

Correcting Accounting For Deferred Revenue

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When changing a method of accounting from an impermissible method to a permissible method, all facts and circumstances must be considered by both the taxpayer and the practitioner, who must both look to various forms of guidance. The following example analyzes changing the method of accounting for deferred revenue from an impermissible method to a permissible method.

Example: Taxpayer C, a C corporation, has adopted its fiscal year end of December 31 as its tax year end. The company has elected the accrual method of accounting for tax purposes.

Historically C's prior year income tax returns were prepared based on unaudited financial statements. During the financial statement audit for the most recently completed three years, the audit firm proposed significant adjustments to the accounting for deferred revenue, and these adjustments were accepted by the client. The firm also discovered that the originally filed tax returns did not include proper tax adjustments for deferred revenue. All prior year returns were filed, on the extended due date, in a consistent manner regarding deferred revenue for all periods of C's existence.

Issues

1. Does the consistency of omitting proper book-to-tax adjustments for deferred revenue, even if erroneous, represent the adoption of an accounting method?
2. Must the taxpayer obtain IRS consent to change its accounting method to properly report income from deferred revenue?
3. In which period may the taxpayer change its erroneous method to the proper method?
4. What is the mechanism for making such a change?

Analysis

In this example, the taxpayer has consistently reported deferred revenue on the previously filed tax returns using its book method, regardless of when advanced [payments](#) were actually received. The IRS ruled in Rev. Proc. 97-27 that consistent treatment of a material item 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 the regulations. Regs. Sec. 1.446-1(a)(1) states that the term "method of accounting" includes not only the overall

accounting method of the taxpayer "but also the accounting treatment of any item."

Regs. Sec. 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 a material item used in the overall plan. A material item is any item that involves the proper time for including the item in income or taking a deduction (Regs. Sec. 1.446-1(e)(2)(ii)(a)). Any change related to deferred revenue will certainly fall under these regulatory definitions and will result in the adoption of such method if consistently used, even if erroneously, by the taxpayer.

A taxpayer who has an erroneous method of accounting should change its method of accounting to an acceptable method. This is more common sense than anything else. A practitioner who discovers an erroneous accounting method while providing services to a new or existing client is under a professional obligation to advise the client to correct its reporting (AICPA Statements on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation*, and No. 7, *Knowledge of Error: Administrative Proceedings*). Certainly under the new Sec. 6694 preparer penalty standards, a practitioner is also acting in his or her own best interests to not continue further erroneous reporting.

Correcting an Erroneous Method

Can the correction be made on an amended tax return for previous years, or must Form 3115, Application for Change in Accounting Method, be filed? The Code, regulations, and published guidance must all be reviewed when answering this question.

Sec. 446(e) states that "except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary."

Rev. Rul. 90-38 states that

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.... Instead, the taxpayer may only change the method of accounting with the consent of the Commissioner pursuant to section 1.446-1(e) of the regulations.

Regs. Sec. 1.446-1(e)(3)(i) states that "to secure the Commissioner's consent to a

taxpayer's change in method of accounting the taxpayer must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting."

Rev. Proc. 2008-52 waives the requirements under Regs. Sec. 1.446-1(e)(3)(i) for certain method changes and allows the application to be filed by the extended due date of the tax return "for any application for a change in method of accounting filed pursuant to this revenue procedure."

Rev. Proc. 2008-52, issued on August 18, 2008, provides for automatic consent to change accounting methods for certain situations. The appendix identifies a broad array of method changes for which the procedure is applicable. One key modification provided by Rev. Proc. 2008-52, §§6.02(2) and (3), states that timely filing is made by filing Form 3115 by the extended due date of the tax return for the year of change. Previously the application needed to be made by the end of the fiscal year in which the change was desired. The taxpayer is precluded from making a change in a previous period by filing amended returns. Because the taxpayer has adopted and continuously used an

erroneous method of accounting, it is barred from filing amended returns to retroactively account for the deferred revenue adjustments.

Conclusion

The company in the example above should file a Form 3115 to obtain IRS consent to change its method of accounting. Under Rev. Proc. 2008-52, the taxpayer must file the [application](#) in duplicate. The original is attached to the income tax return for the year of change (filed by the extended due date), and a signed copy is filed with the IRS National Office no earlier than the first day of the year of change and no later than

the original is filed with the return for the year of change.

This change will create either a positive or a negative Sec. 481(a) adjustment. A positive Sec. 481(a) adjustment is generally taken into account in taxable income in the year of the change and the next three years. A negative adjustment is generally taken into account in taxable income in the year of the change. The adjustment is not a direct tax assessment. This income recognition event may or may not give rise to tax. Therefore, interest and penalties are not applicable on the net Sec. 481(a) adjustment until and unless tax actually results, and then only if not timely paid.