-9 will not apply to such change. See § 6.03(6)(a) of Rev. Proc. 2002-9, as modified and amplified by Rev. Proc. 2002-19, § 2.03(1)(d). This

provision of Rev. Proc. 2002-9 is not modified by §§ 4.01(1) to 4.01(5) of Rev. Proc. 2004-23.

In July of Year 4, the Service issued a Form 5701 with respect to Corporation A proposing to capitalize certain spin-off transaction costs. Accordingly, the methods of accounting to be changed in Taxpayers' Form 3115 were issues pending for a taxable year under examination when the Form 3115 was subsequently filed in September of Year 4. Under § 6.03(6)(a), therefore, the audit protection provisions of § 7.01 of Rev. Proc. 2002-9 do not apply to the accounting method changes requested by Taxpayers.

Taxpayers argue that the denial of audit protection in § 6.03(6)(a) is waived by § 1.263(a)-5(n)(2), which provides that "any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003." This argument is unpersuasive because § 6.03(6) of Rev. Proc. 2002-9 is not a limitation on obtaining automatic consent. If anything, § 6.03(6) of Rev. Proc. 2002-9 expands the availability of automatic consent by making the automatic consent procedures available to taxpayers that are under examination but have an issue pending. Further, the denial of audit protection cannot be a limitation on obtaining automatic consent because audit protection and automatic consent are fundamentally separate concepts. Automatic consent may exist either with or without audit protection; indeed, the denial of audit protection for taxpayers with an issue pending in § 6.03(6) of Rev. Proc. 2002-9 is coupled with the waiver of restrictions that would otherwise preclude such taxpayers from obtaining consent.

Taxpayers assert that the words "any limitations" in § 1.263(a)-5(n)(2) encompasses "terms" and "conditions" of accounting method changes, and that 'terms and conditions' includes audit protection. This reasoning is over broad. The literal application of Taxpayers' approach would arguably waive audit protection altogether for all taxpayers, including those otherwise entitled to audit protection under Rev. Proc. 2002-9. Further, Taxpayers' reasoning would result in the waiver language of § 1.263(a)-5(n) waiving other "terms," "conditions," or "limitations" such as the spreading of Taxpayers' positive net § 481(a) adjustment over 4 taxable years.

We view any detailed inquiry into the exact meaning of these terms, if such could be determined, to be unnecessary. Section 1.263(a)-5(n) does not waive "any limitations" in isolation. Rather, § 1.263(a)-5(n) waives "any limitations on obtaining the automatic consent of the Commissioner." This phrase applies to provisions that would prevent taxpayers from obtaining consent at all, such as provisions that prevent certain taxpayers that are under examination, before Appeals or before a federal court from applying to change their methods of accounting. See § 4.02 of Rev. Proc. 2002-9. This phrase does not apply to matters such as audit protection and spread periods for § 481(a) adjustments. Because matters such as audit protection and spread periods

only become relevant *after* consent is obtained, they cannot be impediments to obtaining consent.

The accounting method change provisions of § 1.263(a)-5(n)

Taxpayers further contend that the accounting method change provisions in § 1.263(a)-5(n) provide audit protection to taxpayers requesting consent to make an accounting method change described within this provision. The most obvious difficulty with this contention is that § 1.263(a)-5(n) contains no language that expressly creates audit protection. The only provisions that arguably implicate audit protection are (i) the general statement that taxpayers seeking to change their method of accounting to comply with § 1.263(a)-5 must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e), and (ii) the directive that a taxpayer making such an accounting method change for its first taxable year ending on or after December 31, 2003, must follow the automatic consent provisions of Rev. Proc. 2002-9. As discussed above, however, §§ 446 and 481 and their associated regulations do not directly create or extend audit protection, and Rev. Proc. 2002-9 denies audit protection to Taxpayers because they had issues pending when they filed their Forms 3115 to request consent.

In support of their contention that § 1.263(a)-5(n) provides audit protection, Taxpayers propose two alternative constructions of § 1.263(a)-5(n). The first construction is that the omission of any explicit reference to audit protection means that no audit protection exists, so that the inclusion of words denying audit protection in the regulation would have been unnecessary surplusage. The second construction, which Taxpayers advocate, is that the omission of any explicit denial of audit protection means that audit protection exists, so that the inclusion of words denying audit protection is necessary to achieve such denial.

Taxpayers' reasoning fails to account for a third, and more persuasive, construction of § 1.263(a)-5(n), namely, that the absence of express provisions either extending or denying audit protection in § 1.263(a)-5(n) means that the applicable administrative procedures promulgated by the Commissioner under § 1.446-1(e) (in this situation, Rev. Proc. 2002-9) control the availability of audit protection. Specific provisions in a regulation regarding audit protection or other aspects of accounting method changes do control over administrative guidance such as revenue procedures; in the absence of such provisions, however, administrative procedures govern accounting method changes.

The operation of the second and third constructions of § 1.263(a)-5(n) is illustrated by their differing interpretations of §§ 1.263A-1(k) and 1.263A-2(e). These provisions, cited by Taxpayers, contain accounting method change provisions that are broadly parallel to § 1.263(a)-5(n), but contain additional paragraphs providing that a taxpayer making the specified accounting method change "does not receive audit protection if its method of

accounting for mixed service cost is an issue under consideration at the time the application is filed with the national office." See §§ 1.263A-1(k)(3), 1.263A-2(e)(3).

Taxpayers contend that the express denials of audit protection in §§ 1.263A-1(k)(3) and 1.263A-2(e)(3) are evidence that audit protection exists for taxpayers making these changes absent express provisions in the regulations to the contrary. By analogy, Taxpayers argue, audit protection should exist by default for taxpayers subject to the § 1.263(a)-5(n), which differs only in the lack of an express denial of audit protection. This counterargument does not address the alternative view that the express denials of audit protection in §§ 1.263A-1(k)(3) and 1.263A-2(e)(3) are evidence that Treasury wished to modify the standard audit protection rules of Rev. Proc. 2002-9 that would ordinarily apply to taxpayers making these changes.

In other words, Taxpayers urge that audit protection exists independently of the administrative procedures issued by the Commissioner (Rev. Procs. 97-27 and 2002-9) and the rules and limitations contained therein. In addition to the lack of any express provisions creating such independent audit protection, noted above, the position urged by Taxpayers would raise serious practical difficulties if adopted. For example, it is unclear whether this independent audit protection would be subject to exceptions such as those enumerated in Rev. Proc. 97-27, § 9.02 or Rev. Proc. 2002-9, § 7.02. Further, the existence of independent audit protection is inconsistent with the creation of audit protection within the general administrative procedures for accounting method changes. Finally, Taxpayers' position fails to explain why independent audit protection, whose existence is not supported by any express legal authority, would override the audit protection which is expressly created and carefully limited within the administrative procedures. These difficulties argue against the interpretation advanced by Taxpayers.

More generally, the construction of §§ 1.263(a)-5(n), 1.263A-1(k), and 1.263A-2(n) proposed by Taxpayers poses imponderable difficulties with respect to other aspects of accounting method changes. None of these regulations, for example, contain provisions regarding the spread periods of § 481(a) adjustments. Under the analysis suggested by taxpayer, the silence in these regulations regarding spread periods would imply that spread periods are not available. This follows from the default rule in § 481 and its associated regulations that the entire § 481(a) adjustment is taken into account in the year of change.

By contrast, the third construction handles the silence regarding spread periods in §§ 1.263(a)-5(n), 1.263A-1(k) and 1.263A-2(e) quite easily, and reaches an intuitively pleasing result. The silence simply implies that the rules regarding spread periods in the administrative procedures apply without modification to changes made under §§ 1.263(a)-5(n), 1.263A-1(k) and 1.263A-2(e). This construction avoids allowing silence in one regulation from overriding the express grant of authority to the Commissioner in

another regulations (§ 1.446-1(e)) to set terms and conditions for accounting method changes.

To summarize, Taxpayers' assertion that Treasury was 'silent' regarding audit protection in § 1.263(a)-5(n) is not persuasive. The Treasury addressed accounting method change issues in § 1.263(a)-5(n) by expressly invoking the detailed administrative procedures issued by the Commissioner under § 1.446-1(e) and modifying those procedures to the extent that a different result was desired. In other words, the Treasury was not silent on audit protection (or § 481(a) spread periods or any other provision of Rev. Proc. 2002-9 not expressly modified in § 1.263(a)-5(n)); to the contrary, Treasury clearly, albeit indirectly, indicated that the administrative provisions would control unless a contrary intention was expressed.

Fairness and sound tax administration

Taxpayers also argue that general considerations of fairness and sound tax administration support audit protection for their accounting method changes. In particular, Taxpayers point out that that the Notice of Proposed Rulemaking issued on December 19, 2002, stated that "taxpayers may not change a method of accounting in reliance upon the rules contained in these proposed regulations until the rules are published as final regulations in the Federal Register." Taxpayers argue that this provision prevented them from filing their accounting method changes prior to the commencement of their audit, which ultimately resulted in the denial of audit protection for their accounting method changes pursuant to § 6.03(6) of Rev. Proc. 2002-9. As a result, Taxpayers contend, they were placed in a worse position than taxpayers that disregarded the Notice of Proposed Rulemaking and filed accounting method change requests prior to the publication of the final regulations. They assert that such a result would be unfair and would be contrary to the general policy of the Service to give better terms and conditions to taxpayers that comply with proper tax accounting principles on a prompt and voluntary basis. This argument fails for the reasons discussed below.

The initial reason Taxpayers' argument fails is that Taxpayers were free to make changes that did not rely upon the proposed regulations. The Notice of Proposed Rulemaking issued on December 12, 2002, only prohibits changes in method of accounting "made in reliance" upon the rules contained in the proposed regulations. Moreover, denying audit protection to Taxpayers for their accounting method change is not inconsistent with the voluntary compliance incentive system. To the extent that Taxpayers changed from an improper method of accounting (and thus would benefit from audit protection), Taxpayers did not do so prior to the initiation of the examination, which is the basic qualification for obtaining the favorable terms and conditions associated with voluntary accounting method changes. With certain exceptions, taxpayers that do not request accounting method changes prior to the initiation of

examination are generally barred from requesting such changes, and obtaining audit protection, after the examination commences. See generally Rev. Proc. 2002-18.

Most significantly, however, Taxpayers are incorrect when they assert that they have been treated less favorably than taxpayers that filed accounting method change requests despite the provisions to the contrary in the Notice of Proposed Rulemaking. The preamble to T.D. 9107 states:

> The preamble to the proposed regulations provides that taxpayers may not change a method of accounting in reliance upon the rules contained in the proposed regulations until the rules are published as final regulations. Nonetheless, the IRS has received numerous Forms 3115 from taxpayers seeking the Commissioner's consent to change their method of accounting for items addressed in the advance notice of proposed rulemaking or in the proposed regulations. The IRS suspended processing of these requests pending publication of these final regulations. Upon publication of the final regulations, the IRS intends to process these requests in a manner consistent with the rules contained in the final regulations, including the effective date rules and rules relating to the computation of the section 481(a) adjustment. For example, if the change is requested for a taxable year ending prior to the effective date of the final regulations and concerns a method of accounting that the Commissioner does not recognize as permissible prior to the effective date of the final regulations, the IRS intends to reject the request. Similarly, if the change is requested for a taxable year ending on or after the effective date of the final regulations and concerns a method of accounting that is permissible under the final regulations, the IRS intends to return the request to the taxpayer (and refund the user fee) and advise the taxpayer to utilize the automatic consent procedures as authorized by the final regulations.

2004-1 C.B. at 455-6. Accordingly, if Taxpayers had pursued their hypothetical course and filed their accounting method change requests contrary to the instructions of the Notice of Proposed Rulemaking, audit protection for their accounting method changes under Rev. Procs. 2002-9 these requests would have been rejected, and taxpayers would not have received audit protection. Contrary to their assertion, therefore, taxpayers have not received less favorable treatment for more compliant behavior.

Summary

Taxpayers requested and obtained consent to change their methods of accounting for transaction costs pursuant to § 1.263(a)-5(n) and Rev. Proc. 2004-23, which incorporate with certain modifications the automatic accounting method change procedures of Rev. Proc. 2002-9. Taxpayers did not receive audit protection for their accounting method changes under Rev. Procs. 2002-9 and 2004-23 because Taxpayers had issues

pending at the time consent was requested. Section 1.263(a)-5(n) does not confer audit protection by its own terms. Similarly, audit protection does not arise independently from §§ 446 and 481 and the regulations promulgated thereunder. Finally, the extension of audit protection in this situation is not required by general considerations of fairness or proper tax administration. Accordingly, we conclude that no audit protection attaches to the changes made by Taxpayers.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.