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INCOME TAX ACCOUNTING METHODS: MORE THAN JUST TIMING

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I. What Is A Method of Accounting

A. Method of Accounting Defined

The phrase "method of accounting" is not defined by either the Internal Revenue Code or the Treasury regulations promulgated thereunder.[2] As the Tax Court once said, the phrase "method of accounting" is "a phrase which, at times, appears to have certain chameleon qualities."[3] In their Federal Tax Accounting Treatise, Stephen F. Gertzman, George A. Hani, and James R. Gadwood explain that, "[a] method of accounting is generally understood to refer to any regularized practice or procedure for determining when to recognize items of income and expense."[4] The elements that are critical in defining a method of accounting are: timing, consistency, certainty and predictability.[5]

Timing. As Gertzman, Hani, and Gadwood explain in their Federal Tax Accounting Treatise, "[m]ethods of accounting are the particular means for determining when to recognize assets, liabilities, and items of income and expense. Consistently, the underlying assumption of tax accounting is that a method of accounting determines the time when an item of income or expense is to be recognized or reported for tax purposes.[6] It does not determine the aggregate amount of income or expense to be recognized from any particular transaction or series of transactions, which should be the same under any method of accounting."[7] Stated differently, a method of accounting will answer the "when" question (when the amount is reportable) not the "whether" question (whether the amount is reportable). To address

1 The author expresses his appreciation to Tom Fraase of Ernst & Young LLP who was instrumental in the preparation of this outline.

[2] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended, (the "Code" or "IRC") and to the Treasury regulations promulgated thereunder.

[3] *Underhill v. Commissioner*, 45 T.C. 489, 496 (1966).

[4] Gertzman, Hani, and Gadwood <u>Federal Tax Accounting</u> ¶ 2.01 (Thomson Reuters/WG&L, 2d ed. 2025). *See also Joyner Family LP*, T.C. Memo. 2019-159 (2019) ("A method of accounting is the consistent treatment of any recurring, material item, whether that treatment is correct or incorrect."); *Greiner v. United States*, 116 AFTR2d 2015-5324 (Fed. Cl. 2015), where the court confirmed that neither the Code nor Treasury regulations define the phrase "method of accounting," but that in layman's terms (and citing various dictionary definitions of the words "method" and "accounting"), the phrase means a manner or procedure for determining in a regular and systematic way the time when items of income and expense should be taken into account.

[5] *Id*.

[6] *Id*. The Tax Court effectively recognized this assumption in *Tate & Lyle, Inc. v. Commissioner*, 103 T.C. 656, 668 (1994), *rev'd on other grounds*, 87 F.3d 99 (3d Cir. 1996) ("The underlying assumption of requiring that taxable income be determined by the taxpayer's "method of accounting" and that the method "clearly reflect income" is that the method of accounting involves *when* an item of income or expense is to be reported for tax purposes.") (emphasis in original); *See also General Motors Corporation v. Commissioner*, 112 T.C. 270, 296 (1999) ("An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting.")

[7] Gertzman, Hani, and Gadwood, *supra* note 4.

this question, taxpayers must consider the well-established "lifetime income test" which is exhibited in both case law[8] and various Internal Revenue Service ("IRS") guidance and pronouncements.[9]

For instance, in Rev. Proc. 91-31, the IRS stated:

> In determining whether a practice involves the proper time for the inclusion of items in income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer's lifetime. If the accounting practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is therefore considered a method of accounting.[10]

When applying the lifetime income test, a relevant issue is the extent to which two or more related "items" should be viewed as a single item for purposes of the test (*i.e.,* whether the lifetime income test must consider the aggregate effect of the change in treatment of related items of income and deductions).[11] The implications of this inquiry loom large as the conclusion determines whether a change in treatment constitutes a "change in method of accounting" or not. The IRS's historical ruling position is that a change from recognizing related items of income and expense to treating such items as non-taxable and non-deductible, respectively, may be considered a change in method of accounting to the extent the lifetime income test is met (*i.e.*, the IRS generally considers the aggregate effect of related income and deductions when applying the lifetime income test).[12] Similarly, certain courts have held that the lifetime income test must consider the combined effect on both income and deductions (*i.e.*, all related accounts and adjustments are taken into account).[13] Conversely, however, other courts have held that items of income and expense should be analyzed separately when applying the lifetime income test, even if they are inextricably linked.[14]

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[8] *See, e.g., GWA, LLC v. Commissioner*, T.C. Memo. 2025-034 ("this adjustment is nevertheless a 'change in method of accounting' because it affects only *the timing* of the taxpayer's cost recovery, without changing the taxpayer's lifetime income associated with the asset." (emphasis in original); *Primo Pants Company v. Commissioner*, 78 T.C. 705, 723 (1982) ("The inquiry [is] whether the accounting practices permanently avoided the reporting of income over the taxpayer's lifetime income or merely postponed the reporting of income.").

[9] CCA 201345025 ("In considering the issue of whether a taxpayer is changing an accounting method as defined by IRC § 446 when its accounting practices are changed, we use the "lifetime income" test… under this test, changing from a current accounting practice to another accounting practice constitutes a change in accounting method under IRC § 446 if the current and proposed accounting practices would result in the same amounts of cumulative income over the lifetime of the taxpayer. Expressed differently, when the difference between the current and another accounting practices [sic] only involves the timing of income or deduction, the lifetime income test is satisfied and a change from one practice to the other is a change in accounting method as defined by IRC § 446.").

[10] 1991-1 C.B. 566.

[11] For additional discussion on the definition of "item," see section I.C. of this outline.

[12] *See, e.g.,* Rev. Proc. 91-31, 1991-1 C.B. 566 (1991) (if a taxpayer includes customer deposits in gross income upon receipt (and deducts deposits upon return or when applied to a bill) and those deposits are not taxable upon receipt, a change in treatment for customer deposits is a change in method of accounting, notwithstanding that deposits received might never be gross income (and deposits returned never deductions) – the relevant inquiry being that lifetime taxable income is the same under both methods); *see also* Rev. Proc. 2005-35, 2005-2 C.B. 76 (2005).

[13] *See, e.g., Johnson v. Commissioner*, 108 T.C. 448 (1998) *aff'd* in part, *rev'd* in part, 184 F.3d 786 (8th Cir. 1999) (both income and related offsetting deductions are considered when determining if lifetime taxable income is affected); *Rankin v. Commissioner*, 138 F.3d 1286 (1998) (the combined effect of current-year deductions and future-year offsetting income must be considered when determining whether a change in method of accounting occurs).

[14] *See, e.g., Saline Sewer Company v. Commissioner*, T.C. Memo. 1992-236 (the taxpayer excluded certain customer connection fees from gross income under IRC § 118 and took a reduced basis in property acquired with such fees. The court held that the fees should be included in gross income and that the taxpayer should take a full purchase price basis in the property acquired with such fees. The court held that a change in such treatment was not a change in method of accounting because it considered the income treatment and the basis/depreciation treatment as two separate

This opens the door for taxpayers to argue either view depending on their individual circumstances. It's unclear how courts and the IRS will rule on this issue in the future given the IRS's recent loss in *Hyatt* (discussed in footnote 14).

Consistency. As Gertzman, Hani, and Gadwood explain in their Federal Tax Accounting Treatise, "[o]nce a method of tax accounting has been adopted, it is assumed that the method will be consistently applied to a taxpayer's activities. Otherwise, there is no 'method,' only arbitrary procedures whose inconsistent application makes the logical determination of income and expense during any particular period impossible."[15]

Certainty and Predictability. As Gertzman, Hani, and Gadwood explain in their Federal Tax Accounting Treatise, "[t]he use of a method of accounting lends certainty and predictability to the recognition and recording of financial transactions and events. Thus, any particular method of accounting, as opposed to an arbitrary practice, should be so defined that any person applying that method to a particular set of facts will reach the same result."[16]

B. Overall Method of Accounting vs. Method of Accounting for Special Items

Treas. Reg. § 1.446-1(a)(1) provides that "[t]he term 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such overall methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc."

As Gertzman, Hani, and Gadwood state in their Federal Tax Accounting Treatise, "[t]he propriety of both overall methods and methods used for individual items is to be determined on the basis of the same standards. There is no general requirement of conformity between the overall method and the method used for individual items, except as affected by the clear reflection of income requirement."[17] See discussion in Section III. A. regarding a taxpayer's discretion to choose its overall method of accounting and its methods of accounting for certain items.

items in applying the lifetime income test; thus, timing was not implicated.); *See also Hyatt Hotels Corporation & Subsidiaries v. Commissioner*, T.C. Memo. 2023-122 (the court considered the taxpayer's reward program revenue and reward program expenses as separate items and independently applied the lifetime income test to each; in doing so, the court held that "timing" was not implicated. Had the court considered the items in aggregate, the treatment would not have affected the taxpayer's lifetime taxable income. Notably, the court in *Hyatt* described the lifetime income test as a two-part test: step one – evaluate whether taxpayer's original treatment implicated timing, and step two – analyze whether a proposed change would distort the taxpayer's lifetime income).

[15] Gertzman, Hani, and Gadwood, *supra* note 4. *See, e.g., Bank One Corporation v. Commissioner*, 120 T.C. 174, 282 (2003), *aff'd in part, vacated in part, remanded sub nom. JPMorgan Chase & Company v. Commissioner*, 458 F.3d 564 (7th Cir. 2006) ("As construed by the courts, section 1.446–1(a), Income Tax Regs., serves to classify as a "method of accounting" the consistent treatment of any recurring, material item, whether that treatment be correct or incorrect."); *Walter H. Potter v. Commissioner*, 44 T.C. 159 (1965), *acq.*, 1966-1 C.B. 3, where the taxpayer's practices were "regularly inconsistent throughout the years."

[16] Gertzman, Hani, and Gadwood, *supra* note 4.

[17] *Id.*.

C. Defining the "Item"

Defining the "item" is the first step in determining whether a method of accounting exists and/or whether a change in method of accounting (as opposed to an error – discussed in Section IV. B. 1.) has occurred. The regulations indicate that the term "method of accounting" includes the accounting treatment of any item. As no formal definition of the term "item" is provided in the regulations, oftentimes identifying or defining the "item," and thus identifying whether a method of accounting exists, or has changed, can be difficult, but yet so important. As George L. White notes in the Accounting Methods BNA "[f]or example, if a relatively broad definition of an 'item' is adopted, the inconsistent treatment of a particular occurrence of that 'item' (which one court called a 'sub-item') would be an 'error' [often referred to as 'an error within a method']. On the other hand, that 'error' might represent a consistent treatment of a more narrowly defined 'item,' and might therefore be a method of accounting itself [although possibly an incorrect one]."[18]

The term "item" is generally used to indicate any recurring incidence of income or expense.[19] For example, the courts and the Treasury Regulations have determined the following non-exhaustive list to be "items":

a. Real estate taxes;[20]
b. Annual fees for state truck licenses;[21]
c. Baseball players' contracts;[22]
d. Employees vacation pay;[23]
e. Corporate officers' bonuses;[24] and
f. Each individual depreciable or amortizable asset.[25]

However, if similar articles differ in some way that would affect their accounting treatment, they are probably different items.[26] For example, in *Anderson-Dougherty-Hargis Company v. U.S.*,[27] the court determined that unit-price contracts and lump-sum contracts were different items for accounting purposes. Thus, although the contracts were similar in the sense that they each were government construction contracts, the terms of two types of contracts were such that they warranted a different accounting treatment. This same concept can be applied to numerous fact patterns. Take bonus plans for example: If a Company has a bonus incentive plan for its employees and a bonus incentive plan for its officers, and the terms of such plans are structured in a way that each plan warrants a different accounting treatment, then the respective plans are likely separate "items" for income tax accounting purposes. Thus, the Company may have one method of accounting for employee bonus expenses and another method of

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[18] White, 570-4th T.M., *Accounting Methods – General Principles*.
[19] *Id.*
[20] *See* Treas. Reg. § 1.446-1(e)(2)(iii) Ex. 2; *Woodward Iron Company v. U.S.*, 396 F.2d 552 (5th Cir. 1968).
[21] *Carlson v. Commissioner*, 26 T.C.M. 537 (1967).
[22] Rev. Rul. 67-379, 1967-2 C.B. 127.
[23] *Oberman Manufacturing Company v. Commissioner*, 47 T.C. 471 (1967), *acq.*, 1967-2 C.B. 3; *Dorr-Oliver, Inc. v. Commissioner*, 40 T.C. 50 (1963); Rev. Proc. 2025-23, 2025-24 I.R.B. 1476, section 20.01(3).
[24] *Connors, Inc. v. Commissioner*, 71 T.C. 913 (1979); Rev. Proc. 2025-23, 2025-24 I.R.B. 1476, section 20.01(2). *See also Evans v. Commissioner*, 55 T.C.M. 902 (1988).
[25] Treas. Reg. § 1.446-1(e)(2)(ii)(d)(4); Rev. Proc. 2025-23, section 6. Note that if assets are depreciated in vintage accounts pursuant to Treas. Reg. § 1.167-11, then the item is each vintage account. Further, if assets are depreciated in general asset accounts or mass/multiple asset accounts then the item is the account.
[26] White, 570 – 4th T.M., *Accounting Methods – General Principles*.
[27] 96 F. Supp. 404 (N.D. Cal. 1950).

accounting for officer bonus expenses.[28] Further, certain courts have gone so far as to suggest that real estate taxes of separate states or of separate properties within one state may be separate items for income tax accounting purposes.[29,]

II. Requirements for all Methods of Accounting ("Permissible Methods")

There are three requirements that all methods of accounting must comply with. The three requirements are as follows:

A. Requirement 1 – Book Conformity

The first requirement is that the method must conform to the taxpayer's method of computing income in keeping its books.[30] This is widely known as the book conformity requirement.

Note: The term "books" is often used in practice to refer to a taxpayer's financial statements; however, the term as used in the regulations refers the taxpayer's underlying accounting records. Although the methods used to determine items of income and expense in a taxpayer's underlying accounting records (i.e., "books") are often the same as those used to prepare the taxpayer's financial statements, sometimes they may differ.

Questions often arise as to the application of the book conformity rule in practice. What if there are special tax methods of accounting prescribed in the Code and regulations that deviate from the book method for a particular item? What if the book method for a particular item is not permitted under the Code and regulations? What if a taxpayer would like to use a permissible method of accounting (overall or for a particular item) for tax purposes that differs from its respective book method and that book method is also permissible under the Code and regulations? In answering these questions, it is easiest to breakdown a taxpayer's methods of accounting into four categories as follows:

1. Accounting methods for particular items whereby book conformity is explicitly required by the Code, regulations or other published guidance.

    a. To the extent a taxpayer wishes to use an accounting method described in this category, it must use such method for purposes of maintaining its books and records (and in most cases, its reports (including financial statements) provided to shareholders, partners, beneficiaries, other proprietors, and for credit purposes). Examples of such methods of accounting include: IRC § 472(c)**,** (e)(2)**,** (g) (use of LIFO); Treas. Reg. § 1.451-4(d)(1) (estimates of future trading stamp redemptions may not be greater than the estimate used for financial reporting purposes); IRC § 451(b) and Treas. Reg. § 1.451-3 (all events test for an item of gross income met no later than when gross income recognized in the taxpayers applicable financial statement); Treas. Reg. § 1.471-11(c)(2)(iii) (capitalization of costs into inventory); Rev. Rul. 72-114, 1972-1 C.B. 124, 125 (time of reporting sales of utility services).

[28] *Summit Sheet Metal Company v. Commissioner*, T.C. Memo. 1996-563 (where the court held that a change from deducting officers' bonuses in the year they are declared to deducting the bonuses in the year following the declaration year constitutes a change in method of accounting).

[29] *See American Can Company v. Commissioner*, 317 F.2d 604 (2d Cir. 1963), *rev'g* 37 T.C. 198 (1961), *nonacq*., 1964-1 C.B. (Pt. 1) 6*; Bullard Company v. U.S*., 364 F.2d 429 (Ct. Cl. 1966); *See also* Rev. Proc. 2025-23, section 20.09 (providing an automatic change in method of accounting specifically with respect to California franchise taxes).

[30] IRC § 446(a).

2. Accounting methods for "special" items whereby the Code, regulations or other published guidance provides a "specialized" method of accounting.

   a. Treas. Reg. § 1.446-1(a)(1) provides an exception to the book conformity requirement for special items. Specifically, conformity ordinarily is not required when taxpayers adopt a specialized method of accounting for particular items, such as the installment method for sales of property under § 453,[31] one of the long-term contract methods,[32] the deduction of circulation expenditures under § 173,[33] the expensing of research and experimental expenditures under § 174,[34] the amortization of organizational expenses under § 248,[35] and other such methods explicitly provided for in the Code and regulations.[36]

3. Accounting methods for particular items whereby the taxpayer's book method is not permitted by the Code and regulations.

   a. A number of courts have reasoned that reconciliation between "book" and "tax" accounts is routine, and necessary, in the many situations where the rules under the Code and regulations differ from an accepted financial accounting practice. Consequently, even where special tax treatment for an item is not specifically prescribed in the Code or regulations, there is no reason to require exact conformity on the item level.[37]

4. Other accounting methods not described in category (1), (2), or (3) above (*e.g.*, the taxpayer's overall method of accounting).

   a. As noted in Treas. Reg. § 1.446-1(a)(1), the general rule is that a method of accounting (overall or for an individual item) must conform to the taxpayer's method of computing income in keeping its books. However, in certain instances (other than those described in categories (2) and (3) above), a taxpayer may wish to deviate from its underlying book method of accounting even though such method is a permissible method of accounting under the Code and regulations. For example, a taxpayer that uses an overall accrual method of accounting for book purposes may wish to use the cash method of accounting for tax purposes.[38] In Rev. Rul. 68-35,[39] the IRS held that the taxpayer may continue to use the cash receipts and disbursements method of accounting for Federal income tax purposes (despite the fact that the taxpayer kept its books on an accrual method of accounting for quarterly financial statement purposes) because the taxpayer's consistently used cash method of

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[31] *See* Treas. Reg. §§ 1.381(c)(4)-1(b)(2), 1.446-1(c)(1)(iii), 1.451-3(a)(13)(ii).
[32] TAM 8245003; *See* Treas. Reg. §§ 1.381(c)(4)-1(b)(2), 1.446-1(c)(1)(iii), 1.451-3(a)(13)(ii), 1.451-8(c)(8)(iv)(B); *See also Lutz v. Commissioner*, 45 T.C. 615, 625 (1966), *acq. on another issue*, 1966-2 C.B. 6, *rev'd on another issue*, 396 F.2d 412 (9th Cir. 1968).
[33] Rev. Rul. 57-526, 1957-2 C.B. 180.
[34] Rev. Rul. 58-78, 1958-1 C.B. 148. Note that this revenue ruling pertains to IRC § 174 as it existed prior to the changes made under Public Law No. 115-9 (2017) (colloquially known as the Tax Cuts and Jobs Act) and subsequent changes under Public Law No. 119-21 (2025) (colloquially known as the One Big Beautiful Bill Act).
[35] Rev. Rul. 67-15, 1967-1 C.B. 71.
[36] *See* Treas. Reg. § 1.446-1(a)(1). *See also, e.g.*, Treas. Reg. § 1.471-11(c)(2) (providing that some types of costs must be capitalized into inventory and others may never be, "regardless of their treatment by a taxpayer in his financial reports").
[37] *See, e.g., Patchen v. Commissioner*, 27 T.C. 592, 598 (1956), *aff'd in part, rev'd in part*, 258 F.2d 544 (5th Cir. 1958); *Geometric Stamping Company v. Commissioner*, 26 T.C. 301, 306 (1956), *acq*., 1958-1 C.B. 4; *Challenge Publications, Inc. v. Commissioner*, 845 F.2d 1541, 1545-46 (9th Cir. 1988).
[38] *See also, e.g., Patchen v. Commissioner, supra.*
[39] 1968-1 C.B. 190.

> reporting income for Federal income tax purposes clearly reflected income, and because the taxpayer made adjustments to convert its books to a cash method of accounting at the end of the year. Consistent with category (3), courts and the IRS have generally considered these types of reconciliation entries to be part of the taxpayer's "books" for purposes of satisfying the book conformity requirement [40]

In summary, IRC § 446(a) does not create a strict *financial statement* conformity requirement. The Tax Court articulated this point in *Fidelity Associates, Inc. v. Commissioner*,[41] stating:

> [R]espondent is attempting to require petitioner to use the same method for tax purposes that is used for financial purposes. We refuse to adopt respondent's interpretation because it is inconsistent with the regulations interpreting section 446 and because it would result in anomalous results. . .[a]dmittedly, petitioner treats the commissions differently for tax purposes from the way it treats such expenses for financial accounting purposes. However, it is well recognized that tax accounting requirements may diverge from financial accounting standards and that financial accounting standards are not controlling for tax purposes. Moreover, numerous situations exist where the tax code requires a different treatment for tax purposes, irrespective of the method of financial accounting used by the taxpayer. The possibility of divergence results from the different objectives of tax accounting, as opposed to financial accounting. . . [w]hile petitioner treats the commissions differently in compiling its financial records, the Internal Revenue Code imposes no absolute requirement that petitioner's treatment of the commissions for financial accounting purposes conform to the way it treats such expenses for tax purposes. . . [t]he essential and pivotal question here is whether respondent may require taxpayers to report (for tax purposes) in absolute conformity with financial reporting. . . [i]mplicit in section 446(a) is the concept that variations will exist between financial and tax items. We disagree with respondent that those variations may exist only when statutorily required or when respondent may otherwise require under his section 446 authority. We hold that a taxpayer may make the type of choice made here so long as other Code requirements are met, the taxpayer's overall method of accounting is in conformity, and the method or reporting clearly reflects income for tax purposes.[42]

B. Requirement 2 – Clear Reflection of Income

The second requirement is that the method must clearly reflect the income of the taxpayer.[43] The term "clear reflection of income" is not defined in the Code or regulations and is one of the most confusing concepts of the tax accounting requirements. As a general rule of thumb, a taxpayer's method of

[40] *See* Treas. Reg. § 1.441-1(b)(7) (defining books to include taxpayer's regular books of account and such other records and data necessary to support entries on taxpayer's books and tax return such as allowing reconciliation between books and tax returns). *See also* Treas. Reg. § 1.167(a)-7(c) (permitting keeping different depreciation reserves for tax purposes than are used for book purposes if "permanent auxiliary records" are available to reconcile the differences); Rev. Rul. 59-389, 1959-2 C.B. 89 (interpreting Treas. Reg. § 1.167(a)-7(c)); Rev. Rul. 67-147, 1967-1 C.B. 105 (imposing a similar "permanent auxiliary records" requirement for taxpayers reporting sales on the installment method). *See also Koebig & Koebig, Inc. v. Commissioner*, 23 T.C.M. 170, 175 (1964) (taxpayer ineligible to use long-term contract methods for tax purposes reported its income on accrual basis but used percentage of completion method on its internal books and made "year end adjustments" to reconcile the two; court and IRS did not question that "petitioner's books and accounting records . . .were adequate for the computation of its taxable income … on the accrual method of accounting used in its returns.").

[41] T.C. Memo. 1992-142.

[42] *Id.*

[43] IRC § 446(b).

accounting will be deemed to clearly reflect income if it correctly uses a method of accounting that is authorized by the Code and regulations.[44] Where a taxpayer deviates from a method of accounting that is authorized by the Code and regulations, the issue of whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by case basis.[45]

C. Requirement 3 – Consistent Use

The third requirement is that except with the permission of the Commissioner (or as might otherwise be provided by the Code, Treasury regulation, or published revenue ruling or revenue procedure), a taxpayer must use its method of accounting consistently[46] and without change.[47] This requirement is discussed in significant detail in the forthcoming sections.

III. Adopting a Method of Accounting

A. Taxpayer's Discretion to Choose its Methods of Accounting

Section 446(a) provides, "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." There is generally no restriction on the method(s) a taxpayer must use in computing its income in keeping its books.[48] Consequently, the taxpayer's method(s) of tax accounting are determined by its preferences, subject to the requirements noted above and as long as such method is not otherwise expressly

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[44] *See, e.g.*, *Hallmark Cards, Inc.*, 90 T.C. 26, 31 (1988) ("Respondent's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis."); *Orange & Rockland Utilities v. Commissioner*, 86 T.C. 199, 215 (1986) (respondent's discretion to challenge a taxpayer's method is relevant only to determine whether a method of accounting not specifically permitted clearly reflects income; respondent may not challenge the taxpayer's permissible method as not clearly reflecting income); *RLC Industries Company v. Commissioner*, 98 T.C. 457, 493-494 (1992) (courts have generally found a taxpayer's method to clearly reflect income where the method is in compliance with the regulations).

[45] *See, e.g.*, *Cross Oil Company v. Commissioner*, T.C. Memo. 2001-126 (2001); *Ansley-Sheppard-Burgess Company. v. Commissioner*, 104 T.C. 367 (1995), and cases cited therein.

[46] Treas. Reg. §§ 1.446-1(a)(2), 1.446-1(e)(2)(ii)(a).

[47] IRC § 446(e).

[48] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 2.03 (Thomson Reuters/WG&L, 2d ed. 2025).

prohibited.[49] This element of taxpayer discretion, for both the overall method and the method for certain items is well-established in the courts.[50]

B. Choice of Method for Taxpayers Engaged in More than One Trade or Business

Section 446(d) provides, "A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business." For this purpose, the regulations require that the businesses be "separate and distinct" and give as an example of the proper application of § 446(d) a taxpayer that uses the cash method in accounting for the operations of a service business and an accrual method in accounting for the operations of a manufacturing business.[51] This concept applies to the taxpayer's overall method of accounting as well as its method of accounting for individual items within the separate and distinct trades or businesses. The question of whether a business activity qualifies as a separate trade or business is fundamentally a factual inquiry.

1. In addition to the requirement in Treas. Reg. § 1.446-1(d)(2) that a taxpayer maintain a complete and separable set of books and records for each trade or business, the courts and the IRS have generally considered the following factors to support the existence of a separate trade or business:

    a. Separate trades or businesses generally exist where the businesses, although under common ownership, are entirely of a different character and are operated independently.[52]

    b. A separate trade or business may be established where a taxpayer keeps separate bank accounts for each of its businesses and handles all of the income and expenses of the businesses from the respective accounts.[53]

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[49] *Id.* Gertzman, Hani, and Gadwood also reference the following authorities in reaching this conclusion. *See, e.g., Mazzocchi Bus Company v. Commissioner*, 14 F.3d 923, 933 (3d Cir. 1994), where the court stated, "To accommodate the needs of different taxpayers, the Code allows corporations the flexibility to embrace at its sole discretion either the cash or accrual method (or one of several other available alternatives) for income tax purposes simply by adopting that method for keeping its books." *See also In re Hillsborough Holdings Corp. v. United States*, 432 B.R.. 318, 325–26 (Bankr. M.D. Fla. 2010) where, citing prior opinions, the court confirmed that a "taxpayer possesses the initial discretion to determine what method of accounting it will utilize which, in its view, clearly reflects income.…[but adding that the Commissioner] then has the authority…to review the taxpayer's choice of method to determine whether said method in fact clearly reflects the taxpayer's income." Rev. Proc. 2000-22, 2000- 1 C.B. 1008 ("taxpayer is entitled to adopt any one of the permissible methods [set forth in § 446(c)] for each separate trade or business, subject to certain restrictions."). In addition, courts have recently reinforced this conclusion. *See, e.g., King Solarman, Inc. v. Commissioner*, T.C. Memo. 2019-103, *aff'd*, 840 F. App'x 74 (9th Cir. 2020) ("While a taxpayer is free to adopt any permissible method of accounting initially, he is not at liberty to change that method unilaterally."); *Conmac Investments Inc. v. Commissioner*, T.C. Memo. 2023-40, *aff'd*, 139 F.4th 723 (8th Cir. 2025) ("A taxpayer has considerable discretion in selecting an accounting method and generally may adopt any permissible method.").

[50] Gertzman, Hani, and Gadwood, <u>Federal Tax Accounting</u> ¶ 2.03 (Thomson Reuters/WG&L, 2d ed. 2025). Gertzman, Hani, and Gadwood also reference the following authorities in reaching this conclusion. *See, e.g., Morris-Poston Coal Company v. Commissioner*, 42 F.2d 620, 621 (6th Cir. 1930) ("The law plainly recognizes that the selection of the system or method of keeping his books is primarily for the taxpayer."); *Huntington Securities Corp. v. Busey*, 112 F.2d 368, 370 (6th Cir. 1940) ("The selection of a system of accounting is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income . . . .").

[51] Treas. Reg. § 1.446-1(d)(1).

[52] *Stern v. Commissioner*, 14 B.T.A. 838 (1928).

[53] *Burgess Poultry Market, Inc. v. United States*, 64-2 USTC9515 (E.D. Tex. 1964). *But see* Parker v. *Commissioner*, 37 T.C. 331 (1961), in which a taxpayer was found to operate two separate trades or businesses even though the taxpayer paid all of the expenses of the businesses from one bank account.

c. Where a taxpayer seeks to treat divisions operated within one entity as separate trades or businesses, financial transactions between the divisions should be handled by actual transfers of cash, other similar payments, or transfers of property, and not merely by bookkeeping entries moving funds between the divisions.[54] In addition, for divisions operated within one entity to be treated as separate trades or businesses, the divisions should operate in the same manner as would any independently operated company within that particular industry.[55] Moreover, the activity performed in the division should not be an incidental activity of the entity as a whole, but rather should be entitled to trade or business status as if it were the entity's sole activity.[56]

d. Separate trades or businesses may exist even if the businesses are controlled by common management, so long as the income-producing activities of the businesses are not integrated.[57] Common management is generally not a disqualifying factor if the employees and customers of each business are mutually exclusive and if the businesses serve different geographic areas.[58]

e. Where a taxpayer is required by statute to operate its businesses separately (i.e., with separate offices, management and employees) these businesses are likely separate trades or businesses.[59]

f. In the context of a solo practitioner or other such individual who may be involved in several different business activities or occupations, if substantial differences exist in the tasks and activities of the various occupations, then each occupation will likely qualify as a separate

[54] *Burgess Poultry Market, Inc., supra.*
[55] *Id*.
[56] *Roselle v. Commissioner*, T.C. Memo. 1981-394.
[57] *Marlin Grocery Store v. Commissioner*., 15 B.T.A. 1080, 1081 & 1083 (1929) ("we think it clear that the petitioner was engaged in two separate businesses... of an entirely different character, owned by the same individuals but operated independently and keeping separate accounts… to lay down a hard and fast rule requiring every business owned by the same individual or the same partnership to use the same method of accounting irrespective of whether it correctly reflects income would be to defeat the object sought."); *cf. Gold-Pak Meat Company v. Commissioner*, 30 T.C.M. 337 (1971) (finding no separate trades or businesses where taxpayer's meat processing activities predominantly relied on the cattle from its raising/selling activities in order to operate. Moreover, as the court noted, "the accountant who kept [taxpayer's] books clearly indicated that the transfer of the cattle from the [cattle raising] operation to the [meat processing] operation was accomplished by adding to the cost of sales the inventory cost of the cattle. The close interrelationship between [taxpayer's] cattle feeding operation and the meat processing makes [Reg. §] 1.446-1(d) inapplicable.").
[58] *Nielsen v. Commissioner*, 61 T.C. 311, 317 (1973). *See also Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007) (finding, for purposes of IRC § 280E, that taxpayer's marijuana sales activity and caregiving activities were separate trades or businesses where: only seven of twenty-five employees dispensed marijuana, taxpayer dispensed marijuana from only one of its three locations, the marijuana distribution activities accounted for 10% of the space within the sole dispensing location, and all but a relatively low amount of caregiving services were provided at all other locations or a church); *but see Patients Mutual Assistance Collective Corporation v. Commissioner*, 151 T.C. 176 (2018), *aff'd*, 995 F.3d 671 (9th Cir. 2021) (finding no separate trades or businesses for purposes of IRC § 280E where the taxpayer engaged in the sale of marijuana products, non-marijuana retail goods, and the provision of holistic health services. Although the taxpayer had specific employee functions, such as HR, security, and consulting, many employees engaged in both marijuana sales/consultation and retail sales of non-marijuana items or otherwise facilitated the sale of marijuana products).
[59] Rev. Rul. 74-270, 1974-1 C.B. 109.

trade or business.[60] Further, as long as the activities of the businesses are different, it is generally not significant that the individual businesses are related.[61]

2. In general, the following factors are not indicative of a separate trade or business:

   a. A taxpayer will fail to prove the existence of separate trades or businesses if the use of different accounting methods for each trade or business creates a shifting of profits and losses between the trades or businesses.[62]

   b. A company failed to establish that it had separate trades or businesses where it used a single general ledger to post entries from the individual journals it maintained for its businesses. The court found that the journals were not physically separable and, therefore, did not meet the requirement in the regulations to use complete and separable books and records.[63]

   c. Using a single bank account to deposit income from and to pay expenses for each line of a trade or business is not generally indicative of a separate trade or business.[64]

   d. A taxpayer was not able to establish the existence of separate trades or businesses where it apportioned administrative costs, including salaries and certain expenses attributable to buildings and equipment, on a pro rata basis among its different businesses.[65]

   e. The courts have also determined that separate trades or businesses do not exist if the different lines of business within a single entity function as "well-integrated departments, not as a loose confederation made up of autonomous divisions."[66]

3. When an existing company enters into a new type of business (e.g., forms a new division), it becomes important to determine whether the new business is a separate trade or business. If a new separate trade or business is established, then the new business may have the opportunity to adopt different accounting methods than those utilized by the existing business.[67]

C. How a Method of Accounting is Established/Adopted

The regulations indicate that while it is possible for a method of accounting to exist in the absence of a pattern of consistent treatment, in most instances, a method of accounting generally is not established without such consistent treatment.[68]

As Gertzman, Hani, and Gadwood note in their Federal Tax Accounting Treatise, "[f]or many years, this issue of consistent treatment has been fraught with uncertainty. Little guidance was provided by cases or published positions of the IRS. Thus, in evaluating the circumstances of each particular case, consideration had to be given to all the facts, including the consequences of finding that a method of

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[60] *Glenn v. Commissioner*, 62 T.C. 270, 275 (1974); *Davis v. Commissioner*, 65 T.C. 1014 (1976).
[61] *Hoye v. Commissioner*, T.C. Memo. 1990-57.
[62] Treas. Reg. § 1.446-1(d)(3).
[63] *Peterson Produce Company v. United States*, 205 F. Supp. 229, 240 (W.D. Ark. 1962), *aff'd* by 313 F.2d 609 (8th Cir. 1963).
[64] *Id at 236*.
[65] *Id*.
[66] *Id.* at 240.
[67] Treas. Reg. § 1.446-1(e)(1).
[68] Treas. Reg. § 1.446-1(e)(2)(ii)(*a*).

accounting had been established. However, in more recent years, the IRS and the courts have attempted to bring greater certainty to at least some of the relevant issues... ." [69]

Making the determination as to whether an accounting method has been adopted/established and when such method was adopted/established largely depends on how "consistent treatment" is defined. This is discussed in more detail in Section III.C.1 below. To the extent an item is not treated consistently under such definition, the general view is that a method of accounting for that particular item has not been established. In that case the taxpayer's past treatment of that particular item may be viewed as an error; however, alternative arguments may exist. See Section IV below.

1. Consistent Treatment (Permissible v. Impermissible Methods)

Rev. Proc. 2015-13, Section 2.01(2), provides that "[a]lthough a method of accounting may exist… without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of [Treas. Reg.] § 1.446-1(e)(2)(ii)(a)."[70] If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting.[71]

The importance of knowing when a method of accounting has been adopted rests in the restrictions that arise upon adoption. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax return(s), or simply change methods of accounting prospectively, instead it must seek consent of the Commissioner to change its method of accounting.[72]

a. **Special Methods and Elections:** In addition to the general rule above, taxpayers wanting to adopt special methods of accounting, or special elective treatment for certain items of income or deduction, must comply with the provisions of the Code and the regulations authorizing such special method (as applicable).[73] If a Code section requires a form or election statement to be

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[69] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 9.04 (Thomson Reuters/WG&L, 2d ed. 2025); *See* Rev. Rul. 90-38, 1990-1 C.B. 57 and Rev. Proc. 2015-13, 2015-5 I.R.B. 419**.**

[70] *See also Thrasys, Inc. v. Commissioner*, T.C. Memo. 2018-199, 4 ("This Court and other courts have generally agreed that an erroneous treatment rises to the level of a 'method of accounting' only if it is employed consistently for two or more years."); *to the same effect, Greiner v. United States*, 122 Fed. Cl. 139, 149 (2015), *aff'd*, 651 F. App'x 1000 (Fed. Cir. 2016); *Pinkston v. Commissioner*, T.C. Memo. 2020-44; *Conmac Investments Inc. v. Commissioner*, T.C. Memo. 2023-40, *aff'd*, 139 F.4th 723 (8th Cir. 2025).

[71] Rev. Proc. 2015-13, section 2.01(2); Rev. Rul. 90-38. *See also Russo v. Commissioner*, 68 T.C. 135 (1977) (where the use of a cash method in the initial return precluded subsequent change to accrual method without the prior approval of the Commissioner). But see, however, the exception for assets erroneously depreciated on a single return in Rev. Proc. 2025-23, sections 6.01(1)(b), 6.04(1)(b), 6.05(1)(b), 6.18(1)(b), 6.20(3)(b), and 6.21(2) which waive the two-year rule for certain impermissible to permissible depreciation changes.

[72] IRC § 446(e). *See* Rev. Rul. 90-38 ("A taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired."); *See also Greiner v. United States*, 122 Fed. Cl. 139, 156-58 (2015), *aff'd*, 651 F. App'x 1000 (Fed. Cir. 2016); *Hawse v. Commissioner*, T.C. Memo. 2015-99; *Diebold, Inc. v. United States*, 16 Cl. Ct. 193, 208, *aff'd*, 891 F.2d 1579 (Fed. Cir. 1989).

[73] Treas. Reg. § 1.446-1(c)(1)(iii).

attached to the return, then the use of the method on the return without attaching the required information may not constitute the adoption of the method.[74]

b. **Foreign Corporation Exception:** Taxpayers are not required to elect or adopt a method of accounting for purposes of computing a foreign corporation's earnings and profits until the earnings and profits are significant for U.S. federal income tax purposes with respect to the controlling domestic shareholders.[75]

2. Binding Effect of Adoption

Once a taxpayer adopts a method of accounting under the above referenced rules, the permission of the IRS National Office (*i.e.*, consent from the Commissioner) is generally required to change its method of accounting (discussed in more detail in the sections below).[76]

IV. Change in Method of Accounting – In General

A. General Definition

The Code does not define the phrase "change in method of accounting." However, guidance as to whether a particular change in reporting amounts to a change in method of accounting is provided in two paragraphs of the applicable Treasury regulations. One paragraph governs what is included in the concept[77] and the other paragraph governs what is excluded from the concept.[78]

1. What is included in the definition of a change in method of accounting

Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) provides that "[a] change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction."

As Gertzman, Hani, and Gadwood explain in their Federal Tax Accounting Treatise, Treas. Reg. §1.446- 1(e)(2)(ii)(*a*) makes three notable points regarding the phrase "change in method of accounting."[79]

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[74] *See, e.g., Kantor v. Commissioner*, T.C. Memo. 2008-297 (trader who failed to adhere to the election requirements of the revenue procedure was not entitled to use the mark-to-market method of accounting under IRC § 475(f)); Rev. Rul. 78-262, 1978-1 C.B. 170 (corporation that does not file Form 970 with its tax return for the taxable year for which it proposes to elect to change to LIFO method of inventory valuation and does not otherwise include in its return for that year information required on Form 970 has not made valid election to use LIFO method). However, depending on the facts, the substantial compliance doctrine may apply to treat a taxpayer as having made an election (or adopted a method) even if every election requirement is not satisfied. The substantial compliance doctrine is outside the scope of this outline.

[75] *See* Treas. Reg. § 1.964-1(c)(6) for a list of events that cause a foreign corporations earnings and profits to have significance.

[76] IRC § 446(e). Note that consent is required even where the taxpayer is proposing to change to the only correct method. *See, e.g., Witte v. Commissioner*, 513 F.2d 391, 391 (D.C. Cir. 1975).

[77] Treas. Reg. § 1.446-1(e)(2)(ii)(a).

[78] Treas. Reg. § 1.446-1(e)(2)(ii)(b).

[79] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 9.02 (Thomson Reuters/WG&L, 2d ed. 2025).

First, a change in method of accounting includes a change in the overall plan of accounting. Accordingly, a change in method of accounting includes, for example, a change from the cash method to an accrual method or vice versa.

Second, a change in method of accounting for a particular item arises only if the item involved in the change is material. This is true even though, as discussed in Section I and II above, a method of accounting may exist for any item of income or expense regardless of the "materiality" of the item. Although materiality is usually thought of in terms of absolute or relative size of the dollar amount of an item, Treas. Reg. §1.446-1(e)(2)(ii)(*a*) defines a "material item" as any item which "involves the proper time for the inclusion of the item in income or the taking of a deduction." [80] Based on a literal reading of the regulations one could conclude that the absolute or relative size of the dollar amount of the item is irrelevant in determining whether a change in method of accounting for that item has occurred. However, this regulatory definition of "material item" has not been accepted in all cases,[81] suggesting that an argument may be made that the absolute or relative size of the dollar amount of the item may be relevant in determining whether a change in method of accounting for that item has occurred.

Third, a method of accounting generally is not established without a pattern of consistent treatment, which, as Gertzman, Hani, and Gadwood note, "is established by using the same method of accounting over a period of consecutive tax years."[82] Thus, a method of accounting must be established prior to being susceptible to change. See the discussion in Section III, above, regarding establishing or adopting a method of accounting for a particular item.

This requirement of consistent treatment suggests that a taxpayer that has not reported on a consistent basis over a period of years may be able to change to a new method without being subject to the requirements affecting changes in methods of accounting (*e.g.*, the need to obtain IRS approval of the change or to make a § 481(a) adjustment).[83] Such requirements are discussed in more detail below.

2. What is not included in the definition of a change in method of accounting

Treas. Reg. §1.446-1(e)(2)(ii)(*b*) provides that "[a] change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in methods of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. . . . A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts."

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[80] *See Rankin v. Commissioner*, 138 F.3d 1286, 288 (noting that an item is "material" when it affects the timing of reporting income as opposed to "*how much* income is reported"); *Starer v. Commissioner*, T.C. Memo. 2022-124 ("If a change leaves a taxpayer's lifetime taxable income constant but affects when it is recognized, the change concerns an 'item that involves the proper time for the inclusion of [an] item in income or the taking of a deduction' and implicates a change in method of accounting.").
[81] *See, e.g.*, *FPL Group, Inc. & Subsidiaries v. Commissioner*, T.C. Memo. 2005-210.
[82] Gertzman, Hani, and Gadwood, <u>Federal Tax Accounting</u> ¶ 9.02 (Thomson Reuters/WG&L, 2d ed. 2025).
[83] *Id.*

As Gertzman, Hani, and Gadwood indicate in their Federal Tax Accounting Treatise, the two paragraphs of the applicable regulation (as cited in item 1 and 2 above) "together demonstrate that three circumstances must coalesce before a change in accounting method may be found. First, the item involved in the change must be material. Second, the accounting practice in question generally must have been applied consistently. Third, the change must not be (1) the correction of an error; (2) a change in character; (3) a change in underlying fact; or (4) a change traditionally handled other than as a change in method."[84]

The correction of an error, a change in character and a change in underlying fact are discussed in more detail below. Because such corrections and or changes do not rise to the level of a change in method of accounting, but may impact when an item of income or expense is reported for federal income tax purposes, significant opportunities for taxpayers may exist in these areas.

B. Potential Benefits When a Change in the Treatment of an Item is Not a Change in Method of Accounting

To understand the potential benefits associated with changing the treatment of an item and not having the change rise to the level of a change in method of accounting, it is first necessary to understand the ramifications of a change in method of accounting.

If a particular change rises to the level of a change in method of accounting, there are three consequences. First, the change may generally be made only with IRS approval. Second, the change will generally require the computation of a § 481(a) adjustment (*i.e.*, a "catch-up" adjustment) to prevent the double inclusion or an omission of items of income or expense. Third, as a practical matter, the making of the change and any subsequent review of the change by the IRS are not subject to the running of the applicable statutory periods of limitation.[85]

On the contrary, if a particular change does not rise to the level of a change in method of accounting then the change does not require IRS approval, nor does it require the computation of a § 481(a) adjustment. This potentially allows for the taxpayer to omit items of income or double deduct a particular expense.[86] Additionally, the change is subject to (and, hence, has the protection or bears the risk of) the running of the applicable statutory periods of limitation.[87] Consequently, amounts attributable to years prior to the year of change cannot increase or decrease the amounts of income or expense to be reported in the year of change and subsequent years, but instead would have to be recovered through amended returns.[88]

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[84] *Id.*

[85] Gertzman, Hani, and Gadwood, <u>Federal Tax Accounting</u> ¶ 9.01 (Thomson Reuters/WG&L, 2d ed. 2025).

[86] This also could work in the opposite direction, in which case having a change not rise to the level of a change in method of accounting may result in an unfavorable answer for the taxpayer. In either case, the circumstances may trigger the mitigation provisions found in §§ 1311 – 1314.

[87] Gertzman, Hani, and Gadwood, <u>Federal Tax Accounting</u> ¶ 9.01 (Thomson Reuters/WG&L, 2d ed. 2025).

[88] As Gertzman, Hani, and Gadwood note in their Federal Tax Accounting Treatise (¶ 9.01), "nevertheless, changes that do not amount to changes in methods of accounting are subject to other provisions of the Code that may affect the normal impact of statutory periods of limitation. *See, e.g.*, the mitigation provisions of sections 1311–1314; the duty of consistency and the principle that double deductions (or their practical equivalent) should not be permitted for a single economic loss absent a clear declaration of congressional intent for such a result. *Thrifty Oil Co. v. Commissioner*, 139 T.C. 198 (2012), and cases cited therein."

An example of the ramifications of a change amounting to a change in method of accounting vs. a change not rising to the level of a change in method of accounting is illustrated in the following example taken from Gertzman, Hani, and Gadwood's Federal Tax Accounting Treatise.

Example:

> "Assume that a taxpayer follows a reporting practice that incorrectly defers the recognition of income for a period of one year and that the aggregate amounts of deferred income at the end of years 1, 2, 3, and 4 are $100, $250, $300, and $400, respectively. As a consequence of its incorrect reporting, the taxpayer has deferred an aggregate of $400 as of the end of year 4. If the statutory period of limitations has run on years 1, 2, and 3 and either the taxpayer or the IRS seeks to correct the reporting of items beginning in year 4, substantially different adjustments result, depending on whether the correction amounts to a change in method of accounting.
>
> If the correction amounts to a change in method of accounting, the taxpayer may not correct its incorrect practice without the prior approval of the IRS. In addition, a § 481(a) adjustment in the amount of $300 will be required. The $300 represents the aggregate amount that properly reported, would have been recognized in years prior to year 4. The change in method will require the $300 to be included in income in year 4 or to be taken into income ratably over some appropriate period of years beginning with year 4. The $100 increase in the deferred amount during year 4 (the $400 balance at the end of year 4 minus the $300 balance at the beginning of year 4) will be taken into account entirely in year 4.
>
> If the change in reporting practice does not amount to a change in method of accounting, the $300 beginning balance, which should have been reported in years prior to year 4, will escape taxation, since the statutory period of limitations has run on such years.[89] The amount of the $100 increase in the deferred income during year 4 will still be taken into account as income in that year."[90]

Note: While there are clearly potential benefits associated with changing the treatment of an item without the change rising to the level of a change in method of accounting, there are also a number of situations where a taxpayer may want the change to rise to the level of a change in method of accounting.

1. Correction of an Error

Treas. Reg. § 1.446-1(e)(2)(ii)(B) provides that "[a] change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit)."[91]

Determining whether the change in the treatment of an erroneous item is a correction of an error or a change in method of accounting can be quite difficult and is often based on the perspective of

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[89] However, consider application of mitigation provisions of §§ 1311–1314.

[90] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 9.01 (Thomson Reuters/WG&L, 2d ed. 2025).

[91] *See also First National City Bank v. United States*, 557 F.2d 1379, (Ct. Cl. 1977); *Capital One Financial Corp. v. Commissioner*, 130 T.C. 147 (2008), *aff'd*, 659 F.3d 316 (4th Cir. 2011). *But see* TAM 8741006 (May 21, 1987), where the IRS ruled that an increase in the taxpayer's loan base for the purpose of computing its bad debt reserve (by including previously excluded accrued interest) constituted a change in method of accounting.

the person making the determination. As the Tax Court stated in *Hawse v. Commissioner*, "[t]he line between a change in accounting method and mere error (or its correction) is a fine one."[92]

The core issue is how broadly one defines the term "correction of an error." Using a broad definition one could argue that any misapplication of the tax law (*e.g.*, the consistent improper treatment of an item) is an error and that a change to correct such error does not amount to a change in method of accounting (thereby escaping the rules governing a change in method of accounting); however this appears to be at odds with the regulations governing accounting methods. As previously stated, the *improper* treatment of an item in two or more consecutive returns generally results in the establishment of an accounting method for that particular item (albeit an erroneous one), which is correctable only by following the rules governing a change in method of accounting. It would appear that simply arguing that a change in such treatment falls within the scope of the "correction of an error" exception provided in Treas. Reg. § 1.446-1(e)(2)(ii)(*b*), and should thus escape the rules governing a change in method of accounting, would be applying the "correction of an error" exception too broadly. The regulations appear to suggest a narrower application of the exception; however, courts have been largely inconsistent on this issue.

In some cases, where the taxpayer has made a mathematical, posting or computational error, its correction generally affects only the amount of income or expense to be taken into account in the particular year, and no issue arises as to whether there has been shifting of income or expenses from one year to another, *i.e.*, when the income should be reported. These cases are more straightforward and the correction of the error generally does not amount to a change in method of accounting.[93]

In other cases, where the correction of an erroneous item affects the reporting of income or expense in more than one year (*i.e.*, where income or expense may be shifted from one year to another), determination of whether the correction of the error, or deviation from the method of accounting, amounts to a change in method of accounting becomes much more difficult. The key factors that should be considered when making this determination are: (1) the "item" (see Section I.C above for a discussion on defining the "item") and (2) the consistency of the erroneous treatment. As a general rule of thumb, if the taxpayer erred in the treatment of a "sub-item" (*i.e.*, a subset of the "item") then the correction of the error with respect to that "sub-item" would likely not amount to a change in method of accounting. The reasoning is that the overall method for the "item" was applied correctly and the taxpayer simply erred in its treatment of a "sub-item." This is commonly referred to as an "error within a method."[94] For example, if the Taxpayer's method of accounting for sales revenue from all shipped goods (the "item") was to recognize revenue upon shipment, but it erred and recognized revenue for certain goods (the "sub-item") upon delivery, the correction of such error would not amount to a change in method of accounting (as the overall method for the "item" is still sound). Additionally, to the extent a taxpayer erred in the treatment of an "item," but made the error in only one tax year, a correction of such error generally would not amount to a change in method of accounting.[95] This is supported by the regulations under IRC §§ 451 and 461, which provide that where a taxpayer determines that an item of income or expense should have been included in or excluded from returns filed in earlier years, the taxpayer should file amended

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[92] *Hawse v. Commissioner*, T.C. Memo. 2015-99.

[93] *See, e.g., North Carolina Granite Corp. v. Commissioner*, 43 T.C. 149 (1964).

[94] *See* Field Service Advisory, 1998 WL 1984336 (1998) and the cases cited therein for a discussion of the concept of an error within a method. *See also* Rev. Rul. 2023-8, 2023-18 IRB 801, which obsoletes Rev. Rul. 58-74, 1958-1 C.B. 148, on the basis that the facts in Rev. Rul. 58-74 were insufficient to determine whether the change in the treatment of a section 174 expenditure was a change in method of accounting or a change to correct an error within an established method. Notably, Rev. Rul. 2023-8 recognizes the concept of an "error within a method" and includes a discussion of factors relevant to the determination of whether an error within a method exists.

[95] *See* Rev. Proc. 2015-13 2015-5 I.R.B. 419, Section 2.01(2).

returns to correct such item, assuming that the statutory period of limitation has not run on such years.[96]

As Gertzman, Hani, and Gadwood indicate in their Federal Tax Accounting Treatise, "To further complicate the matter, some courts have suggested that the concept of "correction of an error" is broad enough to include not only adjustments to apply correctly an existing method[97], but also adjustments permitting taxpayers to change from an incorrect method to a correct method, a result seemingly at odds with the regulations.[98] These courts appear disinclined to place impediments in the way of a taxpayer desiring to change from an incorrect to a correct method. Although this objective is admirable, such an approach is analytically inappropriate and increases the practical opportunity for abuse. Thus, it would appear more appropriate for a change from an incorrect method to a correct method to be subject to the rules governing changes in methods, except as might otherwise expressly be provided by the Code, Treasury regulation, or IRS pronouncement."[99]

Gertzman, Hani, and Gadwood further note that "most jurisdictions will not permit taxpayers unilaterally to change from an incorrect method of accounting to a correct method on the basis of the correction of an error exception.[100] Moreover, it is uncertain whether these changes will be permitted even in jurisdictions that have allowed them in the past. The cases in which these changes were permitted involved unique factual circumstances. Consequently, the scope of such decisions remains uncertain."[101]

2. Change in Character

Whether a "change in character" is mutually exclusive from a "change in method of accounting" is another common area of debate. Certain courts have held that determining the character of an item is not a method of accounting. Once the character of the item is known, the method of determining when that item is reportable income, or deductible, as the case may be, is indeed a method of accounting. In *Underhill v. Commissioner*,[102] the Commissioner challenged Underhill's tax treatment of certain debt obligations he acquired. If the debt obligations were not speculative in nature Underhill was required to report income using a pro-rata basis. This is the manner in which Underhill reported income for all debt obligations prior to 1961. If they were speculative in nature, income was reportable using a cost recovery method. This is the method used by Underhill in 1961 and after. After deciding the factual issue raised by the parties (whether the debt obligations were or were not speculative) the Court addressed the Commissioner's contention that Underhill could not use the cost recovery method for 1961 and after because to do so would constitute an unauthorized change in method of accounting. The Court soundly rejected the Commissioner's contention, noting that the issue before the court was the character of the obligations, not the proper time of reporting an item, the character of which is not in question.[103] The court further noted that once the character of the obligation was determined, there was no choice about the

[96] *See* Treas. Reg. § 1.451-1(a), Treas. Reg. § 1.461-1(a)(3).
[97] *See, e.g., Richard M. Evans v. Commissioner*, T.C. Memo. 1988-228, where the reporting of bonuses on an accrual method for three years (*i.e.*, in the year authorized) by cash method taxpayers did not prohibit these taxpayers from subsequently reporting the bonuses in the years received.
[98] Treas. Reg. § 1.446-1(e)(2)(i) subjects both correct and incorrect methods of accounting to the rules governing changes in accounting methods. *See also Cardulla v. Commissioner*, T.C. Memo. 2023-89, *aff'd*, No. 24-31, 2025 WL 1984265 (9th Cir. 2025) (explaining that IRC § 446(e); Treas. Reg. § 1.446-1(e)(2)(i) "expressly [bring] a change from an improper or unpermitted method of accounting within the ambit of section 446(e)).").
[99] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 9.05 (Thomson Reuters/WG&L, 2d ed. 2025).
[100] *See, e.g., Cargill, Inc. v. United States*, 91 F. Supp. 2d 1293 (D. Minn. 2000), and cases cited therein.
[101] Gertzman, Hani, and Gadwood, Federal Tax Accounting ¶ 9.05 (Thomson Reuters/WG&L, 2d ed. 2025).
[102] 45 T.C. 489 (1966).
[103] *Id*. at 496.

method or time income was reportable.[104] Notably, *Underhill was* a case decided before the 1970 revisions to Treas. Reg. § 1.446-1(e), which redefined "material item" to include language about the proper time for recognizing income and expenses.

Similarly in *McPike, Inc. v. United States*,[105] the United States Claims Court found that the taxpayer had not changed its method of accounting. In *McPike*, the taxpayer sought to challenge the Commissioner's actions for the years before the court as an abuse of discretion because the Commissioner was changing the taxpayer's method of accounting when he previously approved the method, at least tacitly, in previous years. At issue was whether certain payroll costs should be capitalized or could be currently expensed. The Government argued that the Commissioner did not change the taxpayer's method of accounting, but merely challenged the taxpayer's determination of whether a particular expense fell within a category of expense requiring capitalization or within a category susceptible of current deductibility. The Government argued that the taxpayer's process of determining the nature of the payroll costs is "in no way a 'method of accounting' but that plaintiff's treatment of the expenditure once identified by the process may be such a method."[106] The Claims Court accepted the Government's argument, holding that there was no change in method of accounting. In this respect, the court noted that "[a]n accounting method is not a procedure to learn the facts about a taxpayer's expense, but is the *treatment* of that expense by the taxpayer."[107]

Conversely, however, certain courts have stood for the proposition that when evaluating whether a change in method of accounting has occurred, "the fact that the adjustment involved characterization… was irrelevant so long as [the adjustment] related to timing."[108] In *Cargill v. Commissioner*, the petitioner argued that changing from deducting rent associated with a lease to instead treating the building as financed/owned (and claiming depreciation) did not constitute a change in method of accounting, but rather was a "change in characterization." The petitioner argued that because the timing consequences flowed automatically from the characterization of its interest in the lease, its proposed recategorization was not a change in its method of accounting. The court did not find the petitioner's argument (or the cases it cited, such as *Underhill, supra*) to be persuasive. Instead, the court held the cases that the petitioner cited "rely on erroneous legal precepts" and the "erroneous premise that consent is not required if the taxpayer's previous treatment of the item was improper." Ultimately, the court held that petitioner's change constituted a change in method of accounting, noting that "[petitioner] has not directed the Court to any provision of the Code that sets forth such a characterization' exception."

Indeed, the regulations themselves make clear that certain changes in character may constitute a change in method of accounting so long as it implicates timing. Specifically, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*) provides (in relevant part) that "a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting." Example 11 in the regulations applies this concept where a depreciable asset is initially mischaracterized as inventory:

> In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly

[104] *Id*. at 497.
[105] 15 Cl. Ct. 94 (1988).
[106] *Id*. at 98.
[107] *Id*. at 99 (emphasis in original). *See also Thompson-King-Tate, Inc. v. United States*, 296 F.2d 290 (6th Cir. 1961); *Beacon Publishing Company v. Commissioner*, 218 F.2d 697 (10th Cir. 1955), *rev'g* 21 T.C. 610 (1954); *Ross v. Commissioner*, 169 F.2d 483 (1st Cir. 1948), *rev'g* 6 T.C.M. 124 (1947); *North Carolina Granite Corp. v. Commissioner*, 43 T.C. 149 (1964).
[108] *Pinkston v. Commissioner*, T.C. Memo. 2020-44;

treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.[109]

In recent years, several courts have dismissed the view that a change in "characterization" automatically precludes a change in method of accounting. Instead, such courts continue to reiterate that "a change in method of accounting can be generated by the recharacterization of an asset, a transaction, or the income and expenses related thereto, so long as the adjustment affects only timing."[110]

As noted in the cases referenced above (and others), when the issue at hand involves the proper determination of the character of an item (and whether there has been a corresponding change in method of accounting), it is important to consider all relevant facts and evaluate which case(s) on this issue may be analogous or distinguishable. In the author's view, a change in the characterization of an item that affects when that item is taken into account in computing taxable income is better viewed as a change in method of accounting.

3. Change in Underlying Facts

A change in business practices (e.g., alteration of customer contract terms), certain business relationships or an altered fact situation may cause a change in when affected items of income and expense are taken into account in computing taxable income. Treas. Reg. § 1.446-1(e)(2)(ii)(*b*) provides that a change in method of accounting does not include a change in treatment that results from a change in underlying facts.[111]

In *Decision, Inc. v. Commissioner*,[112] the Tax Court held that a change in an accrual basis taxpayer's customer contracts and billing system, which had the effect of deferring income, was not a change of accounting method. Under the contract that taxpayer previously used, customers were billed in the year preceding the year in which the actual services were provided; income was reported in the year the services were provided.[113] In response to a position taken by the IRS that the income should be reported in the year in which the services were billed, not the year in which the services were provided, the taxpayer changed its contracts to provide that amounts would be billed and due in the year in which the services were provided.[114] Having done this, the taxpayer, once again, reported the income in the year the services were provided. The IRS argued that the taxpayer could not report the income in the year the services were provided because to do so would constitute a change in method of accounting without securing the

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[109] Treas. Reg. § 1.446-1(e)(2)(iii), Example 11.
[110] *GWA, LLC v. Commissioner*, T.C. Memo. 2025-034; *See also Conmac Investments Inc. v. Commissioner*, 139 F.4th 723 (8th Cir. 2025) (where the Tax Court discarded the petitioner's "change in characterization" argument by concluding that petitioner's change in the treatment of rented-out acreage base from nonamortizable to amortizable was a change in accounting method because it changed the timing of cost recovery; *Starer v. Commissioner*, T.C. Memo. 2022-124 (where the court held that a change in the treatment of property transfers from loans to sales constituted a change in method of accounting).
[111] *See Pinkston v. Commissioner*, T.C. Memo. 2020-44 (where the Tax Court explained that a "change in underlying facts" is "an exception [that] covers situations where a taxpayer alters his accounting treatment because the facts on the ground have changed in a way that permits or requires a different treatment… [t]his would be true, for example, where an employer changed its accounting for vacation pay after shifting from a nonvested to a fully vested vacation pay plan.").
[112] 47 T.C. 58 (1966).
[113] *Id.* at 60.
[114] *Id.*

necessary consent of the Commissioner. The court acknowledged that the change in the contract had consequences in the annual determination of income but such consequences were not produced by the accounting system.[115] The court viewed the changed contract terms as a business policy change, "no different from a decision to lower prices or halt production for a year."[116] Allowing the IRS' argument that a change in method had occurred, would "have the effect of denying a business the right to determine the terms of sale of its product without" obtaining the approval of the Commissioner.[117] The court accordingly concluded that the contract change was a change in underlying fact, not a change in method of accounting.[118]

In *Hallmark Cards, Inc. v. Commissioner*,[119] prior to a change in contract terms, the taxpayer shipped its merchandise directly from the production line to its customers when the merchandise was demanded, and the sale, and resulting income were reported at the time of shipment.[120] In an effort to reduce various costs and address business concerns, the taxpayer changed its contract terms to provide that certain seasonal merchandise would be shipped to customers in advance of year- end, however, title and risk of loss would not pass to the buyer until after January 1 of the following year.[121] The Court acknowledged that taxpayer's change of when it would recognize income from the sales of seasonal merchandise resulted from a change in business practices necessitating a change in contract terms under which that merchandise was sold. It held, however, that a change in treatment of an item of income that resulted from a change in underlying facts did not constitute a change in method of accounting.[122] To hold otherwise would give the IRS the right to dictate to taxpayer when it could sell its merchandise.[123]

Through these cases, the Tax Court recognized the importance of allowing a business to conduct its operations in a manner it deems most appropriate without the interference of the government. Moreover, these cases recognized the fundamental rule that if a change in the business operations has the effect of changing the timing of income recognition, this latter change does not constitute a change in method of accounting, but merely a change in facts, for which the taxpayer may continue to apply its method of accounting (*i.e.*, both taxpayers continued to use an accrual method of accounting for the new contract terms). Courts have also recognized other circumstances where a change in business practice constitutes a change in facts to which the taxpayer may apply its method of accounting.

In *Esco Corp. v. United States*,[124] the Ninth Circuit established that a change in forecasting methodologies does not rise to the level of an accounting method, thus rejecting the IRS's contention that ESCO unilaterally changed from the cash receipts and disbursements method to an accrual

[115] *Id.* at 64.
[116] *Id.*
[117] *Id.*
[118] *See also Hopkins Partners v. Commissioner*, T.C. Memo. 2009-107 (finding a "change in underlying facts" where landlord changed their accounting treatment to reflect revisions to his lease with the lessee). *Cf. Conmac Investments Inc. v. Commissioner*, T.C. Memo. 2023-40, *aff'd*, 139 F.4th 723 (8th Cir. 2025) (where the Tax Court discarded the petitioner's "change in underlying facts" argument by concluding that petitioner's change in the treatment of rented-out acreage base from nonamortizable to amortizable was a change in accounting method. The Tax Court explained: "petitioner never identifies what facts changed despite having ample opportunity to do so… petitioner did not change its existing business practices; rather, it continued to serve as a landlord to tenant farmers. Nor did petitioner change any of its economic or legal relationships—for example, through modification of lease agreement terms.").
[119] 90 T.C. 26 (1988).
[120] *Id*. at 27–28.
[121] *Id*. at 29.
[122] *Id*. at 35.
[123] *Id.*
[124] 750 F.2d 1466 (9th Cir. 1985).

method of accounting for workers' compensation expenses.[125] Prior to 1974, ESCO deducted the portion of accrued expenses represented by its actual cash expenditures because its forecasting methodology was incapable of estimating its accrued claims expenses with sufficient accuracy.[126] After it began using a more sophisticated forecasting methodology, it was able to estimate the amount of its liability with reasonable accuracy and, thus, deduct its entire workers' compensation claims expenses.[127] The IRS argued that ESCO's change in reporting for its workers compensation expenses constituted a change in method of accounting; ESCO believed it had not changed its method of accounting. The court found in favor of the taxpayer and concluded that ESCO deducted only a portion of its accrued expenses prior to 1974 because of insufficient statistical data and forecasting methodologies.[128] The new techniques more accurately predicted ESCO's expenses and thus did not constitute a change in method of accounting but constituted "a change in treatment resulting from a change in underlying facts."[129]

In *Baltimore and Ohio Railroad Co. v. United States*,[130] the Government argued that the taxpayer had made an unauthorized change in method of accounting when it changed its cost recovery formula for railroad track.[131] The Court of Claims held that a railroad using a retirement- replacement-betterment accounting method could switch from one formula of determining fair market value to another formula of determining fair market value without invoking the method of accounting rules, notwithstanding the fact that the change in formula resulted in an expense deduction timing change. The court held that the change in valuation formulas resulted in a change in treatment caused by the adoption of a more accurate valuation formula.[132] Citing Treas. Reg. § 1.446-1(e)(2)(ii)(*b*), the court based its decision on a conclusion that the valuation formulas merely established a fact of value at a particular time such that the change in fact was not a change in method of accounting.[133]

4. Taxpayer Opportunity – Example

If a taxpayer is in a situation where it is using a method of accounting to defer a particular item of income or accelerate the deduction for a particular item of expense, but such method is impermissible based on the taxpayer's specific facts, an opportunity may exist to file a change in method of accounting to begin using a proper method of accounting for such facts, followed by a change in facts that will allow the taxpayer to adopt a new method of accounting for the new facts. Take the following situation for example:

Company A, a calendar year accrual basis taxpayer, has an employee bonus plan whereby it annually pays around $4,000,000 in employee bonuses. The bonuses for the year are approved by the board at the end of the calendar year in which the employees provided their services and are paid out by March 15th of the subsequent year. Further, as a stipulation of the plan, employees must be employed by the Company on the date the bonuses are paid to be eligible to receive a bonus. Otherwise, they forfeit the bonus payment and the Company retains the amount of the bonus. Assume that the Company does not have a bonus pool whereby the forfeited bonuses are re-distributed to the remaining employees that are still employed with the Company on such date. Because the employee must be employed on the date the bonus is paid, the bonus, per the IRS, is not fixed at year end.[134] Under its present method

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125 *Id*. at 1467.
126 *Id*. at 1470.
127 *Id.*
128 *Id.*
129 *Id.*
130 603 F.2d 165 (1955).
131 The Claims Court, divulging an interesting twist in this case, noted that the Government had argued in several earlier cases with identical facts, that the taxpayer had not changed its method of accounting. *Id*. at 169.
132 *Id*. at 170.
133 *Id.*
134 CCA 201246029.

of accounting, which it has used for multiple years, Company A deducts its bonuses in the year that the bonuses are approved by the board (*e.g.*, 2024), provided such bonuses are paid by March 15th of the following year (2025). It uses such method even though the bonus liability is not fixed as of the end of the earlier year. Upon discovering this issue Company A asks its tax advisor to help them fix this issue for their 2025 tax return . Herein lies the opportunity to file a change in method of accounting (Form 3115) and combine such change with a change in the Company's facts to obtain a benefit in the year of change (*i.e.*, 2025). Here is how it works:

Company A has established an impermissible method of accounting in that it is deducting its bonus liability prior to satisfying the all-events test of IRC § 461. Thus, the Company will have to file a change in method of accounting to begin deducting its bonus liabilities in the taxable year in which the all events test is satisfied, which is the year in which it is paid. As a result, the taxpayer will have to compute an unfavorable § 481(a) adjustment of $4,000,000. The $4,000,000 IRC § 481(a) adjustment represents the bonus liability that was deducted on the 2024 tax return, but that was not paid until 2025 (the year in which the all events test is actually met under the Company's existing facts). As the IRC § 481(a) adjustment is unfavorable the Company will take the adjustment into income ratably over 4 years ($1,000,000 per year) beginning with the year of change (2025). Additionally, as the 2024 bonus liability is now deductible in the 2025 tax year (the year it satisfies the all events test, which is the year in which it is paid) under the Company's new method of accounting, the Company will take a $4,000,000 dollar deduction for the 2024 bonus liability in the 2025 tax year. While this might seem like a double deduction, remember that the double deduction is offset by the § 481(a) adjustment. However, absent a change in facts, the Company will not be able to deduct, in the 2025 tax year, the 2025 bonus that does not get paid until 2026. Absent any additional steps to change the Company's facts for the 2025 tax year the Company's taxable income for the years in question would be as follows:

	2024	**2025**	**2026**	**2027**	**2028**	**2029**
Deduction - 2024 bonus liability	$(4,000,000)	$(4,000,000)				
Deduction - 2025 bonus liability			$(4,000,000)			
Deduction - 2026 bonus liability				$(4,000,000)		
Deduction - 2027 bonus liability					$(4,000,000)	
Deduction – 2028 bonus liability						$(4,000,000)
Section 481(a) Adjustment		$1,000,000	$1,000,000	$1,000,000	$1,000,000	
Total Taxable Income Impact	$(4,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(4,000,000)

However, if the Company, in conjunction with changing its method of accounting, also changes its facts pertaining to the bonus plan such that the bonuses "fix" in the year that they are approved by the board (*e.g.*, by adopting a pooling arrangement whereby forfeited bonuses are put back into a pool and re-distributed to the remaining employees),[135] then the Taxpayer may adopt a new method for the change in facts and deduct, in the 2025 tax year, the 2025 bonus liability that is paid within the first 2½ months of 2026. This is a proper method of accounting, so once used it is adopted and must be used in subsequent years. This allows the Taxpayer to take a net $7,000,000 bonus liability deduction in the 2025 tax year. See the table below for an illustration. Further, because the bonus liability is an annual recurring expense, the additional $4,000,000 deduction in the 2025 tax year effectively provides the Taxpayer with a permanent benefit when the time value of money is considered.

	2024	2025	2026	2027	2028	2029
Deduction - 2024 bonus liability	$(4,000,000)	$(4,000,000)				
Deduction - 2025 bonus liability		$(4,000,000)				
Deduction - 2026 bonus liability			$(4,000,000)			
Deduction - 2027 bonus liability				$(4,000,000)		
Deduction - 2028 bonus liability					$(4,000,000)	
Deduction – 2029 bonus liability						$(4,000,000)
Section 481(a) Adjustment		$1,000,000	$1,000,000	$1,000,000	$1,000,000	
Total Taxable Income Impact	$(4,000,000)	$(7,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(4,000,000)

C. Common Change in Method of Accounting Misconceptions

There are two common misconceptions pertaining to whether a change in treatment of an item amounts to a change in method of accounting for which the rules pertaining to accounting method changes must be followed (*i.e.*, filing a Form 3115).

1. Change in Book Method

Often taxpayers will follow their underlying book or financial reporting method of accounting for tax purposes. To the extent the book/financial reporting method is a permissible tax method, this is acceptable. But understand, the book/financial reporting method is separate from the tax method. To the extent the taxpayer's underlying book or financial reporting method of accounting for a particular item changes, generally such a change will amount to a change in method of accounting for tax purposes. Under these circumstances, the taxpayer is required to follow the accounting method change rules (*i.e.*, filing a Form 3115 – see below). Often taxpayers will argue that their method of accounting for tax purposes was to "follow the book method" and that because they plan to continue to "follow the book method" an

[135] Considered an acceptable arrangement by the IRS in Rev. Rul. 2011-29, 2011-49 I.R.B. 824.

accounting method change has not occurred for tax purposes. This argument, however, likely will be unsuccessful.[136]

2. Change in Law

While taxpayers may realize that a change to comply with a new tax law amounts to a change in method of accounting, they may not realize that such a change must be made pursuant to the applicable accounting method change rules and procedures (*e.g.,* Filing of a Form 3115 – see below). For example, recent legislative tax reform (*i.e.*, Public Law 119-21, 139 Stat. 72 – colloquially known as the One Big Beautiful Bill Act) will result in many taxpayers filing a Form 3115 (or potentially a statement in lieu of Form 3115), Application for Change in Accounting Method, for their domestic research or experimental expenditures under newly enacted IRC § 174A.

V. Rules for Changing a Method of Accounting

A. General

Once a taxpayer has determined that a method of accounting exists for a particular item and that a change in the treatment of the item was, or would amount to, a change in method of accounting, it must then determine the rules applicable to changing such method. Accounting method changes include changes in the following categories: voluntary changes, statutorily mandated changes, changes arising from § 381(a) transactions,[137] involuntary changes (*i.e.*, IRS initiated changes), and unauthorized changes. Changes within each of these categories are governed by a different set of rules.

Generally, taxpayer-initiated changes fall within the voluntary change category and are governed by the general rules of § 446; however, certain taxpayer-initiated changes may be subject to a special set of rules if they are statutorily mandated changes, unauthorized changes, or changes that result from an IRC § 381 transaction. Even changes within the voluntary change category can have a unique set of rules. The rules applicable to the various categories of changes are addressed below.

B. Voluntary Changes

Generally, there are two scenarios where a taxpayer would want to initiate a voluntary accounting method change request for a particular item. Each scenario hinges on whether the taxpayer's present method of accounting for that item is permissible or impermissible. If the taxpayer's present method of accounting for the item in question is permissible, it may wish to change to another, more favorable, permissible method of accounting available for that particular item. Alternatively, if the taxpayer's present method of accounting for the item in question is impermissible, it may wish to change to a permissible method of accounting for such item. The main incentive for a taxpayer to change to a permissible method of accounting under this scenario is that the voluntary change generally provides the

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[136] For example, *see* Rev. Proc. 2025-23, section 16.07 (providing an automatic accounting method change for certain revenue recognition methods of accounting to recognize income consistent with the changed manner for recognizing such revenue in the taxpayer's applicable financial statement).

[137] Accounting method changes arising from § 381(a) transactions are not discussed in this outline. Any time a taxpayer is a party to a transaction governed by IRC § 381(a), or any transaction for that matter (*e.g.,* taxable stock/asset acquisitions, IRC § 351 contributions, etc.), the taxpayer should carefully assess the implications such a transaction has on its methods of accounting and the related attributes (*e.g.,* any IRC § 481(a) adjustments). Generally, this analysis involves a determination of whether existing accounting methods carryover, are required to be changed, or whether new accounting methods must be adopted. To the extent a change in method of accounting is required, special procedures may need to be followed to properly make the change. *See* IRC § 381 and the regulations thereunder for additional details.

taxpayer with protection from IRS examination for years prior to the year of change, so-called audit protection. As discussed in the "Terms and Conditions" section below, this prevents the IRS from raising on examination the use of the impermissible method of accounting and assessing penalties and interest on any under payments of tax. Additionally, where the taxpayer is uncertain as to the appropriateness of its present method of accounting (*e.g.*, where the IRS has taken a position contrary to the taxpayer's present treatment), it should weigh its options as to whether it should continue to use such method and risk having the IRS challenge it on exam, or concede to the IRS position and request to change its method of accounting. Although conceding to the IRS's position and making a voluntary change request would provide the taxpayer with audit protection, it may limit the taxpayer's ability to change back to the original method of accounting at a later point in time.[138]

Note: The general rule under § 446(e) requires that taxpayers that wish to change an accounting method first secure the consent of the IRS. However, a number of cases have addressed the necessity to obtain consent when a taxpayer is changing from an impermissible method of accounting that understates income to a correct method of accounting.[139] As discussed in the "Unauthorized Changes" section below, a decision to change without consent comes with certain elements of risk (including the lack of audit protection). Thus, taxpayers should consider requesting consent prior to making such a change.

Prior to making a voluntary change request the taxpayer must consider a variety of factors that could impact how the change is made. It must first determine whether the change involves an accounting method change that is governed by the general voluntary change procedures provided under § 446 or if the accounting method change procedures are expressly provided for by a separate statute, regulation, or IRS pronouncement. If the accounting method is expressly provided for by a separate statute, regulation, or IRS pronouncement the taxpayer must look to the specific Code section, regulation, or related IRS pronouncement to determine the rules for adopting or changing to such method(s).[140] If these special rules are not followed, the taxpayer's use of the new accounting method may be in jeopardy. To the extent the taxpayer determines that the change is subject to the general accounting method change request rules under § 446, it must consider a variety of factors that may impact the ability to file the change request, the timing of the change request filing, and how the method change is implemented. All voluntary change requests are filed on Form 3115 and are either automatic change requests or non-automatic change requests. These are discussed in greater detail below.

1. Eligibility Limitations & Exceptions Applicable to All Voluntary Changes

a. Eligibility Limitations

In January 2015, the IRS issued Rev. Proc. 2015-13 which updated and revised the general procedures under IRC § 446(e) and Treas. Reg. § 1.446-1(e) to obtain the consent of the Commissioner of Internal Revenue to change a method of accounting for federal income tax purposes. Specifically, Rev. Proc. 2015-13 provides the general procedures to obtain the non-automatic (advance) consent of the Commissioner to change a method of accounting and provides the procedures to obtain the automatic

[138] *See, e.g.*, Rev. Proc. 2015-13, sections 5.04 and 5.05.
[139] *See, e.g.*, *Cardulla v. Commissioner*, T.C. Memo. 2023-89, *aff'd*, No. 24-31, 2025 WL 1984265 (9th Cir. 2025) (explaining that IRC § 446(e); Treas. Reg. § 1.446-1(e)(2)(i) "expressly [bring] a change from an improper or unpermitted method of accounting within the ambit of section 446(e)).").
[140] *See, e.g.*, prepaid subscription income methods under IRC § 455 and anticipated returns of newspapers, paperbacks, or records methods under IRC § 458.

consent of the Commissioner to change a method of accounting described in Rev. Proc. 2015-14 (or successor)[141] (List of Automatic Changes).

Prior to filing any method change request, taxpayers should always refer to Rev. Proc. 2015-13 *as modified, clarified and amplified* and the Code section, regulation or IRS pronouncement that may be applicable to the item being changed as special rules and requirements may be applicable. Taxpayers filing any automatic method change request should also refer to Rev. Proc. 2025-23 (or successor) in addition to Rev. Proc. 2015-13. There are a number of situations where the taxpayer will not be permitted to file either an automatic or non-automatic voluntary change request.[142]

1) Automatic Change

Except as otherwise provided in the List of Automatic Changes, a taxpayer within the scope of Rev. Proc. 2015-13 is eligible to request the Commissioner's consent to make a change in method of accounting under the *automatic change procedures* only if:

(a) List of Automatic Changes

On the date the taxpayer files a Form 3115 (original or duplicate copy under section 6.03(1), whichever is filed earlier), the change is described in the List of Automatic Changes.[143]

(b) Applicable Requirements

On the date the taxpayer files a Form 3115 (original or duplicate copy under section 6.03(1), whichever is filed earlier), the taxpayer meets all requirements for the change provided in the applicable section of the List of Automatic Changes.[144]

(c) Liquidation or Reorganization Transaction under IRC § 381(a)

Within the requested year of change, the taxpayer does not engage in a liquidation or reorganization transaction to which IRC § 381(a) applies as described Rev. Proc. 2015-13, in section 5.02(1).[145] However, certain exceptions are provided in section 5.02(2). Specifically, section 5.02(1) does not apply if the taxpayer is requesting a change in method of accounting described in Treas. Reg. § 1.381(c)(4)-1(a)(4) or (5) or Treas. Reg. § 1.381(c)(5)-1(a)(4) or (5) that is not required to be made under Treas. Reg. § 1.381(c)(4)-1(d)(1) or Treas. Reg. § 1.381(c)(5)-1(d)(1), or a change in method of computing the depreciation allowance under Treas. Reg. § 381(c)(6).

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[141] Note that the list of automatic changes is typically updated every year to reflect law changes and remove obsolete provisions. The most recent version (as of October 2025) is Rev. Proc. 2025-23, as modified by Rev. Proc. 2025-28. The list of successors since Rev. Proc. 2015-14 include: Rev. Procs. 2016-29, 2017-30, 2018-31, 2019-43, 2022-14, 2023-24, 2024-23, and 2025-23.

[142] This list of scope limitations and exceptions is not exhaustive, nor does it include all of the various nuances associated with each of the scope limitations and exceptions discussed. Prior to filing any voluntary change request refer to Rev. Proc. 2015-13, *as modified, clarified, and amplified* (for non-automatic method changes) or Rev. Proc. 2025-23 (or successor) (for automatic method changes), as applicable, as well as the Code section, regulation or IRS pronouncement that may be applicable to the item being changed. Such guidance may contain special rules and exceptions to the general rules listed herein.

[143] Rev. Proc. 2015-13, section 5.01(1)(a).

[144] Rev. Proc. 2015-13, section 5.01(1)(b).

[145] Rev. Proc. 2015-13, section 5.01(1)(c).

(d) Final year of trade or business

The requested year of change is not the final year of the trade or business (as described in section 5.03(1) of Rev. Proc. 2015-13).[146] However, certain exceptions are provided in section 5.03(2)(a). Specifically, section 5.03(1) does not apply to a taxpayer requesting consent to change its method of accounting in the final year of its trade or business as the result of a transaction to which IRC § 381(a) applies.

(e) Prior five-year overall method change

The taxpayer has not made or requested an overall method change (regardless of whether it implemented that change) during any of the five taxable years ending with the year of change as described in section 5.04(1) of Rev. Proc. 2015-13.[147] However, certain exceptions are provided in section 5.04(2). Specifically, section 5.04(1) does not apply to a taxpayer if the national office sent the taxpayer a letter instructing the taxpayer to file the Form 3115, if otherwise eligible, that was originally filed under the non-automatic change procedures, under the automatic change procedures and the taxpayer timely files a Form 3115 for the same change in method of accounting for the same year of change under the automatic change procedures. It is important to note that a taxpayer that changed its overall method of accounting during the five taxable years ending with the year of change may use the automatic change procedures to request a change in method of accounting for a *specific item* when that change may otherwise be implemented under the provisions of this revenue procedure.

(f) Prior five-year item change

The taxpayer has not made or requested a change (regardless of whether it implemented that change) for the same item during any of the five taxable years ending with the year of change as described in section 5.05(1) of Rev. Proc. 2015-13.[148] However, certain exceptions are provided in section 5.05(2)(a)-(c). For example, section 5.05(1) does not apply if the change in method of accounting for the specific item is required as part of another change in method of accounting that the taxpayer may otherwise request under the automatic change procedures.[149]

2) Non-Automatic Change

A taxpayer within the scope of Rev. Proc. 2015-13 is eligible to request the Commissioner's consent to make a change in method of accounting under the non-automatic change procedures only if:

(a) Not Eligible for Automatic Change

On the date the taxpayer files a Form 3115 with the national office, the taxpayer is not eligible to use the automatic change procedures to make the change.[150]

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[146] Rev. Proc. 2015-13, section 5.01(1)(d).
[147] Rev. Proc. 2015-13, section 5.01(1)(e). Note that a change in overall method of accounting does not include the use of an overall method of accounting when computing taxable income for the taxable year that the taxpayer first files a federal income tax return ("adopts an overall method of accounting") or a change in method of accounting imposed by the IRS pursuant to Rev. Proc. 2002-18 (or any successor).
[148] Rev. Proc. 2015-13, section 5.01(1)(f). Note that a change in method of accounting for a specific item does not include the use of a method of accounting (for example, include in income, deduct, or capitalize) for the first taxable year that the taxpayer accounts for the item or a change in method of accounting imposed by the IRS pursuant to Rev. Proc. 2002-18 (or any successor).
[149] Rev. Proc. 2015-13, section 5.02(a).
[150] Rev. Proc. 2015-13, section 5.01(2)(a)

(b) Final year of trade or business

The requested year of change is not the final year of the trade or business as described in section 5.03(1) of Rev. Proc. 2015-13.[151] However, certain exceptions are provided in section 5.03(2). Specifically, section 5.03(1) does not apply to (a) a taxpayer requesting consent to change its method of accounting in the final year of its trade or business as the result of a transaction to which IRC § 381(a) applies or (b) a taxpayer requesting consent under the non-automatic change procedures if the taxpayer demonstrates to the satisfaction of the national office compelling circumstances, or that it is in the interest of sound tax administration, for the taxpayer to change the method of accounting pursuant to section 11.02(1) of Rev. Proc. 2015-13.

b. Waiver of Eligibility Limitations

In certain instances, generally when a new treasury regulation or IRS pronouncement that provides for a new method of accounting for a particular item is released, or to incentivize compliance in a particular area, the IRS will waive some or all eligibility limitations for a particular voluntary change request. The eligibility limitation waiver is usually applicable for a limited period of time and provides taxpayers with an opportunity to get in compliance with the applicable tax law under the automatic consent procedures where they otherwise may have been precluded from using such procedures. For example, Rev. Proc. 2025-23, section 7.01(5)(a) provides that the eligibility rules in Rev. Proc. 2015-13, sections 5.01(1)(d) and (f) do not apply to change described in Rev. Proc. 2025-23, section 7.01(1)(a) (for specified research or experimental expenditures under IRC § 174) made by a taxpayer for any taxable year beginning in 2022, 2023, or 2024.

2. Terms and Conditions Imposed on All Voluntary Changes Upon Consent of the Commissioner

Although certain terms and conditions imposed on a taxpayer making a voluntary change may vary based on the type of taxpayer, the type of change and certain other factors, the following terms and conditions are generally applicable to taxpayers filing an automatic or non- automatic voluntary change request.

Note: Prior to filing any voluntary change request, taxpayers should always refer to Rev. Proc. 2015-13, *as modified, clarified and amplified* and the List of Automatic Changes (currently in Rev. Proc. 2025-23, as modified by Rev. Proc. 2025-28), and the Code section, regulation or IRS pronouncement that may be applicable to the item being changed as special terms and conditions may apply to the particular method change in question. The discussion below focuses on the terms and conditions that generally apply absent a specific exception.

a. Section 481(a) Adjustment

The IRC § 481(a) adjustment is the mechanism by which a taxpayer switches from one method of accounting to another method of accounting without duplicating or omitting items of income or expense. It is essentially a "catch-up" adjustment that is computed as the difference between the amount of income or deductions that the taxpayer took into account in taxable years prior to the year of change and the amount of income or deductions that the taxpayer would have taken into account under the proposed method of accounting prior to the year of change.[152] Absent exception, a taxpayer making a change in

[151] Rev. Proc. 2015-13, section 5.01(2)(b).
[152] Rev. Proc. 2015-13, sections 2.06 and 3.15.

method of accounting under Rev. Proc. 2015-13 must apply IRC § 481(a) and take into account the IRC § 481(a) adjustment in the manner provided in Rev. Proc. 2015-13, section 7.03.[153] Generally, a net negative IRC § 481(a) adjustment is taken into account in the year of change, while a net positive IRC § 481(a) adjustment is taken into account ratably over 4 years, beginning with the year of change (*i.e.*, "the four-year spread").[154] Although the four-year spread for a net positive § 481(a) adjustment is the general rule, there are a number of factors that could accelerate the recognition of the net positive IRC § 481(a) adjustment (*e.g.*, examination status, cessation of a trade or business, de minimis adjustments, etc.).[155] For example, the IRC § 481(a) adjustment period is two taxable years (year of change and next taxable year) for a positive IRC § 481(a) adjustment for a change in method of accounting requested when a taxpayer is under examination, unless an exception applies (*i.e.*, change filed in a three-month window, change filed in a 120-day window, present method not before the director, or new member of a consolidated group in CAP).[156]

Although most voluntary changes require an IRC § 481(a) adjustment as a means of implementing the change, certain changes are required to be made on a cut-off basis.[157] That is, certain changes are implemented without computing a § 481(a) adjustment and are simply applied prospectively.

b. Audit Protection

In general, when a taxpayer timely files a Form 3115 under Rev. Proc. 2015-13, the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change (*i.e.*, the taxpayer is granted audit protection for tax years prior to the year of change which means that the IRS cannot raise the issue on exam and propose an examination adjustment with interest and penalties).[158] However, there are numerous exceptions where a taxpayer is not afforded audit protection, which are found in Rev. Proc. 2015-13, sections 8.02(1) through 8.02(8) and listed below:

- No audit protection for taxpayers under examination (exceptions are discussed below);[159]
- Change lacking audit protection;[160]
- Change not made or made improperly;[161]
- Change in sub-method of accounting;[162]
- CFC or 10/50 corporation (to the extent the 150% rule applies);[163]
- Criminal investigation;[164]

[153] Rev. Proc. 2015-13, section 7.02.
[154] Rev. Proc. 2015-13, section 7.03(1).
[155] Rev. Proc. 2015-13, section 7.03(3) provides certain "shortened" adjustment periods for (a) cooperatives within the meaning of IRC § 1381; (b) taxpayers under examination with positive IRC § 481(a) adjustments; (c) taxpayers eligible for the de minimis election (i.e., positive adjustment that is less than $50,000); and (d) taxpayers making the eligible acquisition transaction election. Similarly, Rev. Proc. 2015-13, section 7.03(4) provides certain "accelerated" adjustment periods for (a) taxpayers ceasing to engage in the trade or business; (b) S corporation election effective for year of LIFO discontinuance; (c) S corporation elections effective for year after LIFO discontinuance; and (d) certain transfers pursuant to an IRC § 351 transaction within a consolidated group.
[156] Rev. Proc. 2015-13, section 7.03(3)(b).
[157] Rev. Proc. 2015-13, section 2.07.
[158] Rev. Proc. 2015-13, section 8.01.
[159] Rev. Proc. 2015-13, section 8.02(1).
[160] Rev. Proc. 2015-13, section 8.02(2).
[161] Rev. Proc. 2015-13, section 8.02(3).
[162] Rev. Proc. 2015-13, section 8.02(4).
[163] Rev. Proc. 2015-13, section 8.02(5).
[164] Rev. Proc. 2015-13, section 8.02(6).

- Issue under consideration (*i.e.*, the item is already under consideration);[165] and
- Prior year IRS-initiated change.[166]

1) Taxpayers under examination

Absent exception, the IRS may require a taxpayer under examination as of the date the taxpayer files Form 3115 to change its method of accounting for the same item that is the subject of a Form 3115 for taxable years prior to the requested year of change. The numerous exceptions to this general rule are set forth in Rev. Proc. 2015-13, sections 8.02(1)(a)-(f), which are summarized below.

It is important to remember that if a taxpayer is under examination, before an Appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide an additional signed copy of the Form 3115 to the examining agent(s), Appeals officer(s), and all counsel to the government, as applicable, no later than the date the taxpayer timely files the Form 3115.[167]

(a) Change filed in three-month window

The rule denying audit protection for taxpayers under examination does not apply to a request for a change in method of accounting for an item filed in a "three-month window" if (1) the taxpayer has been under examination for at least 12 consecutive months as of the first day of the three-month window (for CFCs and 10/50 corporations the period is 24 consecutive months)[168], and (2) the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration (as described in section 3.08) as of the date the taxpayer files the Form 3115.[169]

A "three-month window" is the period beginning on the fifteenth day of the seventh month of the taxpayer's taxable year and ending on the fifteenth day of the tenth month of the taxpayer's taxable year.[170] For example, the three-month window for a calendar year corporation would begin on July 15th and end on October 15th. Special rules apply for taxpayers with 52-53 week taxable years[171] and for taxpayers with certain short taxable years.[172]

(b) Change filed in 120-day window

The rule denying audit protection for taxpayers under examination does not apply to a request for a change in method of accounting for an item filed in a "120-day window" if the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration (as described in section 3.08) as of the date the taxpayer files the Form 3115.[173] However, the 120-day window ends on the date the IRS notifies the taxpayer that jurisdiction for the case has been transferred from Appeals to the examining agent(s) for reconsideration.[174] The 120-day window exception is not available for a CFC or 10/50 corporation.[175]

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[165] Rev. Proc. 2015-13, section 8.02(7).
[166] Rev. Proc. 2015-13, section 8.02(8).
[167] Rev. Proc. 2015-13, section 6.03(3)(a).
[168] Rev. Proc. 2015-13, section 8.02(1)(a)(iii)(A).
[169] Rev. Proc. 2015-13, section 8.02(1)(a)(i). *See* special rules for CFCs and 10/50 corps in Rev. Proc. 2015-13, section 8.02(1)(a)(iii)(A)-(C).
[170] Rev. Proc. 2015-13, section 8.02(1)(a)(ii)(A) (as modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067).
[171] Rev. Proc. 2015-13, section 8.02(1)(a)(ii)(B) (as modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067).
[172] Rev. Proc. 2015-13, section 8.02(1)(a)(ii)(C) (as modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067).
[173] Rev. Proc. 2015-13, section 8.02(1)(b)(i).
[174] *Id.*
[175] Rev. Proc. 2015-13, section 8.02(1)(b)(iii).

A "120-day window" is the 120-day period following the date an examination of the taxpayer ends, regardless of whether a subsequent examination has commenced.[176]

(c) Present method not before director

The rule denying audit protection for taxpayers under examination does not apply to a request for a change in method of accounting for an item when the present method is not before the director.[177]

The present method is not before the director when it is: (A) a change from a clearly permissible method of accounting; or (B) a change from an impermissible method of accounting and the impermissible method was adopted subsequent to the taxable year(s) under examination on the date the taxpayer files the Form 3115.[178]

(d) New member of consolidated group in CAP

The rule denying audit protection for taxpayers under examination does not apply to a request for a change in method of accounting for an item requested by the common parent of a consolidated group that is participating in the Compliance Assurance Process (CAP) on behalf of a new member of the consolidated group for the taxable year the new member became a member of the consolidated group, if, as of the date the common parent of the consolidated group files the Form 3115: (A) the new member is under examination solely because it became a member of the consolidated group during a taxable year in which the consolidated group participates in the CAP, and (B) if the method of accounting for the item the new member is requesting to change is not an issue under consideration (as described in section 3.08) as of the date the taxpayer files the Form 3115.[179]

(e) Change resulting in negative IRC § 481(a) adjustment

The rule denying audit protection for taxpayers under examination does not apply to a change in method of accounting for an item that: (A) results in a negative IRC § 481(a) adjustment for that item for the year of change; and (B) would have resulted in a negative IRC § 481(a) adjustment in each taxable year under examination if the change in method of accounting for that item had been made in the taxable year(s) under examination.[180] An example illustrating this provision is provided in the revenue procedure.[181]

(f) No examination-imposed change and item not under consideration

Absent exception, for a taxpayer that is under examination for one or more taxable years on the date the taxpayer files a Form 3115, the rule denying audit protection for taxpayers under examination ceases to apply to the change in method of accounting for that item as of the date immediately following the earliest date that any of those examinations ends for the taxable year(s) subsequent to that taxable year and prior to the year of change to which the Form 3115 applies, if by the earliest date that any of those

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[176] Rev. Proc. 2015-13, section 8.02(1)(b)(ii).
[177] Rev. Proc. 2015-13, section 8.02(1)(c)(i).
[178] Rev. Proc. 2015-13, section 8.02(1)(c)(i)(A)-(B). Note that the question of whether the present method of accounting is a clearly permissible method of accounting or was adopted subsequent to the taxable year(s) under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2025-2, 2025-1 I.R.B. 118 (or successor).
[179] Rev. Proc. 2015-13, section 8.02(1)(d)(i).
[180] Rev. Proc. 2015-13, section 8.02(1)(e)(i).
[181] Rev. Proc. 2015-13, section 8.02(1)(e)(ii).

examinations ends: (A) the examining agent(s) does not propose an adjustment for the same item that is the subject of the Form 3115 for the taxable year(s) under examination; and (B) the method of accounting for that same item is not an issue under consideration within the meaning of section 3.08).[182] For certain foreign corporations, the applicant must satisfy additional requirements in order to receive audit protection at the end of the examination.[183]

3. Filing Requirements

a. Automatic Change Requests

Certain filing requirements applicable to automatic method changes are described below. Refer to Rev. Proc. 2015-13 *as modified, clarified and amplified* for the complete requirements.

1) Form 3115

The automatic change request should be filed via Form 3115, Application for Change in Accounting Method. The Form should be signed by an individual with the authority to bind the filing taxpayer. Certain statements/attachments may need to be attached, as applicable. No user fee is required to be paid to the federal government (compare to non-automatic change request user fee requirement below).

2) Multiple Taxpayers

Generally, a separate Form 3115 is required for each separate trade or business of the taxpayer to which consent for a change in method of accounting is requested.[184] However, there are common exceptions to this rule provided in Rev. Proc. 2025-1, sections 9.02 and 15.07(4) (or successor). Specifically, taxpayers may file a single Form 3115 on behalf of multiple applicants (*e.g.*, for two or more of its trades or businesses, two or more members of a consolidated group, or two or more controlled foreign corporations) if the present and proposed methods (as well as all other aspects of the change) of each applicant, as applicable, are identical. If relevant, an IRC § 481(a) adjustment is required to be computed for each separate applicant.

3) Time Frame for Filing

A taxpayer must attach the original Form 3115 to its timely filed (including extensions) federal income tax return for the year of change.[185] Importantly, taxpayers must also file a signed copy of the Form 3115 (duplicate copy) with the IRS in Ogden, UT no earlier than the first day of the year of change and no later than the date the original is filed with the federal income tax return for the year of change.[186] Failure to do so could invalidate the method change. As noted below, this filing window is more generous than the filing window afforded for a non-automatic changes. Certain options may exist for filing an automatic change request with a superseded return, provided such superseded return is filed prior to the final extended due date for the original return. Although not explicitly stated in Rev. Proc. 2015-13, it's the filing of the duplicate copy that initiates audit protection (provided audit protection otherwise applies to the change and the change is perfected/properly implemented).

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[182] Rev. Proc. 2015-13, section 8.02(1)(f)(i).
[183] Rev. Proc. 2015-13, section 8.02(1)(f)(ii).
[184] Rev. Proc. 2015-13, section 6.02(4).
[185] Rev. Proc. 2015-13, section 6.03(1)(a)(i)(A).
[186] Rev. Proc. 2015-13, section 6.03(1)(a)(i)(B).

b. Non-Automatic Change Requests

1) Form 3115

The non-automatic change request, similar to the automatic change request, should be filed via Form 3115, Application for Change in Accounting Method. However, the main differences between the non-automatic and the automatic change requests are (1) when/how consent to change the method is granted (2) the user fee requirement for non-automatic changes (discussed below); (3) the more limited time frame for filing non-automatic changes (discussed below) and (4) that the taxpayer must provide a full explanation of the legal basis supporting the proposed method (including all supporting and contrary authorities) for a non-automatic method change.[187] Certain other statements/attachments may also need to be attached, as applicable.

2) User Fee

A non-automatic change request must be accompanied by a user fee.[188] The amount of the user fee is set forth in the first annual revenue procedure (*e.g.*, Rev. Proc. 2025-1[189]) published each year. The user fee under Rev. Proc. 2025-1 is $13,225 for the first applicant and $280 for each additional applicant included on the same change request.[190]

3) Multiple Taxpayers

Generally a separate Form 3115 (and user fee) is required for each separate trade or business of the taxpayer to which consent for a change in method of accounting is requested.[191] However, there are common exceptions to this rule provided in Rev. Proc. 2025-1, sections 9.02 and 15.07(4) (or successor). Specifically, taxpayers may file a single Form 3115 on behalf of multiple applicants (*e.g.*, for two or more of its trades or businesses, two or more members of a consolidated group, or two or more controlled foreign corporations) if the present and proposed methods (as well as all other aspects of the change) of each applicant, as applicable, are identical. If relevant, an IRC § 481(a) adjustment is required to be computed for each separate applicant.

Additionally, taxpayers will sometimes try to file multiple non-automatic method changes on a single Form 3115. If the IRS believes that a Form 3115 contains more than one method change request, it will generally request additional user fees.

4) Time Frame for Filing

To be effective for a particular tax year (*i.e.*, the year of change), a non-automatic method change request (Form 3115) must be filed with the IRS National Office[192] on or before the last day of such year.[193] Note, however, that there are certain limited exceptions which allow a taxpayer additional time to file a Form 3115 after the year of change.[194]

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[187] Note that certain automatic method changes also require an explanation of legal basis. The specific automatic method changes subject to this requirement are listed in the instructions to Form 3115 (see discussion re: Lines 16a-c in the instructions revised in December 2022).
[188] Rev. Proc. 2015-13, section 6.03(2)(c).
[189] 2025-1 I.R.B. 1.
[190] Rev. Proc. 2025-1, Appendix A – Schedule of User Fees.
[191] Rev. Proc. 2015-13, section 6.02(4).
[192] Rev. Proc. 2015-13, section 6.03(2)(b).
[193] Rev. Proc. 2015-13, section 6.03(2)(a)(i).
[194] *See, e.g.,* Rev. Proc. 2015-13, sections 6.03(2)(a)(ii)-(iii) and 6.03(4)(b).

c. IRS National Office Review / Consent Process

Once a non-automatic change request is filed with the IRS National Office it will be assigned to an IRS attorney working in one of the branches that processes method change requests. The IRS attorney will review the request and will generally take one (or more) of the following actions: (1) request additional information (for which the taxpayer will generally have 21 days to furnish the additional information)[195]; (2) tentatively deny the change request, at which point the IRS attorney will offer a conference of right to discuss the method change)[196]; or (3) consent to the change request by issuing a ruling letter and a consent agreement that the taxpayer must sign and return within 45 days for the consent to be valid.[197] In addition, the taxpayer must attach a copy of the consent agreement to the taxpayer's federal income tax return for the year of change unless section 11.03(2)(e) applies (i.e., letter ruling received after implementing change).[198]

In certain instances, the taxpayer may not receive a ruling letter and consent agreement by the due date of the tax return for the year of change. In this situation it is generally recommended that the taxpayer continue to use its existing method of accounting for such year and consider "rolling-forward" the non-automatic change request to the next taxable year.[199] Other options exist; however, they present additional elements of risk. Should the taxpayer wish to request that the IRS delay the year of change until the next tax year, it must follow the procedures set forth in Rev. Proc. 2015-13, section 13. Additional considerations regarding the IRS National Office's review can be found in Rev. Proc. 2015-13, section 11.

C. Statutorily Mandated Changes

A statutorily mandated change is an accounting method change required by function of the tax law. Sometimes they arise from a change in law and other times they arise as a result of the application of existing law. These types of changes are primarily triggered by the growth of a taxpayer from a small taxpayer that is permitted to use a method of accounting available for only small taxpayers to a large taxpayer that is statutorily prohibited from using the method available specifically to small taxpayers (*e.g.,* small corporation taxpayer with less than $31 million in average gross receipts (for tax years beginning in 2025)[200] using the cash method of accounting that grows into a larger corporate taxpayer with average gross receipts in excess of $31 million will be statutorily required to change to the accrual method of accounting).

When encountered with a statutorily mandated accounting method change, taxpayers should always look to the Code and applicable regulations governing the change to determine special requirements for making the change. In some instances formal filings may not be required. To the extent the taxpayer fails to make the accounting method change in the taxable year in which it is

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[195] Rev. Proc. 2015-13, section 11.01(1). The IRS National Office may impose a shorter period (*i.e.,* less than 21 days) for any subsequent requests for additional information. For any request for additional information, taxpayers may request an extension of time to respond (not to exceed 15 days for non-automatic changes) to such request. However, the IRS has the discretion to deny the extension request.
[196] Rev. Proc. 2015-13, section 11.03(1).
[197] Rev. Proc. 2015-13, section 11.03(2)(a).
[198] *Id.*
[199] Rev. Proc. 2015-13, section 13.01(2).
[200] *See* Rev. Proc. 2024-40, section 2.31 ("For taxable years beginning in 2025, a corporation or partnership meets the gross receipts test of [IRC] § 448(c) for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $31,000,000.").

statutorily required to, then it will generally have to request permission (under the voluntary change procedures discussed above) to change its method of accounting to a permissible method.

D. Unauthorized Changes

As previously noted, IRC § 446 and the regulations thereunder require a taxpayer obtain the consent of the Commissioner prior to changing its method of accounting. If the taxpayer makes a change in method of accounting without obtaining consent (either by not filing a Form 3115 or not following the appropriate procedures for making the change), such change will be an unauthorized change.

Although the IRS may accept the unauthorized change in method of accounting if reviewed on exam, it largely depends on the situation. Where the unauthorized change is from an impermissible method of accounting to a permissible method of accounting that clearly reflects income, some courts have held that it would be an abuse of the Commissioner's discretion to deny the unauthorized change and force a taxpayer back on an impermissible method of accounting.[201] However, the prevailing view of most courts and the IRS (as provided in Rev. Proc. 2002-18[202]), is that the IRS may deny the unauthorized change on the grounds that the proper consent procedures were not followed and either place the taxpayer back on its former impermissible method, or go back to the earliest open year and place the taxpayer on any permissible method of accounting (perhaps not the one previously chosen by the taxpayer).[203] The IRS may attempt this, even if the unauthorized change occurred in a closed year.[204] This latter approach allows the IRS to assess interest and penalties on the underpayment of tax, while still permitting the use of the permissible method of accounting. Alternatively, where the method is from a permissible method of accounting to a permissible method of accounting, resulting in a taxpayer favorable § 481(a) adjustment, the IRS is likely to deny the unauthorized change and put the taxpayer back on its historical method of accounting. They would also have the ability to assess interest and penalties on any underpayment of tax caused by the unauthorized change.

In short, the main disadvantage of making an unauthorized change is the fact that the taxpayer is not afforded examination protection for the item in the taxable years prior to the year of change.

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[201] *See* FSA 200102004 and cases cited therein. Although, *see* Rev. Proc. 2002-18, section 2.06,which provides "The Commissioner may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. The Commissioner may do so even when the taxpayer changed from an impermissible to a permissible method."

[202] 2002-13 I.R.B. 678.

[203] *See, e.g., Sunoco, Inc. & Subsidiaries v. Commissioner,* 87 T.C. Memo. 2004-29 ("If the taxpayer changes the method of accounting used in computing taxable income without first requesting the Commissioner's consent, then the Commissioner would appear to have at least two choices. First, the Commissioner could assert section 446(e) and require the taxpayer to abandon the new method of accounting and to report taxable income using the old method of accounting... [s]econd, the Commissioner could accept the change of accounting method and require the taxpayer to make any adjustments which might be necessary to prevent amounts from being duplicated or omitted, sometimes called transitional adjustments."); *Nebeker v. Commissioner*, T.C. Memo. 2016-155 ("Petitioner never filed an application to change the method of accounting, nor did he follow the procedure for automatic consent laid out in Rev. Proc. 97-27, 1997-1 C.B. 680. Under section 446(e) respondent can require the [taxpayer] to abandon the new method of accounting and to report taxable income using the old method of accounting.").

[204] *But see Commissioner v. Brookshire Brothers Holding, Inc.*, 320 F.3d 507 (5th Cir. 2003), *aff'g* T.C. Memo. 2001-150, *reh'g en banc denied,* (5th Cir. 2003) (holding that the IRS may not reach back into a closed year in which an unauthorized method change took place as a basis for denying the use of a method in an open year).

E. Involuntary Changes & IRS Adjustments

When the IRS identifies an improper method of accounting for a particular item, it may either change the taxpayer's method of accounting for such item, or it may propose an adjustment for the years at issue without actually changing the taxpayer's method of accounting (in which case the taxpayer would have to use the voluntary change procedures discussed above to change its method of accounting for subsequent years). Rev. Proc. 2002-18 provides rules and procedures pertaining to both approaches. Rev. Proc. 2002-18 is designed in such a way to encourage taxpayers to use the voluntary change procedures to self-correct impermissible methods of accounting before they are identified by the IRS (*i.e.*, it is to the taxpayers advantage to correct an impermissible method of accounting via the voluntary change procedures as opposed to having the IRS correct via the procedures provided in Rev. Proc. 2002-18 because an involuntary change is generally made with an earlier year of change and a shorter IRC § 481(a) adjustment period for a positive adjustment.).[205]

1. Involuntary Change

When the IRS identifies an improper method of accounting that understates income and chooses to change such method of accounting, it will generally implement the method change in the earliest open year under examination and require the taxpayer to take the § 481(a) adjustment (computed as of the beginning of such open year) into account in full in that year (*i.e.*, no four year spread).[206] Interest and penalties will generally be imposed as a result. However, in certain instances the IRS will implement the change on a cut-off basis (*i.e.*, apply the new method prospectively without a retroactive IRC § 481(a) adjustment).[207] Alternatively, other agreements between the IRS and the taxpayer pertaining to the implementation of the new accounting method may be reached instead.

a. Notice Required

Rev. Proc. 2002-18, section 7.01 provides that the IRS (exam agent, appeals officer or government counsel) must provide the taxpayer with a written notice that the accounting method issue is being resolved via an accounting method change. If such notice is not provided, a new method of accounting will not be established and the "no-change" procedures described below are required to be followed instead. If the IRS provides the written notice, the new method of accounting will be established as of the beginning of the year of change and must be used by the taxpayer in all subsequent years, including those currently under exam for which returns have already been filed, as well as all intervening years.

b. Intervening Years

While the IRS will generally handle the taxable income adjustments (and thus tax liability adjustments) resulting from the involuntary method change for all years under examination, it is usually the responsibility of the taxpayer to file amended returns to reflect the new method of accounting on

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[205] Rev. Proc. 2002-18, section 1.02.

[206] Rev. Proc. 2002-18, section 5.04. *See also Wienke v. Commissioner,* T.C. Memo. 2020-143 ("When the change in method of accounting is involuntary (i.e., not initiated by the taxpayer), the entire amount of the adjustment is included in the taxpayer's income in the first taxable year in which taxable income is computed under a method of accounting that is different from the method that was used in the prior year."). However, see IRC § 481(b) (reduced tax rate on IRC § 481(a) adjustments) and Treas. Reg. § 1.481(a)-1(a)(2) (*removal* of pre-1954 balances from the IRC § 481(a) adjustment) for rules that may potentially reduce the amount of the unfavorable IRC § 481(a) adjustment imposed by the IRS on an involuntary method change.

[207] Rev. Proc. 2002-18, section 5.04.

any returns subsequently filed.[208] In many instances this is required prior to the execution of a closing agreement.[209] The taxpayer must use the new method of accounting for all future tax years unless the taxpayer obtains the consent of the Commissioner to change such method or the IRS changes the taxpayer from such method on a subsequent exam.[210]

2. Adjustment with No Change in Tax Accounting Method

As noted above, the IRS may choose to resolve an accounting method issue on a non-accounting method change basis. If it chooses this approach, it may resolve the issue on an alternative timing basis or a time-value of money basis. A closing agreement is required for both.[211] These resolution methods are generally only available to the IRS if the taxpayer is before appeals or before a federal court with respect to the accounting method issue(s).[212]

a. Alternative-Timing Basis

If an issue is resolved on an alternative-timing basis[213], the IRS will adjust the taxpayer's taxable income and tax liability to correct the issue for the tax years before appeals or before a federal court.[214] The taxpayer will then have to reflect the effect of such alternative-timing adjustments on all subsequent tax returns (as applicable); however, the taxpayer will be required to continue to file all subsequent tax returns using its present method of accounting for the items not covered by alternative-timing adjustments.[215] Stated differently, although previous occurrences of the issue may be resolved via the alternative-timing adjustments, new occurrences of the item must be accounted for on the taxpayer's present method of accounting (provided, of course, that the taxpayer does not file, and receive consent for, a voluntary method change request). These rules and additional rules governing the resolution of accounting method issues on an alternative-timing basis are provided in Rev. Proc. 2002-18, sections 8.03 and 8.04.

b. Time-Value-Of-Money Basis

If an issue is resolved on a time-value-of-money basis, the taxpayer agrees to pay an amount that approximates the time value of money benefit derived from using the method of accounting for the taxable years before appeals or before a federal court, reduced by an amount to reflect the hazards of litigation.[216] The IRS will not make any other adjustments to taxable income with respect

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[208] Rev. Proc. 2002-18, section 7.03.
[209] *Id.*
[210] *Id.*
[211] Rev. Proc. 2002-18, section 8.01.
[212] Rev. Proc. 2002-18, section 5.02.
[213] Rev. Proc. 2002-18, section 6.02(3) provides that in lieu of changing a taxpayer's method of accounting, an appeals officer or counsel for the government may resolve an accounting method issue by agreeing to alternative timing for all or some of the items arising during, or prior to and during, the taxable years before Appeals or a federal court. The resolution of an accounting method issue on an alternative-timing basis for certain items will not affect the taxpayer's method of accounting for any items not covered by the resolution.
[214] Rev. Proc. 2002-18, section 8.03(1)(a).
[215] Rev. Proc. 2022-18, section 8.03(1)(c).
[216] Rev. Proc. 2002-18, section 8.03(2). *See also* Rev. Proc. 2002-18, section 6.02(4) which provides that in lieu of changing a taxpayer's method of accounting, an appeals officer or counsel for the government may resolve an accounting method issue by agreeing that the taxpayer will pay the government a "specified amount" that approximates the time-value-of-money benefit the taxpayer has derived from using its method of accounting for the taxable years before appeals or a federal court (instead of the method of accounting determined by the appeals officer

to the taxpayer's method of accounting in such years.[217] The amount may not be taken as a deduction on the tax return for the year paid. A taxpayer resolving an issue on a time-value-of-money basis must continue to file its subsequent tax returns using its present method of accounting (provided, of course, that the taxpayer does not file, and receive consent for, a voluntary method change request). These rules and additional rules governing the resolution of accounting method issues on an alternative-timing basis are provided in Rev. Proc. 2002-18, sections 8.03 and 8.04.

VI. Recent Accounting Method Opportunities

A. In General

The enactment of Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly known as the Tax Cuts and Jobs Act ("TCJA"), Public Law 117-167, 136 Stat. 1366 (August 9, 2022), commonly known as the Creating Helpful Incentives to Produce Semiconductors Act of 2022 ("CHIPS Act"), Public Law 117-169, 136 Stat. 1818, 1818-1828 (August 16, 2022), commonly known as the Inflation Reduction Act of 2022 ("IRA"), and Public Law 119-21, 139 Stat. 72 (July 4, 2025), commonly known as the One, Big, Beautiful Bill Act ("OBBBA") (collectively, the "New Tax Legislation"), resulted in several new U.S. federal income tax regimes that opened the door for new tax planning strategies involving accounting methods and timing elections (i.e., elections that affect when, and how, an item of income or expense is taken into account). Gone are the days of traditional accounting methods and election planning to achieve "time value of money" benefits by deferring income and accelerating deductions. The New Tax Legislation introduced opportunities to use accounting methods and timing elections to provide permanent and quasi-permanent income tax benefits. The discussion below explores some of these opportunities.

B. The Interest Expense Limitation – Section 163(j)

1. The Regime and the Issue

Section 163(j)(1) limits the deductibility of business interest expense for a taxable year to the sum of (i) the taxpayer's business interest income for the taxable year, (ii) 30 percent of the taxpayer's adjusted taxable income for the taxable year, (iii) and the taxpayer's floor-plan financing interest[218] for the taxable year. A taxpayer's adjusted taxable income for a taxable year is equal to its taxable income for the taxable year with certain adjustments, including, for tax years starting after December 31, 2024, an adjustment to disregard depreciation and amortization.[219]

Any business interest expense that exceeds the limitation for a taxable year is disallowed and treated as incurred in the following taxable year.[220] While this rule has the effect of providing an indefinite carry forward of the disallowed interest expense attribute, taxpayers may find themselves perpetually limited and

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or counsel for the government to be the proper method of accounting), reduced by an appropriate factor to reflect the hazards of litigation.

[217] Rev. Proc. 2002-18, section 8.03(2).

[218] Floor plan financing interest is interest on debt secured by the taxpayer's motor vehicle inventory. *See* IRC § 163(j)(9). Note that section 70303 of the OBBBA modified the term "motor vehicle." The term previously meant any of the following (i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; (ii) a boat; (iii) farm machinery or equipment. The flush language of the statute was modified to make clear that the term "motor vehicle" shall also include "any trailer or camper which is designed to provide temporary living quarters for recreational, camping, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle."

[219] *See* IRC §163(j)(8).

[220] *See* IRC §163(j)(2).

unable to use that attribute (effectively, a permanent disallowance). This means that permanent tax savings can be achieved if otherwise disallowed interest expense can be recovered via other means.

2. The Opportunity

For taxable years beginning on or before December 31, 2025, the limitation under IRC § 163(j) applies only to business interest expense that would be deductible without regard to IRC § 163(j) (i.e., to the business interest expense amount determined after any provisions that disallow, defer, capitalize, or otherwise limit the deduction). Further, capitalized interest expense is not treated as business interest expense for purposes of IRC § 163(j).[221] Accordingly, any business interest expense that is capitalized under the taxpayer's method of accounting (for example, under IRC § 263A(f)), or an interest capitalization election (for example, under IRC § 266), avoids the interest expense limitation and assures the taxpayer of recovery (a potentially permanent tax benefit). Identifying short-lived assets to which business interest expense is required or permitted to be capitalized under IRC § 263A(f) and/or IRC § 266 can provide further value as any capitalized interest would be recovered more quickly (perhaps even during, or shortly after, the taxable year in which the capitalized interest is incurred).

Further, starting in 2025 taxpayers can use accounting methods and elections to capitalize otherwise deductible expenditures into the basis of depreciable or amortizable property (for example under IRC §§ 263(a), 263A, and the regulations thereunder), ideally to property that is eligible for 100% bonus depreciation under IRC § 168(k). This has the effect of increasing ATI (and thus the interest allowed under IRC § 163(j)) without significantly deferring the recovery of the otherwise deductible expenditure.

C. Base Erosion and Anti-Abuse Tax (BEAT) - Section 59A

1. The Regime and the Issue

Section 59A imposes a minimum tax (the BEAT) on an income base that is determined without regard to certain payments to foreign related parties (base erosion payments). Section 59A applies to certain large corporations ("applicable taxpayer") that satisfy a gross receipts test and whose base erosion payments comprise a certain percentage of their total deductions (generally 3%).[222] A base erosion payment ("BEP") includes "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under [Chapter 1 of the IRC]."[223] If a corporation that makes payments to a foreign related party can exclude such payment from the definition of a BEP, then it can potentially avoid status as an applicable taxpayer or reduce or eliminate a BEAT liability that would otherwise be imposed (a permanent tax benefit).

2. The Opportunity

Payments made to a foreign related party that are inventoriable or otherwise required to be capitalized (other than payments described in IRC § 59A(d)(2) to acquire depreciable property from the foreign related party), including by way of an election, are not considered to be BEPs under IRC § 59A(d)

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[221] *See* Reg. § 1.163(j)-3(b)(1) and (b)(5). However, for taxable years beginning after December 31, 2025, the § 163(j) limitation applies before the application of all interest capitalization provisions other than § 263(g) and § 263A(f). *See* section 70341 of OBBBA.
[222] *See* IRC § 59A(e).
[223] IRC § 59A(d)(1). IRC § 59A(d) identifies other payments that are base erosion payments, including payments to foreign related parties to acquire depreciable property from the foreign related party.

because such payments are not allowable as a deduction under chapter 1 of the IRC.[224] Accordingly, taxpayers may be able to utilize inventory and capitalization related methods and elections (for example, under IRC §§ 263A, 263(a), and 266 and the regulations thereunder) to prevent payments made to foreign related parties from being designated as BEPs.

D. Foreign-Derived Intangible Income (FDII) Deduction – Section 250

1. The Regime and the Issue

Section 250 provides a deduction ("FDII Deduction") generally equal to a specified percentage of a U.S. corporation's income that is derived from certain outbound sales and services ("FDII"). For 2025 taxable years, FDII is required to be reduced by all expenses and deductions properly allocable to such income.[225] For taxable years beginning after December 31, 2025, FDII is only required to be reduced by expenses and deductions, *other than interest expense and research or experimental expenditures*, properly allocable to such gross income.[226] The FDII deduction is a noneconomic deduction that reduces a corporation's effective tax rate on qualifying income. Accordingly, any increase in the FDII deduction amount provides a permanent tax benefit.

For domestic research or experimental expenditures incurred in tax years beginning after December 31, 2024, taxpayers can choose to: (i) currently deduct such expenditures under IRC § 174A(a), (ii) capitalize and amortize such expenditures (under § 174A(c)) over a period of not less than 60 months, beginning with the month in which the taxpayer first realizes the benefits from such expenditures, or (iii) elect to amortize such expenditures (under § 59(e)) over a 10-year period, beginning with the taxable year in which the taxpayer makes the expenditure. Additionally, for domestic research or experimental expenditures incurred and capitalized in 2022 through 2024 tax years under IRC § 174, as in effect prior to the amendments made by OBBBA, taxpayers can choose to: (i) continue to amortize such expenditures, (ii) claim a deduction for the unamortized portion of such expenditures for the first taxable year beginning after December 31, 2024, or (ii) ratably deduct the unamortized portion of such expenditures over a two-taxable year period, beginning with first taxable year beginning after December 31, 2024.[227] Selecting one or more of the treatment options above generally requires a taxpayer to make a change in method of accounting or an affirmative election.[228]

2. The Opportunity

Deferring domestic research or experimental expenditures (via one or more of the accounting methods and/or elections described above) results in a permanent increase in the taxpayer's lifetime FDII Deduction (as any domestic research or experimental expenditure deferred from 2025 to a later year will never reduce the lifetime FDII of the taxpayer. Any timing detriment from the deferral of such expenditures is generally more than offset by the permanent tax benefit from an increased FDII deduction.

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[224] *See, e.g.,* Treas. Reg. § 1.61-3(a) ("In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold…"), noting that cost of goods sold is a component of gross income and not a deduction that is allowable against gross income in computing taxable income under IRC § 63, and IRC § 261 ("In computing taxable income no deduction shall in any case be allowed in respect of the items specified in [IRC § 262 through § 280H]").
[225] *See* IRC § 250(b)(3)(A)(ii) as in effect prior to the amendments made by OBBBA.
[226] *See* IRC § 250(b)(3)(A)(ii).
[227] OBBBA § 70302(f)(2)(A).
[228] *See* Rev. Proc. 2025-28 for details on making these accounting method changes and elections.

E. Investment Tax Credits

1. The Regime and the Issue

Several federal income tax credits, many of which were added to the IRC or enhanced by the New Tax Legislation, are equal to a specified percentage of the tax basis of eligible property produced by the taxpayer for use in its trade or business.[229]

2. The Opportunity

Taxpayers can utilize self-constructed property methods of accounting under IRC § 263A to increase their tax basis in the eligible property produced. This has the effect of increasing the credit amount, resulting in a permanent tax benefit. In many cases the amounts capitalized under IRC § 263A will be eligible for 100% bonus depreciation under IRC § 168(k), thereby limiting the timing detriment from capitalizing such amounts.

[229] *See* IRC § 46 and the credits listed therein.