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IRS Removal of Automatic Accounting Methods Sure to Disappoint

- *KPMG reviews revised automatic accounting method procedures*
- *Taxpayers should look at their plans for implementation*

The IRS's April [revision](#) to its automatic accounting method procedures means taxpayers now must obtain IRS consent in a formal letter ruling to change part of their tax treatment. This update is likely to cause disappointment and frustration, because taxpayers generally favor automatic procedures due to their lack of a user fee, deemed consent from the IRS, and less restrictive timeline for filing changes.

The revision affects how taxpayers apply [Rev. Proc. 2015-13](#) by removing two common accounting method changes from the list of automatic ones: changes to certain cost capitalization methods for inventory or self-constructed property, and certain changes to the proper timing of recognizing revenue. Taxpayers planning to make either of these accounting method changes should revisit their timetable for implementation.

[Form 3115](#) for accounting method changes in the automatic list can be filed at any time up until the timely filing of the tax return for the year of change. However, the non-automatic method change procedures require companies to request IRS consent by filing the Form 3115 by the last day of the desired tax year of change (along with a user fee).

If a taxpayer files a non-automatic Form 3115 asking to change a clearly permissible method of accounting, IRS consent typically is expected but not guaranteed. Rev. Proc. 2015-13 states the IRS National Office may deny a request to change a method if it determines the requested method doesn't clearly reflect the taxpayer's income or otherwise wouldn't be in the interest of sound tax administration.

Cost Capitalization Changes

Taxpayers wishing to change their method for capitalizing certain indirect costs to inventory or self-constructed assets may now be subject to non-automatic change procedures.

Changes no longer eligible for automatic consent involve the direct reallocation method (which generally results in allocation and capitalization of all indirect support department costs to property rather than only a portion) or the step-allocation method (which performs a sequential allocation of costs among departments before allocating them to property).

Relative to other methods, both the direct reallocation and step-allocation methods generally result in a taxpayer allocating and capitalizing the most indirect costs to property, resulting in increased tax basis and taxable income.

These methods have become more attractive to taxpayers looking to manage income and attributes via tax planning to postpone/capitalize otherwise deductible amounts. Now those taxpayers will need to revisit their planned method changes to determine whether the non-automatic procedures will apply.

Revenue Recognition Changes

Accrual method taxpayers also must comply with a requirement in the federal tax code involving the all-events test. This mandates that all events fixing an accrual-method taxpayer's right to receive income or incur expense must take place before a taxpayer can report an item of income or expense.

[Section 451](#)'s requirement says the all-events test can't be treated as being met any later than when the related revenue is recognized in the taxpayer's applicable financial statements. This is known as the AFS income inclusion rule.

Absent this rule, the all-events test generally requires income recognition for tax purposes when all the events have occurred that fix the right to receive the income and the amount of such income is determinable with reasonable accuracy.

Automatic consent for changes to comply with the AFS income inclusion rule had been scheduled to sunset in 2023. The new procedures retain that timeline but narrow the scope of the automatic change for the 2023 tax year to exclude any changes to comply with the general all-events test under Section 451.

Some taxpayers working to comply with the AFS income inclusion rule have discovered that they're using impermissible methods of recognizing revenue under the general all-events test. Generally, this is caused either by changes to the overall business or to the way revenue is recorded in the financial statements that inadvertently resulted in an improper tax method.

The obvious overlap between the general all-events test rules and the new AFS income inclusion rule, as well as informal statements from the IRS, made it appear that taxpayers could make any required corrections to their revenue recognition methods under the all-events test as part of the automatic procedures to comply with the new rules. As such, taxpayers thought they had until the filing of their 2023 tax year returns to correct any of these collateral issues that have been uncovered.

The retroactive removal of this change from the automatic procedures likely will be particularly burdensome for companies trying to comply with the final Section 451 [regulations](#). It also seems unnecessarily harsh, given that none of the Section 451 changes would have been automatic for the 2024 tax year under prior automatic method change procedures.

Moving Forward

These procedures are effective for Forms 3115 filed on or after April 30, 2024—the date the revised procedures were released—for a year of change ending on or after Sept. 30, 2023.

If a taxpayer filed an application to change its method for one of the above items prior to April 30, 2024, or its tax year ends before Sept. 30, 2023, it is still eligible to use the automatic method change procedures to implement such a change. Otherwise, these changes must be made using the non-automatic change procedures.

The IRS provided a transition rule for taxpayers to temporarily allow these non-automatic changes to be made until the extended due date of the return for the year of change. This way, taxpayers can still make one of these changes for their last tax year ending before April 30, 2024.

Depending on the type of method change requested and volume of applications being reviewed by the IRS, the company may not have an answer from the IRS on whether their application will be approved by the time the related tax return is filed.

While the IRS is likely to approve a change to a clearly permissible method, the criteria the IRS will use to decide whether to consent to one of these requests is unclear. Taxpayers will have to await feedback from the IRS on their applications to find out exactly what information the IRS will want to grant consent.

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