

IRS Grants Automatic Consent for "Section 118" Accounting Method Changes

Tax Controversy Alert

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In Rev. Proc. 2008-52, 2008-36 I.R.B. (Aug. 18, 2008), the Internal Revenue Service has granted "automatic consent" for taxpayers to change their methods of accounting under section 118 with respect to non-shareholder contributions to capital. The consent applies regardless whether the taxpayer is changing from treating an amount as non-qualifying to treating it as qualifying, or vice versa.

Section 118(a) permits corporations to exclude from gross income any payment received as a contribution to capital, regardless whether received from a shareholder or a nonshareholder. The IRS has become increasingly concerned that some taxpayers are applying section 118 more broadly than intended by Congress, and has identified "section 118 abuse" as a Tier 1 issue under its Industry Issue Focus initiative. This has increased the likelihood that the IRS will closely scrutinize and potentially challenge any taxpayer that has relied on section 118 to exclude any receipt from gross income, regardless of past audit experiences.

Accordingly, a number of taxpayers are reassessing the strength of their positions under section 118 and considering their options for minimizing their audit exposure. Some taxpayers have filed amended returns modifying their application of section 118 to amounts received in prior years; others are changing their positions prospectively, without seeking IRS consent. In Rev. Rul. 2008-30, 2008-25 I.R.B. 1156, the IRS asserts that changes in the application of section 118 are changes in accounting method requiring IRS consent. This position conflicts with the Tax Court's holding in *Saline Sewer Co. v. Commissioner*, T.C. Memo 1992-236. Regardless of the validity of Rev. Rul. 2008-30, it signals that the IRS is likely to challenge a taxpayer that alters its application of section 118 without first obtaining IRS consent.

Rev. Proc. 2008-52 provides some relief. So long as the procedural requirements of the revenue procedure are satisfied, taxpayers can immediately begin including in taxable income receipts that it previously would have excluded as non-shareholder capital contributions, or vice versa. The taxpayer immediately obtains audit protection for prior years, eliminating the risk of an audit adjustment, assuming Exam accepts the validity of the new method.

Under the effective date of Rev. Proc. 2008-52, this method change can be made for any tax year ending on or after December 31, 2007. Taxpayers desiring to make the method change effective for 2007 (generally those seeking to begin applying section 118 to exclude payments from income) have limited time to do so. The Form 3115 required to make the method change must be attached to the taxpayer's timely filed (with extension) federal tax return for the year of change, and a signed copy sent to the IRS National Office by that date. Thus, for calendar year taxpayers seeking to change to a method under which payments will be excluded from gross income, making the change effective for 2007 requires attaching the Form 3115 to the return that will be filed by September 15, 2008. If that is not practical, or for those taxpayers desiring to change to a method under which section 118 will no longer be applied to exclude the payments from income, the change can be made effective for 2008 by filing a signed "duplicate copy" of the Form 3115 with the National Office as soon as practicable, and attaching the original to the 2008 tax return when filed next year. The method change is effective, and the taxpayer receives audit protection, as soon as it mails the signed copy of the Form 3115 to the National Office, regardless whether the change is being made for 2007 or a later year. Taxpayers wishing to make the change for 2008 need not wait until the 2007 return is filed.

Taxpayers changing to a method that treats an amount as qualifying for exclusion under section 118 should be aware that because the new procedures require the Form 3115 to clearly indicate that the taxpayer is changing its method of applying section 118, the method change will not escape the attention of the IRS. The National Office may well have established a tracking system to monitor automatic method changes being made with respect to high-profile issues, including those under section 118. As such,

while the procedure for making this method change is now less burdensome, the likelihood of the IRS reviewing the change on a "post-consent" basis probably has not diminished significantly.

Further, simplifying the ability to change an accounting method does not affect whether the IRS ultimately will agree with the taxpayer's legal analysis that a payment is excludible from income under section 118. Therefore, where the taxpayer is changing its method from including a particular payment in income to instead excluding the payment as a non-shareholder capital contribution, the ability to make this change automatically rather than through the "prior-consent" process of Rev. Proc. 97-27 is unlikely to reduce the level of IRS scrutiny the new method receives.

Miller & Chevalier is available to assist taxpayers in assessing the strength of their positions under section 118, in weighing the options for minimizing audit exposure, and in defending those positions administratively and, where necessary, through litigation. Where a method change is necessary or appropriate, Miller & Chevalier is available to assist.

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