Chapter 2

Selection of Entity, Tax Year, and Accounting Method

Entity Overview

Veterinarians provide their services through proprietorships, partnerships, corporations, and limited liability companies (elective by either a partnership or corporation). If a veterinary medical practice is organized as a C corporation, the corporation may be subject to IRC section 441 (concerning personal service corporations (PSCs)) and IRC section 448 (concerning qualified personal service corporations (QPSCs)). These rules also apply to a limited liability company that elects to be taxed as a corporation.

A. Personal Service Corporation

Under IRC section 441, a "personal service corporation" is a C corporation whose principal activity is the performance of personal services and whose personal services are substantially performed by employee-owners.

IRC section 448 requires all C corporations to use an accrual method of accounting for the first taxable year beginning after December 31, 1986, unless one of the enumerated exceptions is satisfied. IRC section 448(b)(2) provides an exception for qualified personal service corporations. To be a QPSC, a corporation must satisfy both a function test and a stock-ownership test. See IRC section 448(d)(2), Treas. Reg. section 1.448-1T(e)(4), Treas. Reg. section 1.448-1T(e)(5).

Function Test

Substantially all (95 percent or more) of the activities of the corporation must involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. For this purpose, the performance of any activity incident to the actual performance of services in the qualifying field is considered the performance of services in that field. For example, supervising employees who perform qualifying

services and performing administrative and support services incident to those activities. See IRC section 448(d)(2)(A) and Treas. Reg. section 1.448-1T(e)(4).

Stock-ownership Test

Substantially all (95 percent or more) of the corporation's stock (by value) must be owned directly (or indirectly through one or more partnerships, S corporations, or QPSCs not described in IRC section 448(a)(2) or (3)) by:

1. employees who are performing services that satisfy the function test on the corporation's behalf (for example, a physician performing medical services);
2. retired employees who had performed these services on the corporation's behalf;
3. estates of employees or retired employees who had performed these services on the corporation's behalf; or
4. other persons who acquired stock from employees or retired employees who had performed services on the corporation's behalf (but only for a 2-year period). See IRC section 448(d)(2)(B) and Treas. Reg. section 1.448-1T(e)(5).

The common parent of an affiliated group (within the meaning of IRC section 1504(a)) may elect to treat all members of that group as a single taxpayer for the purpose of testing whether the stock-ownership test has been met. See IRC section 448(d)(4)(C) and Treas. Reg. section 1.448-1T(e)(5)(vi).

Effects of Being a PSC

1. **Flat 35 Percent Corporate Tax Rate** -- unlike other C corporations which are subject to graduated income tax rates beginning at 15 percent, a PSC is taxed at a flat tax rate of 35 percent.
2. **Calendar Year Required** -- unlike other C corporations, which can adopt a fiscal tax year, a PSC is required to adopt a calendar year unless they can show a business purpose.
3. **Passive Activity Losses Limited** -- unlike many C corporations which can deduct passive losses against their active income, a PSC cannot offset passive losses against its active income. However, generally a PSC will

not have passive losses because the PSC will be treated as materially participating under IRC section 469(h)(4) as a result of the activity of the majority shareholder.

B. Conversion of a PSC to a Limited Liability Company

Many PSCs might prefer to organize as a Limited Liability Company (LLC) because of the greater flexibility afforded LLCs. Presently, PSCs must pay a corporate tax at the highest corporate rate without the advantage of graduated rates. There are special classification issues for PSCs as to whether they can use the cash method of accounting or elect to use IRC section 444 fiscal year. These same classification issues could be avoided by moving into LLC status.

Converting to an LLC may be relatively easy for the single-owner PSC. In these situations, the PSC probably pays little if any corporate tax because earnings are paid out as deductible compensation to the shareholder/employee.

The most substantial asset that the PSC has is its accounts receivable and possibly a partnership interest in a lower-tier partnership. Under the cash method of accounting, a distribution out of the receivables would trigger an IRC section 336 gain on liquidation to the extent of the fair market value as reflected in the zero basis receivables. Thus, rather than liquidating immediately, the receivables could be retained in the PSC until they are collected and income is recognized on their receipt. Any cash would then be paid out in the form of compensation and the corporation could then be liquidated without any further tax (unless there is a partnership interest distributed).

Note: Costs for converting a PSC to an LLC (that is, legal fees) should be capitalized. See *Indopco, Inc.* v. *Commissioner*, 503 U.S. 79, 112 S. Ct. 1039 (1992).

Determination of a Tax Year

Determining the correct tax year to be used for reporting purposes can have a major impact on how income and expenses will be reflected, both on the practice's books and on the tax return. As previously mentioned, veterinarian practices differ in the type of animals treated which can

affect when income is received versus when expenses are paid. To counter this problem, the veterinarian will have to determine the correct tax year to use.

Generally, a corporation meeting the definition of a PSC under IRC section 441 is required to utilize a calendar year accounting period for purposes of filing its tax return. However, if the corporation can establish a business purpose, they may request a different taxable year under IRC section 441(i).

There are two different methods for establishing a substantial business purpose for using a tax year other than the required calendar year. Under the first method, the partnership, S corporation, or PSC can establish a "natural business year" by meeting a mechanical test. See section 4 of Rev. Proc. 87-32, 1987-2 C.B. 396. An entity that cannot satisfy the requirements for demonstrating a natural business year under Rev. Proc. 87-32 may attempt to establish a substantial business purpose under the more general facts and circumstances test.

The mechanical test for a natural business year is one in which at least 25 percent of the taxpayer's gross receipts are received in the last 2 months of the 12-month period that the taxpayer desires to use as its tax year. The gross receipts from sales and services are calculated for the most recent 12-month period of the requested fiscal year that ends before filing the request. Gross receipts are also calculated for the last 2 months of the same period. The yearly figure is divided into the 2-month figure and must equal at least 25 percent. The same calculations are made for the two 12-month periods preceding the 12-month period used in the initial calculations as required in Rev. Proc. 87-32, Exhibit 2-1. A taxpayer that does not have a 47-month history of gross receipts may not establish a natural business year. If more than one fiscal year qualifies as a natural business year, the taxpayer must use the fiscal year producing the highest percentage of receipts in the last 2 months.

The facts and circumstances test could include factors that may indicate a substantial business purpose such as: seasonal business taxpayers, inability to meet the natural business year test due to unusual circumstances, or more than one natural business year. See Rev. Proc. 74-23, 1974-2 C.B.

489. Factors that are generally insufficient to establish a substantial business purpose include accounting purposes and taxpayer's convenience.

The veterinarian must demonstrate a substantial business purpose for adopting a particular fiscal year based on all of the facts and circumstances, including the tax consequences of the election. If the requested tax year creates a deferral or distortion of income or deductions, nontax factors must demonstrate compelling reasons for the requested tax year. See Rev. Rul. 87-57, 1987-2 C.B. 117.

Some of the tax consequences that will be considered in determining whether to accept a fiscal year based on a substantial business purpose are:

1. whether the tax year would defer a substantial portion of a taxpayer's income or shift a substantial portion of the taxpayer's deductions from one year to another, resulting in a substantial reduction in the taxpayer's tax liability;
2. whether the tax year would cause an income deferral or shift of deductions to any other person, such as a partner, beneficiary, or shareholder; and
3. whether the desired tax year would create a short period in which there is a substantial net operating loss.

How to Request a Change in Tax Year under Rev. Proc. 87-32 (Form 1128)

If a partnership, S corporation, or a PSC desires to change to a tax year that is its natural business year (section 4.01(1)), or an S corporation desires to change to a tax year that meets the "ownership tax year test" (section 4.01(2)), then Form 1128, Application for Change in Accounting Period, must be filed with the IRS, Exhibit 2-2. Form 1128 must be filed on or before the 15th day of the second calendar month following the close of the short period for which a return is required in order to effect the change in the accounting period.

The following information should be attached to Form 1128:

1. whether the selected tax year represents a retention or a change of tax year;
2. the calculations for the mechanical test as described above; and

3. the following representation, whichever is applicable, signed by a partner, in the case of a partnership, or by an authorized corporate officer:

"Under penalties of perjury, I represent that *(insert name of veterinarian)* is changing to a tax year that coincides with its natural business year as defined in section 4.01(1) and as verified by its satisfaction of the requirements of section 4.02(1) of Rev. Proc. 87-32."

or

"Under penalties of perjury, I represent that, as of *(insert the first day of the tax year to which the request relates)*, shareholders holding more than one-half of the shares of the stock of *(insert name of S corporation)* have the same tax year or are concurrently changing to the tax year that *(insert name of S corporation)* is changing to per this statement."

A PSC desiring to change to a fiscal year that coincides with its natural business year may use an expeditious approval process. Form 1128 should be marked "filed under Rev. Proc. 87-32" and filed with the IRS service center where the taxpayer files its returns. There is no user's fee when requesting the change under Rev. Proc. 87-32. Taxpayers who do not meet the natural business year test may request permission to adopt a fiscal year for business purposes by filing Form 1128 with the IRS's National Office in Washington.

Selection of Proper Accounting Method

An accounting method is a set of rules used to determine when and how income and expenses are reported. The choice of accounting method includes not only the overall method of accounting used, but also the accounting treatment used for any material item.

A taxpayer chooses its accounting method when it files its first tax return. After that, if a taxpayer wants to change its accounting method, it must first get permission from the Commissioner of Internal Revenue. See "Change in Accounting Method," later.

There are three main methods of accounting which may be used by veterinarians.

A. Cash Method

The cash method of accounting is used by most sole proprietors, PSCs and partnerships with no inventories. However, if inventories are necessary in accounting for income, then the accrual method for sales and purchases is required. With the cash method, all items of income actually or constructively received during the year are included in gross income. This includes the fair market value of property and services received. Usually, expenses are deducted in the tax year in which actually paid.

B. Accrual Method

Under an accrual method of accounting, income is generally reported in the year earned, even though payment may be received in another tax year. Items are included in gross income in the tax year in which all events that fix the right to receive the income, and the amount can be determined with reasonable accuracy. Business expenses are deducted or capitalized when the liability is incurred, whether or not they are paid in the same year. For this purpose, the liability is recognized in the tax year in which both the "all events" test and the economic performance rules are met. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

C. Hybrid Method

The hybrid method is the use of any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and it is used consistently. However, the following restrictions apply:

1. If inventories are necessary to account for income, then the accrual method must be used for purchases and sales of inventory items. An accrual method must also be used to account for the receipts from services that are intertwined with the sales of inventory items. The cash method may generally be used for all other items of income and expenses.
2. If the cash method for reporting expenses is used, then the cash method for computing income must also be used.
3. If an accrual method for reporting expenses is used, then that accrual method must also be used for figuring income.

Use of the hybrid method of accounting in a veterinary practice could include reporting the sale of veterinary products that are not provided in connection with services on the accrual basis AND reporting the veterinary services and *de minimis* merchandise provided in connection with such services under the cash method. Treas. Reg. section 1.446-1(c)(1)(iv) recognizes that a combination of methods of accounting may be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. A hybrid method might clearly reflect income if:

1. the merchandise provided incident to services is *de minimis*;
2. the other veterinary products sold by the taxpayer are severable from the services and related *de minimis* merchandise; and
3. the taxpayer keeps its books and records in such a way that the purchase and sale of veterinary products can be separated from the sales of services and *de minimis* merchandise (for example, the taxpayer bills separately for the veterinary products, and the mixed services and *de minimis* merchandise, and, to the extent common payments are received, they are reasonably allocated between the separate bills).

A taxpayer using a hybrid method of accounting may operate as a single trade or business and may maintain a single set of books and records for such business.

Is Merchandise an Element in the Taxpayer's Business and Is It Income-Producing?

Historically, veterinary practices have been considered a service industry. However, as noted in Chapter 1, most practices act as a pharmacy since commercial pharmacies rarely have the required type or amount of pharmaceuticals for animals. Treas. Reg. sections 1.471-1 and 1.446-1(a)(4)(i) require accounting for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the business. Items sold must be "merchandise" and an "income-producing factor," in order for the Commissioner to require the use of inventories.

The first step in this analysis is to determine whether the taxpayer has "merchandise." At this stage, it is important to

distinguish between merchandise for sale and material/ supplies. The term "merchandise" is not defined within the Code or underlying regulations. However, in *Wilkinson-Beane, Inc.* v. *Commissioner*, 420 F.2d 352, 354 (1st Cir. 1970), the Court defined merchandise as tangible personal property held for sale. Based on the regulations and the case law, the Service has determined that for purposes of Treas. Reg. section 1.471-1, merchandise is property transferred to a customer (including property physically incorporated in that which is transferred to a customer), whereas materials and supplies are property consumed during the production of property or provision of services.

The next step in the analysis is to determine whether the production, purchase, or sale of such merchandise is an income producing factor in the taxpayer's business. In cases involving the provision of services and the transfer of related merchandise by a taxpayer, the courts have generally compared the cost of the merchandise purchased to the taxpayer's case method gross receipts. There is no bright line test with respect to when merchandise will be regarded as an income producing factor in a taxpayer's business. However, courts have found that merchandise is an income producing factor in a taxpayer's business where its cost is approximately 15 percent of the taxpayer's cash method gross receipts.

Below are listed some steps which may help determine if a veterinarian has inventory which is income-producing:

1. Purchases must be analyzed to determine what is bought throughout the year, and whether the purchased items are transferred to the veterinarian's customers. A small year-end balance is not an indication that inventory is insignificant and need not be considered. It also does not matter whether the customer is charged separately for items such as prescription drugs which may be delivered at the same time as the service or at a later date. If an item is consumed in the course of providing a service, it is more akin to a supply. Some examples of supplies are: alcohol, whippets, combs, tongue depressors, disposable syringes, rubber gloves, and like

items. However, if the same supplies listed above are sold to the veterinarian's customers, they may still constitute inventory.

2. The cost of the inventory items purchased during the year should be compared with the taxpayer's cash method gross receipts in order to determine whether the production, purchase, or sale of merchandise is an income producing factor in the taxpayer's business.

   Note: Veterinarians are required to maintain inventory records on some controlled substances by the U.S. Drug Enforcement Agency and state drug enforcement agencies. A review of those records may be helpful in verifying balances.

If the production, purchase, or sale of merchandise is an income producing factor in the veterinarian's business, propose that the taxpayer change from cash to an accrual method of accounting. If the taxpayer keeps its books in such a way that the sale of merchandise is severable from the sale of services, propose a change to a hybrid method of accounting.

How a Taxpayer Requests a Change of Accounting Method (Form 3115)

The procedures for requesting a change in accounting method can be found in Rev. Proc. 97-27, 1997-1 C.B. 680, Exhibit 2-3. The three sections that specifically apply are as follows:

Section 5.	Procedures for Taxpayer Not Under Examination
Section 6.	Procedures for Taxpayers Under Examination, Before an Appeals Office, or Before a Federal Court
Section 8.	General Application Procedures

Exhibit 2-1

Revenue Procedure 87-32

holder (as defined in section 7.367(b)-2(b) of the temporary regulations or section 953(c) of the Code) unless the U.S. transferor receives back stock in a controlled foreign corporation (as defined in section 953(c), section 957(a) or section 957(b) of the Code) as to which the U.S. transferor is a United States shareholder immediately after the transfer. Furthermore, in no event will an exception to section 367(a)(1) of the Code apply to the transfer of stock or securities in a domestic corporation to a foreign corporation where the U.S. transferor owns (applying the attribution rules of section 958) more than fifty percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer. Specifically, the exceptions will be as follows:

(1) Each U.S. transferor of stock or securities who owns less than 5 percent of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer will not be subject to section 367(a)(1) of the Code and will not have to enter into a gain recognition agreement;

(2) If the U.S. transferors in the aggregate own less than fifty percent of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer, the transfer by a U.S. transferor of stock or securities that owns five percent or more of the total voting power or the total value of the transferee foreign corporation's stock immediately after the transfer will not be subject to section 367(a)(1) of the Code if that U.S. transferor enters into a five-year gain recognition agreement as provided in section 1.367(a)-3T(g) of the temporary regulations; and

(3) If all U.S. transferors own in the aggregate fifty percent or more of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer, a transfer by a U.S. transferor of stock or securities owning five percent or more of the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer will not be subject to section 367(a)(1) of the Code if that U.S. transferor enters into a gain recognition agreement as provided in section 1.367(a)-3T(g) of the temporary regulations except that a ten-year period shall be substituted for the five-year term of agreement specified in the temporary regulations.

The term "U.S. transferor" shall include a U.S. person who transfers property other than stock or securities. In determining the ownership of stock for purposes of these exceptions the rules of section 958 shall apply.

If a U.S. transferor cannot determine whether all of the U.S. transferors own in the aggregate less than fifty percent of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer, the U.S. transferors will be deemed to own in the aggregate fifty percent or more of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer. Since the stock transfer rules under the final regulations will depend generally on the amount of stock the U.S. transferors own in the transferee foreign corporation after the transfer, the operating asset, consolidation of integrated business, and same-country stock transfer exceptions from 367(a)(1) of the Code under the temporary regulations will be omitted from the final regulations.

The rules described above, when incorporated in final regulations, will apply to transactions occurring after December 16, 1987. The final regulations will specify the extent to which these rules may be applied with respect to transactions occurring on or before December 16, 1987. This document serves as an "administrative pronouncement" as that term is used in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

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26 CFR 601.201: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 441, 442, 706, 1378; 1.441-1, 1.442-1, 1.706-1, 18.1378-1.)

Rev. Proc. 87-32[1]

CONTENTS

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[1]Also released as News Release IR-87-77, dated June 30, 1987.

SECTION 1. SUMMARY

.01 Introduction

This revenue procedure provides guidance for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to adopt, retain, or change its tax year. Sections 441, 706, and 1378 of the Internal Revenue Code, as amended by section 806 of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 279, generally require that all partnerships, S corporations, and personal service corporations conform their tax years to the tax years of their owners. An exception to these rules is made in the case where the partnership, S corporation, or personal service corporation establishes to the satisfaction of the Secretary a business purpose for having a different tax year.

For purposes of this revenue procedure, the term "S corporation" shall not include a corporation that is electing to be an S corporation.

.02 Purpose

This revenue procedure provides the following:

(1) Expeditious approval provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to retain a tax year that coincides with its natural business year, as defined in section 4.01(1). See section 4;

(2) Expeditious approval provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to change to a tax year that coincides with its natural business year, as defined in section 4.01(1), and such tax year results in less deferral of income to the owners than its present tax year. See section 4;

(3) Expeditious approval provisions for any S corporation or corporation electing to be an S corporation that desires to adopt, retain, or change to a tax year that is the tax year of a majority of its shareholders (ownership tax year). See section 4;

(4) Special notification provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that intends to adopt, retain, or change its tax year as required by the Act. See section 5;

(5) Special notification provisions for any partnership or S corporation that desires to retain a grandfathered fiscal year. See section 5; and

(6) Instructions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to adopt, retain, or change its tax year but can do so only by establishing a business purpose because it does not qualify for either the expeditious approval provisions or the special notification provisions. See section 6.

SEC. 2. BACKGROUND

.01 Section 441(b)(1) of the Code provides that the term "taxable year" (tax year) generally means the taxpayer's annual accounting period if it is a calendar year or a fiscal year. Section 441(c) provides that the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes its income in keeping its books.

Section 441(d) of the Code defines the term "calendar year" as a period of 12 months ending on December 31. Section 441(e) defines the term "fiscal year" as a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided in section 441(f), the term fiscal year means the annual period (varying from 52-53 weeks) so elected. Section 441(f)(1) states that a taxpayer who, in keeping its books, regularly computes its income on the basis of an annual period which varies from 52 to 53 weeks and ends always on the same day of the week and ends always—

(A) on whatever date such same day of the week last occurs in a calendar month, or

(B) on whatever date such same day of the week falls which is nearest to the last day of a calendar month,

may elect to compute its taxable income on the basis of such annual period.

.02 Section 706(b)(1)(B) of the Code, as added by section 806(a) of the Act, requires that, except as provided in section 706(b)(1)(C), a partnership shall not have a tax year other than: (i) the tax year of one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50 percent; (ii) if there is no tax year described in clause (i), the tax year of all the principal partners of the partnership; or (iii) if there is no tax year described in clause (i) or (ii), the calendar year unless the Secretary by regulations prescribes another period. A principal partner is defined in section 706(b)(3) as a partner having an interest of 5 percent or more in partnership profits or capital. Section 706(b)(1)(C) states that a partnership may have a tax year not described in section 706(b)(1)(B) if it establishes, to the satisfaction of the Secretary, a business purpose therefor. For purposes of section 706(b)(1)(C), any deferral of income to partners is not a business purpose. Subparagraphs (B) and (C) of section 706(b)(1) are effective for tax years beginning after December 31, 1986.

.03 Section 1378(a) of the Code, as amended by section 806(b) of the Act, states that the tax year of an S corporation shall be a permitted year. Section 1378(b), as amended by section 806(b) of the Act, states that the term "permitted year" means a tax year that (1) is a year ending December 31, or (2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary. For purposes of section 1378(b)(2), any deferral of income to shareholders is not a business purpose. The Act's amendments to section 1378(a) and (b) are effective for tax years beginning after December 31, 1986.

.04 Section 441(i)(1) of the Code, as added by section 806(c) of the Act, states that the tax year of any personal service corporation shall be the calendar year unless the corporation establishes, to the satisfaction of the Secretary, a business purpose for having a different period for its tax year. For purposes of section 441(i)(1), any deferral of income to shareholders is not a business purpose. Section 441(i) is effective for tax years beginning after December 31, 1986.

.05 Rev. Proc. 72-51, 1972-2 C.B. 832, provides that a request by a partnership to adopt or change to a tax year differing from that of its principal partners will generally be approved when the requested tax year would result in a deferral of income to the partners of three months or less. Rev. Proc. 72-51 also applies to a change of tax year by S corporations. The Act made Rev. Proc. 72-51 obsolete.

.06 Rev. Proc. 74-33, 1974-2 C.B. 489, provides that the requirement of a business purpose may be satisfied if the desired tax year coincides with the natural business year of the business. Moreover, section 4.02 of Rev. Proc. 74-33 states that in the absence of substantial distortion of income, or other factors showing that the change is requested for purposes of tax advantage, the showing of a natural business year will ordinarily be accepted as a substantial business purpose for approval of a change in accounting period. Rev. Proc. 74-33 is clarified by this revenue procedure.

.07 Rev. Proc. 83-25, 1983-1, C.B. 689, provides a procedure whereby a corporation electing to be an S corporation may obtain approval of an adoption, a retention, or a change to a tax year other than a tax year ending on December 31. Rev. Proc. 83-25 is modified and superseded by this revenue procedure.

.08 The Conference Report for the Act indicates that, by incorporating amendments made by the Senate, the Act generally requires any partnership, S corporation, or personal service corporation to conform its tax year to the tax year of its owners. An exception to the rule is made for any partnership, S corporation, or personal service corporation that establishes, to the satisfaction of the Secretary, a business purpose for having a different tax year. The deferral of income to owners for a limited period of time, such as the three-month-or-less rule of Rev. Proc. 72-51, is not intended to be treated as a business purpose. 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-318 (1986) 1986-3 (Vol. 4) C.B.

The Conference Report states that the conferees intended that if a partnership, under the provisions of Rev. Proc. 74-33, received permission to use a fiscal year (other than a year that resulted in a three-month-or-less deferral of income), then it would be allowed to continue to use that tax year without obtaining the approval of the Secretary. Similarly, if an S corporation received permission on or after the effective date of Rev. Proc. 74-33 to use a fiscal year (other than a year that resulted in a three-month-or-less deferral of income), then it would be allowed to continue to use such tax year without obtaining the approval of the Secretary. 2 H.R. Rep. No. 99-841 at II-319.

The Conference Report states that the Secretary may prescribe tests to be used to establish the existence of a business purpose if, in the discretion of the Secretary, such tests are desirable and expedient towards the efficient administration of the tax laws.

.09 Section 1.441-2(b)(1) of the Income Tax Regulations states that for purposes of determining the effective date or the applicability of any provision of title 26 C.F.R. that is expressed in terms of tax years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52-53-week tax year is deemed to begin on the first day of the calendar month beginning nearest to the first day of the 52-53-week tax year and is deemed to end on the last day of the calendar month ending nearest to the last day of the 52-53-week tax year, as the case may be.

.10 Section 1.442-1(b)(1) of the regulations provides that approval for a change of a taxpayer's tax year will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. In general, a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to the facts and circumstances relating to the change, including the tax consequences of the change.

SEC. 3. SCOPE

.01 Expeditious Approval

(1) Coverage

Except as provided in section 3.01(2), the expeditious approval provisions contained in section 4 of this revenue procedure apply to:

(a) a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation, if that taxpayer desires to retain a fiscal tax year that coincides with its natural business year, as defined in section 4.01(1);

(b) a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation, if that taxpayer desires to change to a fiscal tax year that coincides with its natural business year, as defined in section 4.01(1), and such year results in less deferral of income to the owners than its present tax year; and

(c) an S corporation (or a corporation electing to be an S corporation) that desires to adopt, retain, or change to a fiscal tax year that satisfies the "ownership tax year test" set forth in section 4.01(2).

(2) Exceptions

The expeditious approval provisions of section 4 do not apply to:

(a) any taxpayer, except as provided in 3.01(3) below, that has used section 4 of this revenue procedure to adopt, retain, or change its tax year at any time within the most recent six tax years ending on or before the date of application;

(b) a personal service corporation that is seeking to change its tax year if that taxpayer makes an S corporation election (under section 1362 of the Code) for the tax year immediately following the short tax year; or

(c) a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation if that taxpayer, as of the date described below, is a partner in a partnership, a beneficiary of a trust or estate, a United States shareholder of a controlled foreign corporation, or a shareholder of a Domes-

tic International Sales Corporation. The date referred to in the preceding sentence is:

(i) in the case of a change in tax year by a partnership, S corporation, or personal service corporation, the last day of the short tax year required to effect the change;

(ii) in the case of an adoption of a tax year by a partnership or personal service corporation, the last day of the first tax year;

(iii) in the case of an adoption, retention, or change of a tax year by a corporation electing to be an S corporation, the first day of the first tax year the taxpayer is an S corporation; or

(iv) in the case of a retention of a tax year by a partnership, an S corporation, or a personal service corporation, the first day of the first tax year beginning on or after January 1, 1987.

(3) Exception for Ownership Tax Year Test

An S corporation that previously met the ownership tax year test may use the expeditious approval provisions in section 4 of this revenue procedure in the first year it no longer meets the ownership tax year test.

.02 Special Notification

The special notification provisions of section 5 of this revenue procedure apply to:

(1) a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation that intends to adopt, retain, or change to a calendar year or to a fiscal year under section 806 of the Act; or

(2) a partnership or an S corporation that intends to retain a grandfathered fiscal year, as defined in section 5.01(2).

.03 Instructions for Any Other Taxpayer

The instructions for any taxpayer that desires to adopt, retain, or change its tax year but does not qualify for either the expeditious approval provisions or the special notification provisions are contained in section 6.

SEC. 4. EXPEDITIOUS APPROVAL PROVISIONS

.01 Definitions

(1) Natural Business Year

For purposes of this section 4.01(1), the natural business year of a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation is determined by the following "25-percent test":

(a) Gross receipts from sales and services for the most recent 12-month period that ends before the filing of the request and that ends with the last month of the requested fiscal year are computed. This amount is divided into the amount of gross receipts from sales and services for the last two months of this 12-month period.

(b) The same computation as in (a) above is made for the two 12-month periods immediately preceding the 12-month period described in (a).

(c) If each of the three results described in (a) and (b) equals or exceeds 25 percent, then the requested fiscal year is the taxpayer's natural business year.

(d) Notwithstanding (c), if the taxpayer qualifies under (c) for more than one natural business year, the fiscal year producing the highest average of the three percentages (rounded to 1/100 of a percent) described in (a) and (b) is the taxpayer's natural business year.

To apply the 25-percent test described above for any particular year, the taxpayer must compute its gross receipts under the method of accounting used to prepare the tax returns for such tax year.

If a taxpayer has a predecessor organization and is continuing the same business as its predecessor, the taxpayer must use the gross receipts of its predecessor for purposes of satisfying the 25-percent test. If the taxpayer (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested tax year plus additional 11-month period for comparing requested tax year with other potential tax years), then it cannot establish a natural business year under section 4.01(1) of this revenue procedure.

If the requested tax year is a 52-53-week tax year, the calendar month ending nearest to the last day of the 52-53-week tax year shall be treated as the last month of the requested tax year for purposes of computing the 25-percent test described above.

(2) Ownership Tax Year

An S corporation or a corporation electing to be an S corporation meets the "ownership tax year test" if the corporation is adopting, retaining, or changing to a tax year and shareholders holding more than one-half of its issued and outstanding shares of stock (as of the first day of the tax year to which the request relates) have, or are concurrently changing to, the same tax year. A shareholder in an S corporation that desires to change its tax year concurrently should see the instructions generally applicable to taxpayers changing their tax years. These instructions are contained in section 1.442-1(b)(1) of the regulations.

If, as of the first day of any tax year, the S corporation no longer meets the ownership tax year test, it must change its tax year to a permitted year by following the instructions for a change in tax year contained in this revenue procedure.

.02 Application

(1) Instructions

A partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation has established, to the satisfaction of the Secretary, a business purpose for the use of a requested tax year, if the following two conditions are met:

(a) The requested tax year is a natural business year as defined in section 4.01(1), or in the case of an S corporation or corporation electing to be an S corporation, the requested tax year satisfies the ownership tax year test set forth in section 4.01(2); and

(b) In adopting, retaining, or changing to the requested tax year, the taxpayer complies with, and satisfies all the conditions of, section 4 of this revenue procedure.

Approval is hereby granted to any such taxpayer to adopt, retain, or change to a tax year for which such a business purpose has been so established.

(2) Conditions

If a partnership, an S corporation, a corporation electing to be an S corporation, or a personal service corporation is relying on section 4 of this revenue procedure to adopt, retain, or change its tax year, that

taxpayer must comply with the following conditions:

(a) The taxpayer must file a federal income tax return for the short period required to effect the change or adoption or for the retained tax year (whichever is applicable) by the due date of the return, including extensions.

(b) If a short period is required to effect the change, that period shall begin with the day following the close of the old tax year and shall end with the day preceding the first day of the new tax year.

(c) The books of the taxpayer must be closed as of the last day of the short period in the case of a change or adoption that establishes a new tax year. Returns for subsequent years generally must be made on the basis of a full tax year.

(d) The taxpayer's books and records (including financial reports and statements for credit purposes) must be kept on the basis of the retained or new tax year.

(e) In the case of a personal service corporation, taxable income must be annualized and the tax computed in accordance with the provisions of section 443(b) of the Code and section 1.443-1(b) of the regulations.

.03 Filing Instructions

(1) Forms 1128—Partnerships, S Corporations, and Personal Service Corporations

If a partnership, an S corporation, or a personal service corporation desires to change to a tax year that is its natural business year as defined in section 4.01(1) or if an S corporation desires to change to a tax year that meets the "ownership tax year test" set forth in section 4.01(2), that taxpayer must effect such change of tax year by filing a current Form 1128, Application for Change in Accounting Period, with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the taxpayer files its income tax returns. The Form 1128 must be filed on or before the later of (i) the 15th day of the second calendar month following the close of the short period for which a return is required in order to effect the change in accounting period or (ii) September 11, 1987.

If no short period is created because the taxpayer is retaining its fiscal year in accordance with section 4.01(1) or section 4.01(2) of this revenue procedure, the Form 1128 must be filed with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the taxpayer files its tax returns. The Form 1128 must be filed on or before the later of (i) the 75th day of the first tax year beginning on or after January 1, 1987 or (ii) September 11, 1987.

The burden of proof of filing rests with the taxpayer. The taxpayer will be notified only if the Form 1128 is received by the Service Center but was not timely filed. The taxpayer must also attach a copy of the Form 1128 to the return filed for the short period or, in the case of a retention, for the first tax year beginning on or after January 1, 1987.

In order to assist in the processing of the retention or change in tax year, taxpayers should refer to this revenue procedure by either typing or legibly printing the following statement at the top of page 1 of the Form 1128: "FILED UNDER REV. PROC. 87-32."

(2) Forms 2553—Corporations Electing to be S Corporations

A request to adopt, retain, or change to a tax year under this section by a corporation electing to be an S corporation should be made by properly completing Form 2553, Election by a Small Business Corporation, when the election to be an S corporation is filed. If the election is valid and the corporation receives permission to adopt, retain, or change to a tax year ending other than December 31, the S corporation election shall be effective. If a corporation electing to be an S corporation desires to use a fiscal year not described in this section, it should follow the instructions in section 6.02 of this revenue procedure.

(3) Additional Information to be Submitted

The following additional information should be attached to the Form 1128 or Form 2553:

(a) In the case of Form 1128, whether the selected tax year represents a retention or a change of tax year;

(b) The amount of gross receipts for the most recent 47 months for the taxpayer (or any predecessor) if the taxpayer is retaining or changing to a fiscal year on the grounds that the requested year is the taxpayer's natural business year as defined in section 4.01(1). In the case of Form 2553, the monthly gross receipts must be attached to any Form 2553 filed on or after September 11, 1987; and

(c) In the case of Form 1128, one of the following representations, whichever is applicable, signed by a partner in the case of a partnership, or by an authorized corporate officer:

—"Under penalties of perjury, I represent that _____ [insert name of taxpayer] is
(retaining)
(changing to)
[whichever is applicable] a tax year that coincides with its natural business year as defined in section 4.01(1) and as verified by its satisfaction of the requirements of section 4.02(1) of Rev. Proc. 87-32."

—"Under penalties of perjury, I represent that, as of _____ [insert the first day of the tax year to which the request relates], shareholders holding more than one-half of the shares of the stock of _____ [insert name of S corporation] have the same tax year or are concurrently changing to the tax year that [insert name of S corporation] is
(retaining)
(changing to)
[whichever is applicable] per this statement."

In the case of a corporation electing to be an S corporation, the taxpayer should check the appropriate box on Form 2553 in order to make a corresponding representation.

SEC. 5. SPECIAL NOTIFICATION PROVISIONS UNDER THE ACT

.01 Definitions

(1) Required Tax Year

For purposes of this revenue procedure, a "required tax year" is the tax year a partnership, an S corporation, or a personal service corporation is required to use under the Act if that taxpayer does not establish a business purpose for a different tax year.

(2) Grandfathered Fiscal Year

For purposes of this revenue procedure, a "grandfathered fiscal year" is a fiscal year:

(a) that a partnership or an S corporation received permission to use on or after July 1, 1974; and

(b) that, as of the date of the letter granting permission, did not result in a three month-or-less defer-

ral of income. Thus, any taxpayer with calendar year owners (as of the date of the letter granting permission) that received permission to use a tax year ending September 30, October 31, or November 30 does not have a grandfathered fiscal year.

.02 Filing Instructions

In order to allow the Service to process federal income tax returns in an efficient manner, taxpayers that desire to use a required tax year or a grandfathered tax year should indicate the following:

(1) In the case of a taxpayer that uses a required tax year, the taxpayer should type or legibly print at the top of the first page of the return for the first required tax year, "FILED UNDER SECTION 806 OF THE TAX REFORM ACT OF 1986." The taxpayer must file a return on or before the due date (including extension) for the retained year or for the short period (in the case of adoptions and changes). Any taxpayer that is required to retain the calendar year need not notify the Internal Revenue Service of such retention.

(2) In the case of a partnership or an S corporation that retains a grandfathered fiscal year, that taxpayer should indicate such retention on its return for the first tax year beginning on or after January 1, 1987. The taxpayer should type or legibly print at the top of the front page of the return, "GRANDFATHERED FISCAL YEAR." The taxpayer must attach to the return a copy of the ruling letter that granted it permission to use its present tax year. If the taxpayer does not have a copy of the ruling letter and it desires to retain its present tax year, it must apply to retain its fiscal year under either section 4 or section 6.

SEC. 6. INSTRUCTIONS TO TAXPAYERS THAT DO NOT QUALIFY FOR EITHER EXPEDITIOUS APPROVAL PROVISIONS OR THE SPECIAL NOTIFICATION PROVISIONS

.01 Forms 1128—Partnerships, S Corporations, and Personal Service Corporations

(1) Retentions

If a partnership, an S corporation, or a personal service corporation desires to retain a tax year not described in section 4 or section 5 of this revenue procedure, then that taxpayer must request permission to retain its tax year by filing a Form 1128 on or before the 75th day of the tax year for which the retention is to apply. The Form 1128 should be filed with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attn: CC:C:4. Before filing Form 1128, the taxpayer should refer to Rev. Rul. 87-57, page 117, this Bulletin. If the taxpayer does not receive permission to retain its tax year, it must use the calendar year (or in the case of a partnership, the year prescribed by section 706(b)(1)(B) of the Code).

(2) Changes

If a partnership, an S corporation, or a personal service corporation desires to change to a tax year not described in section 4 or section 5 of this revenue procedure, then that taxpayer must request permission to change to the desired tax year in accordance with section 1.442-1(b)(1) of the regulations.

(3) Adoptions

(a) If a partnership desires to adopt a tax year not described in section 5 of this revenue procedure, then that partnership must request permission to adopt the tax year in accordance with section 1.706-1(b)(4)(ii) of the regulations.

(b) If a personal service corporation desires to adopt a fiscal year, then it must request permission to adopt by filing Form 1128 on or before the 15th day of the second calendar month following the close of the first tax year for which a return is required to effect the adoption of the tax year. The Form 1128 should be filed with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attn: CC:C:4. Before filing Form 1128, the taxpayer should refer to Rev. Rul. 87-57.

.02 Extension of Time for Filing Form 1128

The due date for filing a Form 1128 described in section 6.01 is the later of: (i) the date referred to in section 6.01 or (ii) September 11, 1987.

.03 Forms 2553—Corporations Electing to be S Corporations

If a corporation electing to be an S corporation desires to adopt, retain, or change to a fiscal year not described in section 4 or section 5 of this revenue procedure, then it should attach additional material to its S corporation election. The additional material should satisfy the then-effective requirements for a request for rulings. *See, e.g.*, Rev. Proc. 87-1, 1987-1 C.B. 503. The additional material should set forth the business purpose for the desired tax year. These requests will be forwarded by the Service Centers to the National Office for consideration. If the request is denied, the corporation will be required to use the calendar year if it chooses be an S corporation.

SEC. 7. GENERAL RULES OR PROCEDURES

.01 If the taxpayer's year is determined by the tax years of the taxpayer's owners, then for purposes of determining the tax year that the taxpayer is required to use, the tax years of the owners are considered to be the tax years that the Act requires those owners to use.

For example, *Y*, a personal service corporation as defined in section 441(i), uses a tax year ending January 31. *Y* is a partner of *PRS1*, a calendar year partnership. *Y* has a greater than 50 percent interest in the profits and capital of *PRS1*. *Y* is required under section 806(c) of the Act to change to a calendar year for its tax year beginning February 1, 1987. For purposes of determining the tax year which *PRS1* is required to use, the tax year of *Y* is considered to be the calendar year. Based on the above facts, *PRS1* is required to retain the calendar year as its tax year under the Act. *PRS1* may not first change to a tax year ending January 31, 1987, and then subsequently change to a tax year ending December 31, 1987.

.02 If, because of a change in a partnership's or S Corporation's tax year required by the Act, a partner or shareholder is required to report in any one tax year of the partner or shareholder income from more than one tax year of the partnership or S corporation, then the partner or shareholder may account for its share of income in excess of expenses for the short tax year of the partnership or S corporation by including a ratable portion of that share in each of its first four tax years beginning with the year in which ends the first tax year of the partnership or S corporation that begins after December 31,

Exhibit 2-1 (7 of 7)

1986. The partner or shareholder may, however, elect to include that share entirely in the year in which the partnership's or S corporation's short tax year ends.

For example, *PRS2*, a partnership with a tax year ending September 30, is required by the Act to change its tax year to a calendar year. All of the partners of *PRS2* are individuals that use a calendar year for tax purposes. *PRS2* is required to change to a calendar year for its tax year beginning October 1, 1987, and to file a return for the short tax year ending December 31, 1987. Under section 806(e) of the Act, each partner's distributive share of the income in excess of expenses of *PRS2* for the short tax year ending December 31, 1987, shall be taken into account ratably by that partner in each of that partner's first four tax years beginning with the partner's 1987 tax year. However, each partner may elect to include all of that excess amount in that partner's 1987 tax year.

SEC. 8. LATE FILING OF FORM 1128

Any taxpayer described in section 4 or section 6 of this revenue procedure that does not timely file Form 1128 to adopt, retain, or change its tax year may request relief under section 1.9100-1 of the regulations. *See* section 1.9100-1(a)(3) of the regulations and section 2 of Rev. Proc. 79-63, 1979-2 C.B. 578. Applications received beyond 90 days after the time required by this revenue procedure for filing Form 1128 will be considered to jeopardize the interest of the Government and, except in very unusual and compelling circumstances, will not be approved.

SEC. 9. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 83-25 is modified and as modified is superseded. If any revenue procedure or revenue ruling makes reference to Rev. Proc. 83-25, a reference to this revenue procedure should be appropriately substituted.

As a result of section 806 of the Act, Rev. Proc. 74-33 is clarified to provide that a natural business year, as defined in the revenue procedure, is not the sole factor used to determine if a business purpose has been satisfied. All factors, including the deferral of income to the owners, will be considered in making such determination.

Rev. Proc. 72-51 is obsoleted.

SEC. 10. EFFECTIVE DATE

This revenue procedure is effective for adoptions, retentions, and changes of a tax year in which the requested tax year begins on or after January 1, 1987.

SEC. 11. MONITORING OF THE 25-PERCENT TEST

This revenue procedure sets forth a test (the 25-percent test), the purpose of which is to identify those taxpayers with genuine business reasons for using a fiscal tax year. If the Service determines that the 25-percent test is not achieving that purpose, the Service may modify the requirements of this procedure. First, taxpayers using a fiscal year on the basis of a natural business year under section 4.01(1) of this revenue procedure may be required periodically to demonstrate the continued existence of such a year. Second, different requirements may be issued under which taxpayers must demonstrate a natural business year to establish a business purpose. Such new requirements may apply to taxpayers seeking to retain a tax year previously granted under this revenue procedure.

SEC. 12. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Commissioner of Internal Revenue, Attention: CC:C:4, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, Section 1059.)

Rev. Proc. 87-

SECTION 1. PURPOSE

The purpose of this revenue procedure is to provide guidance to corporate taxpayers on how to make the election under section 1059(c)(3) of the Internal Revenue Code and how to establish the fair market value of stock for purposes of that election. This revenue procedure sets forth an automatic procedure to value certain stocks and informs taxpayers unable to use that automatic procedure how to establish the fair market value of the stock to the satisfaction of the Secretary.

SEC. 2. BACKGROUND

Section 1059(a)(1) of the Code generally provides that if any corporation receives any "extraordinary dividend" with respect to any share of stock and the corporation has not held the stock for more than 2 years before the "dividend announcement date," the basis in the stock held by the corporation shall be reduced (but not below zero) by the "nontaxed portion" of the dividend.

Section 1059(a)(2) of the Code provides that, in addition to any gain recognized under normal income tax rules, there shall be treated as gain from the sale or exchange of any stock for the taxable year in which the sale or disposition of the stock occurs an amount equal to the aggregate nontaxed portions of any extraordinary dividends with respect to the stock that did not reduce the basis of the stock by reason of the limitation on reducing basis below zero.

Under section 1059(b) of the Code, the nontaxed portion of any dividend generally equals the amount of the dividend not taxed because of a corporate shareholder's dividends received deduction under section 243, 244, or 245.

Under section 1059(c)(1) of the Code, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of the dividend equals or exceeds the "threshold percentage" (5 percent for preferred stock, 10 percent otherwise, and specified in section 1059(c)(2)) of the taxpayer's adjusted basis in the share of stock. Under section 1059(c)(3)(A), all dividends that are received by a taxpayer with respect to any share of stock and that have "ex-dividend dates" within the same period of 85 consecutive days are treated as one dividend. Moreover, under section 1059(c)(3)(B), all dividends that are received by a taxpayer with respect to any share of stock and that hav