§448 - Limitation on use of cash method of accounting

The changes made by P.L. 115-97 (12/22/17), Section 13102, are shown below using track changes.

(a) **GENERAL RULE**  Except as otherwise provided in this section, in the case of a—

(1) C corporation,

(2) partnership which has a C corporation as a partner, or

(3) tax shelter, taxable income shall not be computed under the cash receipts and disbursements method of accounting.

(b) **EXCEPTIONS**

(1) **FARMING BUSINESS**  Paragraphs (1) and (2) of subsection (a) shall not apply to any farming business.

(2) **QUALIFIED PERSONAL SERVICE CORPORATIONS**  Paragraphs (1) and (2) of subsection (a) shall not apply to a qualified personal service corporation, and such a corporation shall be treated as an individual for purposes of determining whether paragraph (2) of subsection (a) applies to any partnership.

(3) **ENTITIES WITH WHICH MEET GROSS RECEIPTS OF NOT MORE THAN $5,000,000 TEST**  Paragraphs (1) and (2) of subsection (a) shall not apply to any corporation or partnership for any taxable year if, for all prior taxable years beginning after December 31, 1985, such entity (or any predecessor) meets the $5,000,000 gross receipts test of subsection (c) for such taxable year.

(c) **$5,000,000 GROSS RECEIPTS TEST**  For purposes of this section—

(1) **IN GENERAL**  A corporation or partnership meets the $5,000,000 gross receipts test of this subsection for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year which precedes such taxable years does not exceed $25,000,000.

(2) **AGGREGATION RULES**  All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).

(3) **SPECIAL RULES**  For purposes of this subsection—

(A) **Not in existence for entire 3-year period**  If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.

(B) **Short taxable years**  Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(C) **Gross receipts**  Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.
(D) Treatment of predecessors Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

(4) ADJUSTMENT FOR INFLATION.—In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, b substituting ‘calendar year 2017’ for ‘calendar year 2016’ in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000,000, such amount shall be rounded to the nearest multiple of $1,000,000.

(d) DEFINITIONS AND SPECIAL RULES For purposes of this section—

(1) FARMING BUSINESS

(A) In general The term “farming business” means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) Timber and ornamental trees The term “farming business” includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

(2) QUALIFIED PERSONAL SERVICE CORPORATION The term “qualified personal service corporation” means any corporation—

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by—

(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

(ii) retired employees who had performed such services for such corporation,

(iii) the estate of any individual described in clause (i) or (ii), or

(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

(3) TAX SHELTER DEFINED The term “tax shelter” has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section
461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.

(4) **SPECIAL RULES FOR APPLICATION OF PARAGRAPH (2)** For purposes of paragraph (2)—

(A) community property laws shall be disregarded,

(B) stock held by a plan described in section 401(a) which is exempt from tax under section 501(a) shall be treated as held by an employee described in paragraph (2)(B)(i), and

(C) at the election of the common parent of an affiliated group (within the meaning of section 1504(a)), all members of such group may be treated as 1 taxpayer for purposes of paragraph (2)(B) if 90 percent or more of the activities of such group involve the performance of services in the same field described in paragraph (2)(A).

(5) **SPECIAL RULE FOR CERTAIN SERVICES**

(A) In general In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of such person’s experience) will not be collected if—

   (i) such services are in fields referred to in paragraph (2)(A), or

   (ii) such person meets the gross receipts test of subsection (c) for all prior taxable years.

(B) Exception This paragraph shall not apply to any amount if interest is required to be paid on such amount or there is any penalty for failure to timely pay such amount.

(C) Regulations The Secretary shall prescribe regulations to permit taxpayers to determine amounts referred to in subparagraph (A) using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected by such person. A taxpayer may adopt, or request consent of the Secretary to change to, a computation or formula that clearly reflects the taxpayer’s experience. A request under the preceding sentence shall be approved if such computation or formula clearly reflects the taxpayer’s experience.

(6) **TREATMENT OF CERTAIN TRUSTS SUBJECT TO TAX ON UNRELATED BUSINESS INCOME** For purposes of this section, a trust subject to tax under section 511(b) shall be treated as a C corporation with respect to its activities constituting an unrelated trade or business.

(7) **COORDINATION WITH SECTION 481** In the case of any taxpayer required by this section to change its method of accounting made pursuant to this section for any taxable year—

(A) such change shall be treated **for purposes of section 481** as initiated by the taxpayer, and

(B) such change shall be treated as made with the consent of the Secretary.
(C) the period for taking into account the adjustments under section 481 by reason of such change—

(i) except as provided in clause (ii), shall not exceed 4 years, and

(ii) in the case of a hospital, shall be 10 years.

(8) USE OF RELATED PARTIES, ETC. The Secretary shall prescribe such regulations as may be necessary to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section.

PL 115-97 Sec. 13102 also makes changes to Sections 447 (farming), 263A (unicap), 471 (inventory tracking), and 469(e) (certain construction contracts) to apply the new small business definition of Section 448. See these revised sections for details.

“EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to taxable years beginning after December 31, 2017.

(2) PRESERVATION OF SUSPENSE ACCOUNT RULES WITH RESPECT TO ANY EXISTING SUSPENSE ACCOUNTS.—So much of the amendments made by subsection (a)(5)(C) as relate to section 447(i) of the Internal Revenue Code of 1986 shall not apply with respect to any suspense account established under such section before the date of the enactment of this Act.

(3) EXEMPTION FROM PERCENTAGE COMPLETION FOR LONGTERM CONTRACTS.—The amendments made by subsection (d) shall apply to contracts entered into after December 31, 2017, in taxable years ending after such date.”

Section 448 is relevant to C corporations and partnerships with a C corporation partner. Generally, for the other rules that use the new §448 definition of “small,” “the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.”

Caution: These favorable method rules do not apply to “tax shelters” as defined at §448(d)(3); they are still required to use the accrual method regardless of gross receipts level. In addition, the new exceptions for small businesses at §§263A, 471 and 460(e) do not apply to tax shelters that are prohibited from using the cash method under §448(a)(3).

The §448(d)(3) definition of tax shelter involves several Code sections and can include operations not commonly thought of as a tax shelter. Per §448(d)(3), “the term “tax shelter” has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement
applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.” [Also see Reg. 1.448-1T(b)]

Per §461(i)(3): “For purposes of this subsection, the term “tax shelter” means—

(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,

(B) any syndicate (within the meaning of section 1256(e)(3)(B)), and

(C) any tax shelter (as defined in section 6662(d)(2)(C)(ii)).”

Section 461(i)(4) provides a special rule for farming: “In the case of a trade or business of farming (as defined in section 464(e)), in determining whether an entity is a tax shelter, the definition of farming syndicate in subsection (j) shall be substituted for subparagraphs (A) and (B) of paragraph (3).”

A syndicate per §1256(e)(3)(B) “means any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).”

Section 464(e)(2) was removed by P.L. 113-295, without §1256(e)(3)(B) being fixed to reflect that change. It appears based on the changes of P.L. 113-295 (Sec. 221) that the definition of limited entrepreneur was moved to §461(j)(4):

Limited entrepreneur. For purposes of this subsection, the term ‘limited entrepreneur’ means a person who—

(A) has an interest in an enterprise other than as a limited partner, and

(B) does not actively participate in the management of such enterprise.

Section 6662(d)(2)(C)(ii) provides the “traditional” definition of a tax shelter:

“(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.”

Thus, pending any other interpretation from the IRS or change to the statute, the “syndicate” approach for defining a tax shelter will prevent some LLCs from taking advantage of the new favorable methods for “small” despite having gross receipts of $25 million or less (for example, LLCs with over 35% of the losses allocated to owners who are passive and not involved in management of the entity). Prior to the P.L. 115-97 changes, the treatment of some LLCs as a “tax shelter” only meant they were unable to use the cash method. Now, they still must use the accrual method and cannot take advantage of the new exceptions for small businesses under §§263A, 471 and 460(e). In addition, such tax shelters (despite the gross receipts level) are subject to the new interest limitations at §163(j).