RELIEF FOR SMALL BUSINESS TAX ACCOUNTING METHODS

An increase in the gross receipts ceiling under TCJA 2018…

The law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, which generally took effect in 2018, provides welcome simplifications for small business taxpayers. This article highlights some of these new provisions compared with prior law and how small business taxpayers are affected.

As with most components of the Code, these new provisions are anything but simple. However, the TCJA generally provides that businesses with less than $25 million in gross receipts can now choose to:

- Use the cash method of accounting instead of the accrual method of accounting (Sec. 448(c));
- Not capitalize additional uniform capitalization (UNICAP) costs to inventory (Sec. 263A(i));
- Treat inventories as non-incidental materials and supplies or use an inventory method that conforms to their financial accounting treatment of inventories (Sec. 471(c)); and
- Not account for long-term construction contracts using the percentage-of-completion method (PCM) of accounting (Sec. 460(e)(1)(B)).

Changes to adopt each of these provisions will require a change in accounting method. The procedures for requesting a change in accounting method are discussed later in this article.

WHAT IS A SMALL BUSINESS?

Each of these provisions hinges on whether a business is considered a small business under a gross receipts test provided by Sec. 448. The TCJA amends Sec. 448 by redefining a small business as a corporation or partnership with average annual gross receipts for the prior three-year period (ending with the tax year that precedes the current tax year) that do not exceed $25 million (Sec. 448(c)). This represents a significant increase from the $5 million threshold under prior law. In addition, the rule now 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 of accounting 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.

Example: A business has gross receipts of $20 million in 2015, $25 million in 2016, and $30 million in 2017. For its 2018 tax year, the prior three-year average gross receipts are $25 million. The business's average gross receipts for the prior three-year period do not exceed $25 million and the business is considered a small business for purposes of Sec. 448(c).

Under previous guidance, Treasury and the IRS anticipated that larger businesses might attempt to meet the former $5 million gross receipts test by separating activities into multiple entities to fall beneath the threshold. To combat these attempts, the Sec. 448 regulations, which remain unchanged by the TCJA, require the gross receipts of related entities to be aggregated for purposes of applying the gross receipts test if the related entities are treated as a single employer. Generally, the aggregation rules apply to entities that are members of a controlled group with more than 50% common control or are considered affiliated service groups (Secs. 52(a) or (b) and 414(m) or (o)).

CASH VERSUS ACCRUAL METHOD

Under the cash method of accounting, items of income are generally included in taxable income when actually or constructively received, and a deduction is allowed when expenses are paid. The accrual method of accounting generally recognizes items of income upon the earlier of (1) when cash is received, or (2) when all the events have occurred that fix the right to receive the income, and the amount of the income can be determined with reasonable accuracy (Sec. 451). Taxpayers using the accrual method generally cannot deduct items of expense before (1) all events have occurred that fix the obligation to pay the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred (Sec. 461).

In addition, several Code sections work in conjunction with the overall cash and accrual methods to defer expense recognition, such as Sec. 263A (requiring the capitalization of certain costs to property produced or purchased for resale); Regs. Sec. 1.162-3 (requiring capitalization of non-incidental materials and supplies); and Sec. 263(a) (requiring capitalization of improvements to property).

Prior-law limitations on use of the cash method

Under prior law, the availability of the cash method of accounting was relatively limited. A C corporation taxpayer or a partnership with a C corporation partner could not use the cash method if it failed the aforementioned $5 million gross receipts test of Sec. 448 (c) for any prior tax year. Even if a taxpayer satisfied the $5 million gross receipts test, it was still prohibited from using the cash method if it was required to account for inventories (Sec. 471(a)).

However, two exceptions prior to the TCJA allowed taxpayers to use the cash method of accounting despite limitations imposed by other Code sections. Under the first exception, a taxpayer (other than a tax shelter) that was required to account for inventories and had average annual gross receipts not exceeding $1 million was permitted to use the cash method under Rev. Proc. 2001-10. A second exception in Rev. Proc. 2002-28 allowed a taxpayer with average annual gross receipts of $10 million that was not prohibited from using the cash method under Sec. 448 and did not have a prohibited business activity under Section 4.01 of Rev. Proc 2002-28 to use the cash method regardless of whether it had inventories. Under the prior law, it was difficult for many businesses — except those that were very small or did not carry inventory — to use the cash method of accounting.

Expansion of small business exception to the accrual method

For many small businesses, the cash method has several significant advantages over the accrual method, as it is generally easier for most businesses to administer, simplifying the accounting. In addition, the cash method can yield tax savings over the accrual method by deferring the recognition of income until cash is received. For example, if accounts receivable exceed accrued expenses and accounts payable, the taxpayer will defer paying taxes on the net taxable income until the period when the cash is constructively received and expenses are actually paid. This can be a significant benefit for businesses with accounts receivable in excess of accounts payable and accrued expenses.

The TCJA expands the availability of the overall cash method of accounting to any taxpayer — other than a tax shelter — meeting the new $25 million gross receipts test under Sec. 448(c). It also removes the limitations placed on small taxpayers operating in certain industries from using the cash method of accounting.

Also, the TCJA did not modify the exceptions from the required use of the accrual method. Specifically, under Sec. 448 — if they are not tax shelters — qualified personal service corporations, farming businesses, partnerships without C corporation partners, and S corporations generally continue to be permitted to use the cash method regardless of how they measure against the $25 million gross receipts test. While this is not a new provision, it is an often misunderstood application of Sec. 448(c). In addition, under the general rule for methods of accounting in Sec. 446, the accrual method is generally not required for businesses in which the sale of inventory is not a material income-producing factor, as long as the use of the cash method clearly reflects income and is consistently used.

As described below, entities planning to convert from the accrual to the cash method based on the new rules must request a change in accounting method.

ACCOUNTING FOR INVENTORIES

Before the TCJA, taxpayers were required to account for inventories whenever the production, purchase, or sale of goods was an income-producing factor (Sec. 471(a) and Regs. Sec. 1.471-1). The same two exceptions described above permitting the use of the cash method of accounting also apply to the exception to the requirement to account for inventories — the first for businesses with gross receipts that did not exceed $1 million (Rev. Proc. 2001-10) and the second for businesses in certain industries with gross receipts that did not exceed $10 million (Rev. Proc. 2002-28). Businesses meeting either exception could account for their inventories as "non-incidental materials and supplies," which are deductible when used or consumed (Regs. Sec. 1.162-3(a)(1)).

The TCJA modified these rules to exclude certain taxpayers from the requirement to account for inventories. Specifically, taxpayers meeting the $25 million gross receipts test are not required to account for inventories under Sec. 471 and may follow a method of accounting that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's applicable financial statement (AFS). If the taxpayer doesn't have an AFS, it may account for inventories following its books and records in accordance with its accounting procedures.

Many businesses will find it simpler to account for their inventories following one of these two methods, providing additional administrative ease. The change from accounting for inventories will also require a change in accounting method.

UNIFORM CAPITALIZATION (UNICAP)

The UNICAP rules require certain direct and indirect costs allocable to real or personal tangible property produced by the taxpayer to be either included in inventory or capitalized into the basis of the property produced, as applicable. For real or personal property acquired by the taxpayer for resale, Sec. 263A generally requires certain purchasing, storage, and handling costs allocable to the property to be included in inventory.

Prior to the TCJA, there were a number of exceptions to the requirements to capitalize costs under Sec. 263A. One exception was for certain small business taxpayers that acquire property for resale and have $10 million or less of average annual gross receipts (not to be confused with the $10 million gross receipts test under Rev. Proc. 2002-28). These taxpayers were not required to capitalize additional Sec. 263A costs to inventory (Sec. 263A (b) (2) (B)).

The TCJA expanded the exception for small business taxpayers from the UNICAP rules. Now, any producer or reseller that meets the $25 million gross receipts test under Sec. 448(c) is exempted from the application of Sec. 263A. This is welcome relief for many small businesses, as the UNICAP calculation under Sec. 263A can be cumbersome and tedious.

Changing from applying UNICAP to forgoing its application requires a change in accounting method.

PERCENTAGE-OF-COMPLETION METHOD

Taxpayers with long-term contracts generally determine the taxable income from those contracts using the PCM (Sec. 460(a)). Under the PCM, a taxpayer must include in gross income for the tax year an amount equal to the product of the gross contract price and the percentage of the contract completed during the tax year. The percentage of the contract completed during the tax year is determined by comparing contract costs incurred before the end of the tax year with the estimated total contract costs.

Costs allocated to the contract typically include all costs (including depreciation) that directly benefit, or are incurred by reason of, the taxpayer's long-term contract activities. The allocation of costs to a contract is made in accordance with regulations. Costs incurred on the long-term contract are deductible in the year incurred, as determined using the general accrual-method accounting principles and limitations.

An exception from the requirement to use the PCM was provided under prior law for certain small construction contracts (Sec. 460(e)). Contracts falling within this exception are those for the construction or improvement of real property if the contract is:

- Expected (at the time the contract is entered into) to be completed within two years of its commencement; and
- Performed by a taxpayer whose average annual gross receipts for the prior three tax years did not exceed $10 million.

The TCJA expanded the exception for small construction contracts from the requirement to use the PCM (Sec. 460(e)(1)(B)). Under the new provisions, contracts falling within this exception are contracts for the construction or improvement of real property if the contract is:

- Expected (at the time the contract is entered into) to be completed within two years of commencement of the contract; and
- Performed by a taxpayer that meets the $25 million gross receipts test for the tax year in which the contract is entered into.

Taxpayers may find that using the PCM is not as tax-efficient as alternative methods. Applying the PCM typically results in an acceleration of taxable revenue — and accelerated payment of tax — when compared with the cash, accrual, or completed-contract methods of accounting.

The PCM must still be used to compute alternative minimum taxable income (which now applies only to individual taxpayers, as the TCJA repealed the alternative minimum tax (AMT) for C corporations). This could result in unexpected tax consequences where pass through businesses are not using the PCM for regular tax but must use it for AMT purposes.

A change from using the PCM to another method of accounting, such as the completed-contract method, requires a change in accounting method.

EFFECTIVE DATES AND CHANGES IN ACCOUNTING METHOD

The first three accounting methods discussed in this article (overall cash method, exemption from accounting for inventories, and exemption from UNICAP) apply to tax years beginning after Dec. 31, 2017. The exemption from the PCM for long-term contracts applies to contracts entered into after Dec. 31, 2017.

The first three accounting methods also are subject to Sec. 481(a), which requires the taxpayer to compute an adjustment equal to the difference between taxable income in all prior tax years computed under the (1) original accounting methods and (2) the proposed accounting methods. This difference is computed as of the beginning of the year of change. A negative adjustment (resulting in a reduction in taxable income) is taken into taxable income in the tax year of change. A positive adjustment (resulting in an increase to taxable income) is taken into taxable income evenly over four tax years beginning with the year of change, subject to certain exceptions. However, any change from the PCM is computed on a "cutoff" basis, ignoring the difference between lifetime taxable income in all prior years and, therefore, does not require or permit a Sec. 481(a) adjustment. Contracts entered into by the taxpayer prior to the year of change must remain on the original method of accounting.

A change in method of accounting requires the consent of the IRS, which is generally obtained by filing Form 3115, *Application for Change in Accounting Method*. The form is filed under either "automatic" or "advance consent" procedures. Consent is deemed granted when filing under the automatic procedures if the request is attached to a timely filed federal tax return and filed in duplicate with the IRS in Covington, Ky. All automatic accounting method changes are published in a revenue procedure, which is updated and reissued periodically with revisions and additional automatic method changes. The current list of automatic method changes may be found in Rev. Proc. 2018-31.

Accounting method changes not specified as an automatic method change by Rev. Proc. 2018-31, its successor, or supplemental guidance must receive advance consent from the IRS before the change may be implemented. A taxpayer requesting an advance consent method change must file Form 3115 with the IRS National Office no later than the last day of the tax year in which the taxpayer wishes to implement the change (Dec. 31, in the case of a calendar-year-end taxpayer).

On Aug. 3, 2018, the IRS issued Rev. Proc. 2018-40, which contains automatic method change guidance for adopting the small taxpayer accounting methods newly allowable under the TCJA changes. The table "Automatic Method Changes" highlights a few of the key terms and procedures of these methods.