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New Accounting Method Rules for Small Business Taxpayers Under IRC 448

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February 7, 2019

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Agenda

- Prior Section 448 Provisions
- 2017 Tax Law Changes to Small Business Treatment
- Rev. Proc. 2018-31 Initial Guidance
- Rev. Proc. 2018-40 Modifications and Automatic Change Procedures
- Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Changes

Prior Section 448 Provisions

Prior Section 448 Provisions

- Small business taxpayers with **average annual gross receipts of $5 million or less** for all prior years (including the prior taxable years of any predecessor to the entity) may use the cash method of accounting.
- Businesses were required to use an inventory method if maintaining inventory was a *material income-producing factor* to the business, and these taxpayers were required to use the accrual method of accounting for tax purposes.
  - There was an exception for small businesses and businesses in certain identified industries with annual gross receipts of less than $1M and $10M.
- Businesses with **less than $10 million of average annual gross receipts** is not subject to the UNICAP rules with respect to personal property acquired for resale.
- In the case of a long-term contract, taxable income must be determined under the percentage-of-completion method, unless a small construction contract (average annual gross receipts less than $10 million).

2017 Tax Law Changes to Small Business Treatment

2017 Tax Law Changes to Small Business Treatment

- Increased gross receipts thresholds and calculations
- Cash method of accounting eligibility
- Simplified inventory reporting
- Changes to 263A capitalization requirements
- Elections on long-term construction contract accounting treatment for tax purposes

Increased gross receipts thresholds and calculations

- The TCJA allows small business taxpayers with **average annual gross receipts of $25 million or less** in the prior three-year period to use the cash method of accounting.
  - The revised rule takes into account gross receipts only in the three-year period immediately preceding the current tax year, while previously, a taxpayer was prohibited from using the cash method if it failed the gross receipts test in any prior year.
    - A business not in existence for the entire three-year period must compute its average gross receipts for the periods it has been in existence.
    - If any of the prior three years were "short years," the business must **annualize** the gross receipts for the short periods before computing the three-year average.
  - Aggregation rule survives, unchanged by TCJA to prevent large businesses attempts to meet the gross receipts test by separating activities into multiple entities to fall under the threshold.

Cash method of accounting eligibility

- May be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor
- Expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the gross receipts test
- Retains exception from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations
  - Qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they satisfy the gross receipts test, so long as the use of such method **clearly reflects income**.

Simplified inventory reporting

- Taxpayers that satisfy the gross receipts test are not required to account for inventories under section 471, but rather may use a method of accounting for inventories that either:
  - Treats inventories as non-incidental materials and supplies, or
  - Conforms to the taxpayer's financial accounting treatment of inventories.

Changes to 263A capitalization requirements

- Expands the exception for small taxpayers from the uniform capitalization rules.
- Under the provision, any producer or reseller that satisfies the gross receipts test is exempted from the application of section 263A.
- The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer’s gross receipts.

Elections on long-term construction contract accounting treatment for tax purposes

- Expands the exception for small construction contracts from the requirement to use the percentage-of-completion method.
- Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if the contract
  - (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract, and
  - (2) is performed by a taxpayer that (for the taxable year in which the contract was entered into) satisfies the gross receipts test.

Rev. Proc. 2018-31
Initial Guidance

Rev. Proc. 2018-31 Initial Guidance

- Rev. Proc. 2018-31 provides a list of automatic changes to methods of accounting.
  - Deleted four obsolete methods;
  - Three method changes unavailable after Dec. 2017 in light of the TCJA;
  - Removal of the 5-year limitation waiver with respect to two mark-to-market method changes;
  - Addition of a 5-year limitation waiver for method changes relating to advance payments.

Rev. Proc. 2018-31 Initial Guidance

- Obsolete Methods
  - Removed temporary waiver of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 with respect to a change in the depreciation of leasehold improvements.
    - The eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 prohibits a taxpayer from making a change in an accounting method if the taxpayer had made or requested a change for the same item during any of the 5 taxable years ending with the year of the change.
  - Removed the revocation of the partial disposition election under the remodel-refresh safe harbor of Rev. Proc. 2015-56.

Rev. Proc. 2018-31 Initial Guidance

- Obsolete Methods
  - Removed the temporary waiver of the eligibility rules in section 5.01(1)(d) and (f) relating to a change to the remodel-refresh safe harbor described in Rev. Proc. 2015-56.
    - The eligibility rule in section 5.01(1)(d) of Rev. Proc. 2015-13 prohibits a taxpayer from making a change in an accounting method if requested year of change in the final year of the trade or business.
  - Removed temporary of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 relating to sales-based vendor chargebacks.

Rev. Proc. 2018-31 Initial Guidance

- Unavailable Changes
  - A “small reseller” may not make certain UNICAP method changes used by resellers and reseller-produces for any taxable year beginning after December 31, 2017.
    - Section 12.01(3)(b) defines a “small reseller” as a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence for the three preceding taxable years) do not exceed $10,000,000.
  - A small taxpayer, meeting the gross receipts requirements of section 448(c), may not change its overall cash receipts and distributions method with respect to the small taxpayer exception from the requirement to account for inventories under section 471.

Rev. Proc. 2018-31 Initial Guidance

- Unavailable Changes
  - A regulated public utility (as described in section 118(c)) may no longer make certain method changes with respect to nonshareholder contributions of capital after December 22, 2017.
  - An accrual method taxpayer may no longer make certain changes in accounting methods with respect to the year of receipt for advance payments.

Rev. Proc. 2018-31 Initial Guidance

- Mark-to-Market Changes
  - Eligibility rule under section 5.01(1)(f) of Rev. Proc. 2015-13 no longer applies to the election to the mark-to-market method of accounting under section 475(e) or (f).
  - Eligibility rule under section 5.01(1)(f) of Rev. Proc. 2015-13 no longer applies to change in method for securities or commodities from the mark-to-market method of accounting to a realization method of accounting.
- Advance Payments Change
  - Eligibility rule under section 5.01(1)(f) of Rev. Proc. 2015-13 does not apply to banks (or other lenders) to change their method of accounting to comply with section 451 with respect to qualified stated interest on nonperforming loans.

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Issued August 3, 2018
- Provides the procedures by which a small business taxpayer may obtain automatic consent to change its method of accounting to reflect the statutory changes provided by the TCJA
- Requests comments containing suggestions for future guidance under 263A, 447, 448, 460 and 471
- Effective for taxable years beginning after December 31, 2017

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Allows small business taxpayers (those that meet the gross receipts test of section 448(c)) to change to a cash method of accounting.
- Allows small business taxpayers (those that meet the gross receipts test of section 448(c)) to change to a method that no longer capitalizes costs under section 263A.

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Allows small business taxpayers (those that meet the gross receipts test of section 448(c)) to change its section 471 method to:
  - Treating inventory as non-incidental materials and supplies under Treas. Reg. § 1.162-3; or
  - A method that conforms with the method used in the taxpayer's applicable financial statements under section 451(b).
    - If the taxpayer does not have applicable financial statements, it may change its method to a method that conforms with the books and records of the taxpayer, as prepared in accordance with its accounting procedures.

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Allows small business taxpayers (those that meet the gross receipts test of section 448(c)) to change:
  - Its exempt long-term construction contracts (section 460(e)(1)(B)) from the percentage of completion method (Treas. Reg. § 1.460-4(c)) to an exempt contract method (Treas. Reg. § 1.460-4(b)); or
  - Stop capitalizing costs under section 263A.

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Transition Rule
  - If taxpayers requested a change in one of the methods noted above using non-automatic procedures, a taxpayer may switch its prior filing to the use of automatic procedures.
  - To be eligible, taxpayers must have properly filed Form 3115 before August 3, 2018, and the Form must be pending with the IRS national office on August 3, 2018.

Rev. Proc. 2018-40 Modifications and Automatic Change Procedures

- Transition Rule
  - If eligible, taxpayers must notify the IRS of their intent to use the automatic procedures by either September 2, 2018 or the issuance of a letter granting/denying consent for the change.
    - The IRS will then send a letter of acknowledgement.
  - The taxpayer must then file a new Form 3115 using the automatic change procedures within the earlier of 30 days of the letter noted above or the date the taxpayer is required to file a duplicate copy of the Form 3115.

Overview of Automatic Method Changes

	DCN	Effective Date	Sec. 481(a) Adjustment	Small taxpayer reduced filing requirement	Five-year scope limitation waiver	Combine multiple change requests?
Change to cash method	233	Tax years after 12/31/17	Yes	Yes	Yes, limited	Yes
Simplified inventory reporting	235	Tax years after 12/31/17	Yes	Yes	Yes, limited	Yes
Changes to Section 263A requirements	234	Tax years after 12/31/17	Yes	Yes	Yes, limited	Yes
Exception to PCM method for certain long-term contracts	236	Contracts entered into after 12/31/17	No, cutoff	Yes	Yes, limited	No

Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Change

Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Change

- A “tax shelter” may not use a cash method of accounting and cannot be exempt from interest limitation under section 163(j).
- What is a tax shelter?
  - (1) An entity, plan, or arrangement where a significant purpose is to avoid or evade federal income tax;
  - (2) Non-corporate entities that have had their interests offered for sale in an offering required to be registered with a state or federal regulatory agency;
  - (3) A “syndicate,” which is a non-corporate entity where more than 35% of the entity’s losses are allocable to limited partners or limited entrepreneurs.
- Determination made on a yearly basis.

Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Change

- Section 163(j)
  - A taxpayer's deduction for business interest expense is limited to the sum of:
    a) 30% of the taxpayer's adjusted taxable income,
       i. Adjusted taxable income does not include:
          i. Any income, gain, loss, or deduction not allocable to a trade or business;
          ii. Any business interest income or business interest expense;
          iii. Any net operating loss under section 172;
          iv. Any deduction allowed under section 199A;
          v. Any deduction allowed for depreciation, amortization, or depletion for tax years beginning before 2022.

    b) The taxpayer's business interest income, and
    c) The taxpayer's floor plan financing interest.
  - Any amount disallowed as a deduction is carried forward indefinitely.

Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Change

- Certain trades or businesses are exempt from section 163(j)
  - Small businesses that meet the gross receipts test of section 448(c);
  - Publically-regulated utilities;
  - Electing farming businesses; and
  - Electing real property trade or businesses.
- For small businesses with tax shelter risk, an alternative exception may be necessary to remain exempt from section 163(j).

Tax Shelter Definition Impact on Small Businesses

- Need to clearly understand the definition of limited entrepreneur
  - Focus on whether the limited partner, S corporation shareholder, or LLC member “actively participates” in the management or operations of the enterprise
- Caution not to allocate more than 35% of an entity’s losses to such a taxpayer
  - For example, an enterprise that is consistently profitable and that experiences one loss year would be a tax shelter for the loss year if more than 35% of that loss is allocated to a limited entrepreneur or limited partner

Thank You

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