

New Favorable Methods for Small Businesses

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Successfully Navigating the TCJA for Small Business Clients

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H. R. 1

One Hundred Fifteenth Congress
of the
United States of America
AT THE FIRST SESSION

Began and held at the City of Washington on Tuesday,
the third day of January, one thousand and seventeen

An Act

To provide for reconciliation pursuant to title II and V of the concurrent resolution
on the budget for fiscal year 2018.

Review - What is a method of accounting?

- Involves timing
 - Treatment doesn't affect lifetime income.
 - "when" questions, not "whether" questions
 - Example – when is an item included in income?
- Consistent application ("method")
- Change in method is not a change in facts or correction of an error
 - Almost always, involves Form 3115 (rather than amended return)

Per IRS (Rev. Proc. 2015-13)

“(1) The term “method of accounting” includes (a) an overall plan of accounting, such as for gross income and deductions, and (b) the treatment of any **material item**. A material item is any item that involves the **proper time** for the inclusion of the item in income or the taking of the item as a deduction, or both. In determining whether a taxpayer's accounting practice for an item involves **timing**, generally the relevant question is **whether the practice permanently changes the amount of the taxpayer's lifetime taxable income**. If the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year(s) in which the item is taken into account, it involves timing and is therefore a method of accounting.

(2) Although a method of accounting may exist under this definition without a pattern of **consistent treatment** of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed federal income tax returns, without regard to any change in characterization of the method as permissible or impermissible, represents consistent treatment of that item for purposes of §1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first federal income tax return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive returns to have adopted a method of accounting. Once a taxpayer has adopted a method of accounting, the taxpayer has established a method of accounting. An established method of accounting includes a finalized Internal Revenue Service (IRS) imposed method of accounting under Rev. Proc. 2002-18, 2002-1 C.B. 678.”

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Method definition continued

“(3) The regulations under §446 provide that no method of accounting is acceptable **unless, in the opinion of the Commissioner, it clearly reflects income**. To clearly reflect income, the method must, for example, be used consistently from one taxable year to another.

(4) Section 446(a) and §1.446-1(a)(1) provide that taxable income shall be computed under the method of accounting on the basis of which the taxpayer **regularly computes income in keeping the taxpayer's books** (§446 book-tax conformity requirement). Section 1.446-1(a)(4) requires each taxpayer to maintain accounting records that will enable the taxpayer to file a correct return and states that accounting records include the taxpayer's regular books of account and other records and data as may be necessary to support the entries on the taxpayer's books of account and on the taxpayer's return, as for example, a reconciliation of any differences between such books and his return. Thus, a taxpayer satisfies the §446 book-tax conformity requirement if the taxpayer reconciles the results obtained under the method of accounting used in keeping its records and accounts and the method used for federal income tax purposes and maintains sufficient records to support that reconciliation.”

TCJA Favorable Method Changes for Small Businesses

First – what is a “small business” for these purposes?

- Small = \$25 million or less of average gross receipts in the prior 3-year period (and not a tax shelter per §448(d)(3))
- Example:
 - AB Partnership owned by Andy and Barbara, uses calendar year and had gross receipts of:
 - 2015 \$17,000,000
 - 2016 \$14,000,000
 - 2017 \$19,000,000
 - Average for 2018 measure = \$16,666,667
 - AB is a small business for 2018 assuming it is not a tax shelter.

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Measuring Gross Receipts

- Gross receipts test of §448(c) is modified by TCJA
 - Average annual gross receipts for prior 3 years is \$25 million or less.
 - Prior year exception removed (before, if ever crossed \$5 million threshold of §448, were forever prohibited from using cash or hybrid).
 - See existing special rules at §448 and regulations for aggregation, short tax years, etc.
 - For taxpayers other than corporation or partnership, gross receipts test is applied as if each trade or business of such taxpayer were a corporation or partnership.
 - Query: Will an individual’s wages affect the gross receipts measure?

TCJA Favorable Method Changes for Small Businesses

- §448 – Required use of the accrual method
 - Exceptions:
 - C corporation or p/s with C corp partner not required to use accrual (unless tax shelter)
 - If QPSC, no gross receipts limit (same as pre-TCJA law)
- §471 – Requires use of inventories if necessary to clearly reflect income (and per 1.471-1, if merchandise is an income producing factor)
 - New Exception at §471(c) – Small business is not required to account for inventory (unless is a tax shelter)
 - So, Reg. 1.446-1(a)(2)(i) n/a – “In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales”
- §263A Unicap – New exception:
 - Small businesses not subject to any part of §263A (see §263A(i)) (unless is a tax shelter)
- §460(e) exception for certain construction contracts is now \$25 million threshold (pre-TCJA was \$10 million threshold)

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Small Business Caution

§§448, 263A, 471 and 460(e) small business exemption includes:

“in the case of any taxpayer (other than a **tax shelter** prohibited from using the cash method under §448(a)(3) for any tax year)” ...

Tax Shelter under §448

Refers to §461(i)(3)

- (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 [see more at §448(d)(3)]
- (B) any syndicate (within the meaning of §1256(e)(3)(B)), and
 - See next slide. ----→
- (C) any tax shelter (as defined in §6662(d)(2)(C)(ii))
 - A partnership or other entity, any investment plan or arrangement, or 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.

More on “syndicate”

Again - New small business method provisions n/a to “tax shelter” as defined at §448(d)(3)

- Definition (since TRA 1986) *includes* “syndicate”
 - §1256(e)(3)(B) “any partnership or other entity (other than a corporation which is not an S corporation) if more than 35% of losses of such entity during the tax year are allocable to limited partners or limited entrepreneurs (within meaning of §464(e)(2)*).”
 - Limited entrepreneur = Person with interest other than as limited partner and does not actively participate in mgmt.
 - Also see explanatory rules at §1256(e)(3)(C) ----→
 - **Thus, tax shelter could easily be an LLC with over 35% inactive owners.**
 - **So can’t use favorable methods.**

*Should have been changed to §461(k)(4) by P.L. 113-295. This was fixed by technical corrections included in P.L. 115-141 (3/23/18).

More on syndicate - §1256(e)(3)(C)

(C) Holdings attributable to active management For purposes of subparagraph (B), an interest in an entity shall not be treated as held by a limited partner or a limited entrepreneur (within the meaning of section 464(e)(2))—

(i) for any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity,

(ii) for any period if during such period such interest is held by the spouse, children, grandchildren, and parents of an individual who actively participates at all times during such period in the management of such entity,

(iii) if such interest is held by an individual who actively participated in the management of such entity for a period of not less than 5 years,

(iv) if such interest is held by the estate of an individual who actively participated in the management of such entity or is held by the estate of an individual if with respect to such individual such interest was at any time described in clause (ii), or

(v) if the Secretary determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.

For purposes of this subparagraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

Allocation of losses under §1256(e)(3)(B)

- Little guidance, but see PLR 8911011
 - “with respect to any taxable year during which M has a taxable loss, ..., M will nonetheless not be a “syndicate” within meaning of section 1256(e)(3)(B), as long as not more than 35 percent of such loss is allocable to the last-tier interests held by limited partners after the application of section 1256(e)(3)(C)....
 - With respect to profit years, M will not be a “syndicate” within the meaning of section 1256(e)(3)(B) because there will be no losses allocable to partners, whether treated as limited partners or otherwise.”
- Binding guidance? (also see Reg. 1.448-1T)
- What is method if status as tax shelter changes periodically?
- What if the negative §481(a) adjustment in 2018 creates a loss for the year of change?
 - Seems that guidance is needed.

§471 as amended

So, if don't want to treat as non-incidentals supplies, but instead as expensed when acquired (if that is the accounting procedure), be sure client doesn't have AFS.



(c) EXEMPTION FOR CERTAIN SMALL BUSINESSES.—

(1) IN GENERAL.—In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year—

(A) subsection (a) shall not apply with respect to such taxpayer for such taxable year, and

(B) the taxpayer's method of accounting for inventory for such taxable year shall not be treated as failing to clearly reflect income if such method either—

(i) treats inventory as non-incidentals materials and supplies, **OR**

(ii) conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year **OR**, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures.

Applicable Financial Statement (AFS) – see §451(b)

http://www.sjsu.edu/people/annette.nellen/451_as_AmendedByHR1_115th.pdf

Treating inventory as non-incidentals supplies

- Per Rev. Proc. 2001-10:
 - “Under section 1.162-3, materials and supplies that are not incidentals are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidentals are consumed and used in the year in which the taxpayer sells the merchandise or finished goods. **Thus, under the cash method, the cost of such inventoriable items are deductible only in that year [year sold to customer], or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later.** Producers may use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw materials that were used to produce finished goods that are sold during the tax year, provided that method is used consistently.”
- Watch for any new guidance from IRS under TCJA.

Example of Treating Inventory as Non-Incidental Supplies

- Jane, sole proprietor, sells widgets online, averaging about \$2.7 million of sales over past 3 years.
- Buys inventory on credit, usually paying within 30 days.
- 2018 – will start treating inventory as non-incidental supplies
- Beginning inventory at 1/1/18 \$ 30,000 (cost) (paid for in 2017)
- Purchases in 2018 \$1,800,000 (cost)
- Ending inventory at 12/31/18 \$ 20,000 (cost)
- Outstanding payables for purchases \$ 50,000 (includes EI not yet paid)

What is Jane's inventory deduction for 2018?

Item	Cost
BI paid for in 2017, but sold in 2018	\$30,000
Purchases in 2018 less \$50,000 not paid by year end including the ending inventory	<u>\$1,750,000</u>
Inventory deduction for 2018	\$1,780,000

What if instead of fungible widgets, Jane was selling cooking equipment and supplies?
Would need to track cost per each type of item.

TCJA Guidance on Method Changes for Small Businesses

- Generally, method change treated for purposes of §481 as initiated by taxpayer and made with the consent of the IRS.
- §460(e) change – must use cut-off (no §481 adjustment)
 - “Such change shall be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change.”
 - Effective for contracts entered into after December 31, 2017, in tax years ending after such date.

Example – method change

- **Watch for details from IRS on timing, change #, and whether cut-off will be allowed, etc.**
- ABC Corporation is retailer using accrual method, and cost and FIFO for inventory; was not using §263A (because gross receipts of \$10 million or less).
- 12/31/17
 - A/R \$560,000
 - A/P \$430,000
 - Ending Inventory \$780,000
- In 2018 will change to cash and treat inventory as non-incidentals.

ABC's §481(a) adjustment

- A/R \$560,000
 - As accrual method t/p, already reported as income. If had always been using cash method would not have reported as income since not yet received. So, need to remove from income.
 - Negative §481(a) adjustment.
 - Will get picked up into cash method income when collected.
- A/P \$430,000
 - As accrual method t/p, already deducted these items. If had always been using cash method, no deduction because not yet paid. So, need to add back to income because as cash method, will deduct when ABC pays these liabilities.
 - Positive §481(a) adjustment.
- Ending Inventory \$780,000
 - As accrual method t/p using inventory method, this was never deducted. If had always treated inventory as non-incidental supplies, would not be written off until used (sold). So no §481(a) adjustment. Assume that ABC has paid for this inventory already.

§481(a) adjustment = negative \$130,000
Pick up all in the year of change (2018).

What if ABC will change to treat inventory as expensed when acquired (per its accounting procedure/has no AFS)?

- If ABC had always done this, it would have expensed the BI already (\$780,000) (assuming ABC already paid for the inventory).
- So, negative §481(a) adjustment of \$780,000.
 - In 2018 and later when sell this inventory, no tax effect.
- The total negative §481(a) adjustment for 2018 = \$910,000.

More on methods for “small” businesses

- If currently on accrual and Rev. Proc. 2004-34, need to also stop using Rev. Proc. 2004-34 (relevant in calculating §481(a) adjustment).
- If currently on §263A, lower-of-cost-or-market or LIFO or other special inventory method, factor that in when calculating §481(a) adjustment.
- If currently under \$1 million of gross receipts and using cash and non-incidental supplies treatment for inventory, can stay on that even if gross receipts go above \$1 million. If want to stop using non-incidental supplies and use something more favorable and don't have AFS, likely need method change.
- Take your time computing §481(a) adjustment AND have someone double-check your calculations

Watch for IRS Guidance on Method Changes for Small Business

- We need to know:
 - Will Form 3115 be required? If yes, any lines that can be skipped?
 - What are the designated change numbers (DCN)? (goes on page 1 of 3115)
 - Will cut-off option be available (no §481(a) adjustment for cut-off)
 - If §481(a) adjustment, are they all netted into a single figure?
 - More on certain terms used in the new rules.
- Rev. Proc. 2018-31 (<https://www.irs.gov/pub/irs-drop/rp-18-31.pdf>)
 - New list of automatic method changes (replaces most of Rev Proc. 2017-30)
 - Pages 324-325 – automatic method changes don't include the TCJA – wait for later guidance.

Summary ...

Taxpayers who can adopt favorable methods after TCJA include ...

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- C corps and p/s with C corp partner with gross receipts over \$5 million but under \$25 million
 - Change from accrual to cash
- Small taxpayers using unicap (§263A)
- Small taxpayers accounting for inventory and using accrual who prefer cash and other treatment for inventory per §471(c)
- Taxpayers using cash and treating inventory as non-incidentals supplies per Rev. Proc. 2001-10 (or per Rev. Proc. 2002-28)
 - Stay on cash
 - No longer have to treat inventory as non-incidentals supplies assuming have no applicable financial statement (AFS).
- Small contractors with over \$10 million but with \$25 million or less of GR (§460(e))

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What to do now?

- Watch and wait for IRS guidance on how to make method change.
- Keep 2018 records on the new method, assuming taxpayer wants to adopt new method.
- Figure out if taxpayer is a tax shelter (same definition, but more important now).

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More TCJA Method Changes

Form **3115**
(Rev. December 2015)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

► Information about Form 3115 and its separate instructions is at www.irs.gov/form3115.

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Tax Reform and R&D

- Research tax credit retained.
- Delayed change - Amortize §174 R&E over 5 years for amounts paid or incurred in tyba 12/31/21
 - Half-year convention
 - Includes software development
 - Continue even when dispose of during amortizable life
 - 15 years for foreign research
 - Change via cut-off basis (no §481(a) adj)

Craft Beverage Tax Reform

- Exempt aging period for beer, wine and distilled spirits from consideration as production (so, avoid interest capitalization)
 - Terminates for interest costs paid or accrued after 12/31/19; effective for interest costs paid or accrued in calendar years beginning after 12/31/17.



Note: Also see excise rate and other changes (temporary) at Sec. 13802, et seq.

§451 Income Timing for Accrual Method Taxpayers

- TCJA SEC. 13221. CERTAIN SPECIAL RULES FOR TAXABLE YEAR OF INCLUSION – Adds:
 - §451(b) – Inclusion not later than for financial accounting purposes - “all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in” –
 - (i) an applicable financial statement, or
 - (ii) such other financial statement as Secretary may specify.
 - §451(c), Treatment of advance payments - codifies Rev. Proc. 2004-34 and related changes
- Special rule for income from a debt instrument having OID.
- Watch for guidance from IRS on the method changes and how and when to make them.
- Track changes for §451 – see
 - http://www.sisu.edu/people/annette.nellen/451_as_AmendedByHR1_115th.pdf

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More on §451(b) change for accrual method taxpayers

- §451(b)(2) – new rule n/a to gross income from “special method of accounting provided under any other provision of this chapter” (with limited exceptions)
 - So should still be allowed to use installment method of §453 and long-term contract methods of §460.
 - What else?
 - Wait for IRS guidance.

Committee Report Footnote 872 Related to New §451(b)

- “The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.”
- Meaning?
 - Commission on 5 year renewable insurance contract?
 - Estimate might be included in financial statements when entered into.
 - Will §451(b) also require reporting in tax return of similar amount?
 - Or is there no realization event until the renewals are signed? Or is that a condition precedent to now be ignored under §451(b)?

<https://www.congress.gov/115/crpt/hrpt466/CRPT-115hrpt466.pdf>

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Committee Report Footnote 880 Related to New §451(c)

- “Thus, the provision is intended to override any deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods.”
 - Reg 1.451-5 allows longer deferral than does RP 2004-34
 - So, Congress wants no more than subsequent year to receiving the advance payment
 - But could adopt Rev Proc. 2004-34 for advance payments which is now part of §451.
 - Watch for method change guidance from IRS.

<https://www.congress.gov/115/crpt/hrpt466/CRPT-115hrpt466.pdf>

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Applicable Financial Statement Per §451(b)(3)

- A. GAAP certified and is:
 - i. 10-K, annual statement filed with SEC
 - ii. Audited FS used for credit purposes, reporting to owners or any “other substantial nontax purpose,” but only if no (i) statement
 - iii. Filed with any other Federal agency for other than tax purposes, but only if not (i) or (ii) statement.
- B. Financial statement using int’l financial reporting standards and filed with agency of a foreign gov’t equivalent to US SEC with reporting stds no less stringent than those of SEC, but only if no (A) statement, or
- C. Financial statement filed with any other regulatory or gov’t body specified by IRS but only if no (A) or (B) statement.

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Rev. Proc. 2004-34 versus new §451(c)

Differences include:

- Slight differences in defining AFS.
- Rev. Proc. 2004-34 applies even if taxpayer has no AFS – look at what was earned in the year advance payment was received.
 - But §451(b) gives IRS authority to specify other types of financial statements.
 - Stay tuned for IRS guidance!
- Rev. Proc. 2004-34 allows another year of deferral if year after receipt is a short tax year of 92 days or less
- How to adopt deferral method for advance payments:
 - §451(b) elect to use
 - Rev. Proc. 2004-34 adopt automatically in first year taxpayer has advance payments

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Advance Payments and Transition

- Notice 2018-35 (4/12/18)
 - Ok to continue to rely on Rev. Proc. 2004-34 until guidance issued under §451(c).
 - “During this time, the Service will not challenge a taxpayer’s use of Rev. Proc. 2004-34 to satisfy requirements of § 451, although the Service will continue to verify on examination that taxpayers are properly applying Rev. Proc. 2004-34.”
 - Requests comments to specific questions by 5/14/18
 - No reference to advance payment for goods rule of Reg. 1.451-5.

<https://www.irs.gov/pub/irs-drop/n-18-35.pdf>