Chief Counsel Should Address Questions Related to Proposed Changes in the Automatic Consent Process

June 3, 2008

Reference Number: 2008-10-123

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

June 3, 2008

MEMORANDUM FOR CHIEF COUNSEL

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Chief Counsel Should Address Questions Related to Proposed Changes in the Automatic Consent Process (Audit # 200810030)

This report presents the results of our limited-scope review to evaluate the possible impact of the automatic consent process proposed in Notice 2007-88.[1] We limited our review to an assessment of the Office of Chief Counsel's (Chief Counsel) proposal to change the consent processes used by taxpayers to request changes to another method of accounting. This audit was conducted as a supplement to the Treasury Inspector General for Tax Administration Office of Audit Fiscal Year 2008 Annual Audit Plan.

Impact on the Taxpayer

The Chief Counsel is responsible for reviewing a taxpayer's request to change their method of accounting for Federal income tax purposes through its Change in Accounting Method (CAM) program. Although Chief Counsel has initiated and recommended actions to improve the efficiency of the CAM program, questions with the proposed automatic consent process must be addressed to ensure that the changes do not inadvertently affect tax compliance or the Internal Revenue Service's (IRS) ability to effectively administer this law provision. A strong CAM program will enable taxpayers to better understand the requirements for changing to another accounting method and help the IRS apply the tax laws correctly and uniformly.

[1] Proposed Changes to the Process for Obtaining the Commissioner's Consent to Change a Method of Accounting (Notice 2007-88), page 993 of Internal Revenue Bulletin 2007-46 (November 13, 2007).

Synopsis

During Fiscal Year 2007, the Chief Counsel initiated efforts to improve the efficiency of its CAM program and conducted an analysis to identify problems facing the program and provided recommendations for improvement. The results of this analysis were used to develop and issue Notice 2007-88, which requested public comments regarding the proposal to change the process taxpayers use to obtain the Commissioner's consent for changing their accounting methods. We reviewed the proposed changes and identified questions the IRS should address before implementing the proposed automatic consent process. Specifically, Chief Counsel should consider the:

- Possibility that the Commissioner's authority to extend the automatic consent process[2] to include non-routine and controversial accounting methods might be questioned. The Commissioner has applied the automatic consent process to the routine and non-controversial accounting methods. However, the proposed automatic consent process in Notice 2007-88 intends to expand the automatic consent process to all accounting methods, unless the accounting method the taxpayer wants to adopt is specifically identified as requiring the advance consent process.

- Impact proposed changes might have on the IRS' ability to ensure that taxpayers are compliant with tax laws governing accounting methods. While Notice 2007-88 indicates that automatic consent requests will be reviewed for completeness and permissibility of the accounting method change, it does not provide details on the level of review that will be performed. Further, at the time of our review, Chief Counsel had not developed a detailed plan for reviewing these requests to ensure that taxpayers would not change to accounting methods that were not permissible.

- Impact on the IRS' ability to detect taxpayers who make inappropriate use of the automatic consent process. A March 2007 analysis conducted by Chief Counsel showed that it is important for a post-consent review (i.e., examination) to exist. Chief Counsel management indicated that an option under consideration may be to shift review responsibilities to the Operating Divisions.[3] However, shifting the review from Chief Counsel to the Operating Divisions could adversely affect the IRS' administration over accounting method changes, particularly if the Examination functions do not have the resources or do not want the responsibility for reviewing the requests.

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[2] Under the automatic consent process, the Commissioner grants eligible taxpayers automatic consent to change to certain methods of accounting that Chief Counsel has determined to be routine and non-controversial. If the accounting method is not eligible for the automatic consent process, taxpayers must use the advance consent process.

[3] The four IRS operating divisions are the Wage and Investment, Small Business/Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities Divisions.

Response

We made no recommendations in this report. However, Chief Counsel management agreed with the observations and conclusions presented. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by this report. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

Table of Contents

Abbreviations

CAM	Change in Accounting Method
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
ITA	Income Tax and Accounting

Background

Each year, individuals and businesses are required to keep records and report income and expenses for a certain period of time called a tax year. Individuals and businesses must account for income and expenses in a way that clearly shows taxable income. The methods by which taxpayers assign items of income and expenses to specific taxable years are referred to as methods of accounting. Most taxpayers use either the cash method[1] or the accrual method[2] for their accounting. Usually, the determination of which accounting method to choose is made when a taxpayer files his or her first tax return.

If taxpayers want to change to another method of accounting, they must follow the statutory provisions in Internal Revenue Code (I.R.C.) Section (§) 446(e) and § 481. I.R.C. § 446(e) requires taxpayers to obtain the consent of the Internal Revenue Service (IRS) Commissioner (the Commissioner) prior to changing a method of accounting for Federal income tax purposes. This consent requirement permits the IRS the opportunity to review consent requests in advance to determine whether the new methods of accounting are permissible. Under the automatic consent process, the Commissioner grants eligible taxpayers automatic consent to change to certain methods of accounting that the Office of Chief Counsel (Chief Counsel) has determined to be routine and non-controversial. I.R.C. § 481 requires taxpayers to compute and report adjustments to their taxable income for any taxable year when changing accounting methods.

The Associate Chief Counsel, Income Tax and Accounting (ITA) Division, is primarily responsible for the administration of the Change in Accounting Method (CAM) program. The CAM program is the largest program for the Associate Chief Counsel, ITA Division, both in terms of number of cases received and amount of direct time spent. In Fiscal Year 2006, the ITA Division spent 34 percent of its direct time on the CAM program, even though one request to change an accounting method typically impacts only one taxpayer. By comparison, the ITA Division spent only 15 percent of its direct time developing published guidance[3] where one published guidance project impacts many taxpayers. To identify ways to improve the efficiency of the CAM program and enable the shifting of resources to other programs, the Associate Chief Counsel, ITA Division, requested the staff to perform a detailed analysis of its program.

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[1] Under the cash receipts and disbursements method (cash method), taxpayers report income when received and expenses when paid.
[2] Under the accrual method, taxpayers report income when earned and expenses when incurred.
[3] Published guidance is Chief Counsel's primary means of providing interpretation of the internal revenue laws.

The March 2007 analysis[4] shows the ITA Division spent approximately 30 percent of its direct time on a low volume of advance consent requests.[5] According to the study results, in many cases, the ITA Division was unable to respond to the advance consent requests in time for taxpayers to implement the changes on their tax returns. The inability to respond in a timely manner was caused by several fundamental problems facing the advance consent process. These problems included delays in assigning requests to an ITA Division professional upon receipt and delays caused by taxpayers providing incomplete information. Also, advance consent requests often involve novel and complex legal issues, which require a more in-depth review of the request to determine whether it is appropriate.

The Associate Chief Counsel, ITA Division, discussed the results of the March 2007 analysis with the Chief Counsel, Deputy Chief Counsel (Technical), and Deputy Chief Counsel (Operations). The Associate Chief Counsel, ITA Division, received approval to proceed with a project to consider whether to modify the process for requesting accounting method changes. On November 13, 2007, Notice 2007-88[6] was published in Internal Revenue Bulletin 2007-46[7] and outlined the proposed changes to the CAM program and expanded the number of accounting methods eligible for the automatic consent process. The notice requested that the public provide written comments by January 18, 2008 regarding the proposed change. After considering all public comments, Chief Counsel management informed us the plan is to implement the new CAM program on a pilot basis before making permanent changes.

We limited the scope of our review to an assessment of Chief Counsel's proposal to change the consent processes used by taxpayers to request changes of accounting methods. This review was performed at the Associate Chief Counsel, ITA Division, in Washington, D.C., during the period January through February 2008. We conducted this review in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[4] The Accounting Method Change Program: Analysis of the Problems and Recommendations for Improvement (March 16, 2007).
[5] Advance consent is required for all changes in accounting methods other than changes specifically permitted to be made under the automatic consent program.
[6] Notices are public pronouncements that may contain guidance that involves substantive interpretations of the I.R.C. or other provisions of the law. Proposed Changes to the Process for Obtaining the Commissioner's Consent to Change a Method of Accounting (Notice 2007-88), page 993 of Internal Revenue Bulletin 2007-46 (November 13, 2007).
[7] The Internal Revenue Bulletin is the authoritative instrument of the IRS used to announce all substantive rulings necessary to promote a uniform application of the tax law.

Results of Review

The Office of Chief Counsel Should Address Questions Regarding the Proposed Change in Accounting Methods Process

Notice 2007-88 describes in detail the existing accounting method change process versus the proposed accounting method change process. Under the existing process, taxpayers must use the advance consent process unless the accounting method the taxpayer wants to change to is specifically listed as an eligible method for the automatic consent process. According to Chief Counsel personnel, the IRS has identified more than 100 accounting methods for eligible taxpayers to elect to use under the automatic consent process. Most of these accounting methods are described in an appendix to Revenue Procedure 2002-9.[8] Taxpayers who comply with all of the applicable provisions of this revenue procedure are presumed to have obtained the consent of the Commissioner to change their method of accounting under the automatic consent process.

The notice proposes replacing the existing CAM program with a system under which taxpayers request to change their accounting methods through either the standard consent process[9] (proposed automatic consent) or the specific consent process[10] (proposed advance consent). The major difference between the existing and proposed consent processes is that taxpayers will be eligible to use the automatic consent process for many types of non-routine and controversial accounting methods, unless the method the taxpayer wants to change to is specifically identified as having to use the advance consent process. In addition, the scope of the review to be performed on the proposed accounting methods eligible for the automatic consent process is not specified. This could impact the tax compliance and administration that relate to changes in accounting methods. As a result, several stakeholders have raised concerns about the proposed consent processes, including whether the proposed consent process would violate I.R.C. § 446(e). The Treasury Inspector General for Tax Administration has identified the following questions for Chief Counsel's consideration. Specifically, Chief Counsel should consider the:

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[8] Methods of Accounting: Automatic Consent (Revenue Procedure 2002-9), page 327 of Internal Revenue Bulletin 2002-03 (January 22, 2002).

[9] The standard consent process is expected to operate similar to the existing automatic consent process. The IRS anticipates the majority of accounting method changes would be made through this process.

[10] The proposed specific consent process is to be available for two categories of accounting method changes: 1) accounting methods specifically identified in published guidance as required to be made under the specific consent process and 2) changes that otherwise qualify under the standard consent process, but specific consent is requested.

- Possibility that the Commissioner's authority to extend the automatic consent process to include non-routine and controversial accounting methods might be questioned.
- Impact proposed changes might have on the IRS' ability to ensure that taxpayers are compliant with tax laws governing accounting methods.
- Impact on the IRS' ability to detect taxpayers who make inappropriate use of the automatic consent process.

The Commissioner's authority to extend the automatic consent process to include non-routine and controversial accounting methods could be questioned

I.R.C. § 446(e) requires taxpayers to obtain the Commissioner's consent before changing to another method of accounting for Federal income tax purposes. Under the current rules, all requests are made using the advance consent process specified in Revenue Procedure 97-27,[11] unless the method being sought is specifically exempted from the advance consent requirement. If a method is exempt, taxpayers are permitted to use the automatic consent process. Accounting method changes made under the current automatic consent process include methods the IRS has determined to be routine and non-controversial.

Although the automatic consent process is not specifically provided for in I.R.C. § 446(e), the Commissioner has applied the automatic consent process to the routine and non-controversial accounting methods. However, the proposed automatic consent process in Notice 2007-88 intends to expand the automatic consent process to all accounting methods, unless the accounting method the taxpayer wants to change to is specifically identified as having to use the advance consent process. Under the automatic consent process, taxpayers are deemed to have obtained consent to make the change without an extensive IRS review. However, extending the automatic consent process to non-routine and controversial accounting methods could be viewed as not satisfying the consent requirement in I.R.C. § 446(e) because the central policy underlying this requirement is to allow the Commissioner the opportunity to review consent requests in advance.

Extending the automatic consent process to these accounting methods could allow the Commissioner's authority to be questioned. Notice 2007-88 indirectly acknowledges this in the language of the notice's Reasons for Change section. This section states, "The IRS believes that the proposal contained in this notice fulfills the broad policy aims of I.R.C. § 446(e)." In our opinion, some uncertainty exists in Chief Counsel's position, especially because the notice does not clearly address the legality of how the proposed automatic consent process fulfills the broad policy aims of I.R.C. § 446(e).

We are concerned that this authority might be questioned if the automatic consent process is expanded to include non-routine and controversial accounting methods. If this occurs and an

[11] Changes in Accounting Periods and Methods of Accounting (Revenue Procedure 97-27), page 10 of Internal Revenue Bulletin 1997-21 (May 27, 1997).

adverse ruling is later rendered on the change, Chief Counsel will probably be involved in the adverse decision. If this begins to occur regularly, some of Chief Counsel's resources will need to be refocused on the CAM program, instead of being shifted to other programs, such as published guidance.

The proposed changes might impact the IRS' ability to ensure that taxpayers are compliant with tax laws governing accounting methods

Under the existing advance consent process, taxpayers will generally not request a change to an accounting method they know Chief Counsel will not approve. This is because Chief Counsel conducts a review of the request, including requesting supplemental information or explanations from the taxpayer to help in determining whether the request is permissible. The effectiveness of this control is shown in Chief Counsel's March 2007 analysis, which reported that 87 percent of the advance consent requests reviewed by Chief Counsel were approved with little or no change.

However, the proposal outlined in Notice 2007-88 would extend the automatic consent process to methods not listed in Rev. Proc. 2002-9 or other automatic consent guidance. While Notice 2007-88 indicates that the automatic consent requests will be reviewed for completeness and permissibility of the accounting method change sought, it does not contain specific details on the level of review that will be performed. Further, at the time of our review, Chief Counsel had not developed a plan detailing the review process that will be performed when reviewing these requests to ensure that taxpayers would not change to accounting methods that were not permissible.

If the specifics of the review process for the newly eligible automatic consent requests are not adequately developed, taxpayers might be more likely to request a change to inappropriate or controversial accounting methods that might not be initially detected by the IRS. It is feasible that accounting method change requests, once sought using the advance consent process, could now be requested under the proposed automatic consent process and no longer be subject to a detailed review prior to approval. This might result in reduced compliance with the tax laws if taxpayers request changing to the non-routine and controversial accounting methods using this proposed process.

The IRS' ability to detect taxpayers who make inappropriate use of the automatic consent process could be adversely impacted

The review process for the proposed automatic consent requests under Notice 2007-88 might be limited and might be indirectly transferred to the Examination functions in the IRS Operating Divisions.[12] Requests by taxpayers to change to a new method of accounting that is not reviewed

[12] The four IRS operating divisions are the Wage and Investment, Small Business/Self Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities Divisions.

in advance would potentially become an issue that is considered during an examination (i.e., post-consent review).

The March 2007 analysis shows Chief Counsel's opinion "that a post-consent review process exist." This was based on Chief Counsel's belief that the determination of whether to select a tax return for examination rests with the IRS Operating Divisions, not with the Associate Chief Counsel, ITA Division's office. As a result, Chief Counsel management indicated that an option under consideration might be to shift review responsibilities to the Operating Divisions. At the end of our field work, no decision had been made as to whether Chief Counsel would continue the review of automatic consent requests or if the Operating Divisions would perform this review. However, shifting the review from Chief Counsel to the Operating Divisions could adversely affect the IRS' administration over accounting method changes, particularly if the Examination functions do not have the resources or do not want to accept the responsibility for reviewing the proposed automatic consent requests.

In addition, the post-consent review process by the Examination functions will only occur if the taxpayer's return is selected for examination, and the change of accounting method is one of the issues selected for review. In this instance, the Examination function would review the taxpayer's books and records and determine whether the taxpayer needs to make adjustments for improper or incorrect methods of accounting. As a result, the taxpayer might be required to pay interest and penalties to correct the return and might also be required to revert to their original method of accounting. This process could result in increased burden on taxpayers.

In summary, when taxpayer returns are selected for examination, the IRS could face a significant tax administration burden to identify and review the propriety of accounting method changes months or years later. This could reduce the IRS' ability to identify missing taxable income associated with accounting method changes and impact its ability to promote the uniform application of accounting methods. A strong CAM program will enable taxpayers to better understand the requirements for changing to another accounting method and help the IRS apply the tax laws correctly and uniformly. We are providing these observations for Chief Counsel's information, and we are not making any recommendations.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this limited-scope review was to evaluate the possible impact of the accounting method change consent processes proposed in Notice 2007-88.[1] These processes are used by taxpayers to obtain the IRS Commissioner's consent to change their method of accounting for income tax purposes. We limited the scope of our review to an assessment of the Office of Chief Counsel's (Chief Counsel) proposal to change the consent processes used by taxpayers to request changes of accounting methods. This report is being used to elevate our concerns that should be addressed prior to the issuance of any final guidance. To accomplish our objective, we:

I. Evaluated whether the change in the accounting method process, proposed under Notice 2007-88, might reduce tax compliance with respect to accounting methods.

   A. Evaluated the current and proposed published guidance used by taxpayers to obtain consent to change to another accounting method for income tax purposes.

   B. Interviewed the attorneys who drafted Notice 2007-88 and reviewed the Associate Chief Counsel, ITA Division's March 2007 analysis of the CAM program to determine whether additional program measures are planned or were implemented to ensure that the IRS' administration of accounting method changes is not adversely affected and result in reduced compliance with the tax law with respect to accounting methods.

   C. Evaluated inside and outside stakeholder's comments and suggestions to assess their position and concerns with the current and proposed changes in accounting method processes, both in complying with the new guidance (external) and in enforcing tax compliance (internal).

II. Evaluated the published guidance program controls used to initiate, develop, and issue Notice 2007-88.

   A. Determined why the published guidance project was initiated, developed, and approved.

   B. Evaluated the March 2007, Associate Chief Counsel, ITA Division's analysis and determined the reasons for the program change and the challenges facing the CAM

[1] Proposed Changes to the Process for Obtaining the Commissioner's Consent to Change a Method of Accounting (Notice 2007-88), page 993 of Internal Revenue Bulletin 2007-46 (November 13, 2007).

program that supports the need to change the process for taxpayers to request consent to change their accounting methods.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. In performing this review, we limited our analysis of internal controls to a review of the procedures used to process changes in accounting method requests. Our review did not identify any material weaknesses.

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Jeffrey M. Jones, Director
Diana M. Tengesdal, Acting Director
Joseph F. Cooney, Audit Manager
John W. Baxter, Lead Auditor
Tim A. Chriest, Senior Auditor
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Appendix III

Report Distribution List

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Office of the Commissioner – Attn: Chief of Staff C
Deputy Chief Counsel (Operations) CC
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Chief Counsel CC

Appendix IV

Management's Response to the Draft Report

CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR NANCY A. NAKAMURA
ASSISTANT INSPECTOR GENERAL FOR AUDIT
(HEADQUARTERS OPERATIONS AND EXEMPT ORGANIZATIONS PROGRAMS)

FROM: Donald L. Korb
Chief Counsel
Internal Revenue Service

SUBJECT: Draft Audit Report – Concerns Regarding Proposed Changes in the Automatic Consent Process Should be Considered Before Implementation (Audit # 200810030)

Thank you for the opportunity to review your draft report. As you know, we are studying the Change of Accounting Method (CAM) process to improve its efficiency for taxpayers, practitioners and the IRS. As part of our study, we issued Notice 2007-88 proposing an alternative to the current process, effectively (1) allowing taxpayers to make more changes under an automatic process thus (2) shifting Service resources to the review of more significant changes. Your report does not disagree with our approach but rather focuses largely on the question of monitoring compliance.

Your report correctly observes that the absence of a detailed review process may result in reduced compliance by taxpayers. We fully appreciate that concern and are designing a process for reviewing CAM requests for completeness and legal permissibility. Notice 2007-88 did not include a detailed description of the CAM review process for several reasons. First, we had not decided on the details at the time we issued Notice 2007-88. Second, the notice was a preliminary proposal intended to generate public comment. We did not want to limit comments to particular options. Third, we did not want to discuss our *internal* deliberations prematurely.

We have *internally* considered shifting the responsibility for reviewing automatic consent requests to the IRS Operating Divisions. Your report proposes to disclose that fact and to suggest that shifting responsibility from Counsel to the Operating Divisions could adversely impact the IRS's administration over method changes, if the Examination functions lack the expertise or resources to review automatic consent requests. We appreciate that risk. We want to emphasize that we have not yet decided to shift review responsibility to the Operating Divisions. That was just one of the options being considered. We are also considering continued Counsel review. As noted in our internal report, we intend to discuss these alternatives with the Operating Divisions before implementing either. Because of these continuing discussions, we intentionally did not specify in Notice 2007-88 whether Counsel or the Operating Divisions would review the requests. We ask that your report clearly indicate that shifting review responsibility is merely an issue under consideration and not a part of the proposal.

We remain confident that our proposal will improve taxpayer service while ensuring compliance in the CAM process. If you have any questions or need additional information about our proposal, please contact me or Clarissa Potter, Deputy Chief Counsel (Technical) at 202-622-3300.