

# ACCOUNTING FOR BUSINESSES

¶570 Expanded Availability of Cash Method, Exceptions to Inventory and UNICAP Rules, and Small Construction Contract Exception

# **NEW LAW EXPLAINED**

Single gross receipts test added for cash method, inventory, UNICAP, construction contract rules.—A single \$25 million gross receipts test has been put in place for determining whether certain taxpayers qualify as small taxpayers that can use the cash method of accounting, are not required to use inventories, are not required to apply the UNICAP rules, and are not required to use the percentage of completion method for a small construction contract (Act Sec. 13102 of the Tax Cuts and Jobs Act).

## COMMENT

The combined effect of the statutory changes is to replace a number of different gross receipts tests for determining what is a small taxpayer with a single gross receipts test with a \$25 million threshold. In nearly all cases, the \$25 million threshold is a significant increase from the prior thresholds which ranged from \$1 million to \$25 million. The changes not only increase the number of businesses that will qualify as a small taxpayer but also greatly simplify the gross receipts determinations.

**Gross receipts test expanded.** The exception to the general limit on the use of the cash method for small businesses is expanded for tax years beginning after December 31, 2017. Under the exception, a C corporation or a partnership with a C corporation partner that meets a gross receipts test can qualify to use the cash method of accounting (Code Sec. 448(b)(3), as amended by the 2017 Tax Cuts Act). A C corporation or a partnership with a C corporation partner meets the gross receipts test for a tax year if its average annual gross receipts for the three-tax-year period that ends with the tax year preceding such tax year do not exceed \$25 million (to be adjusted for inflation for tax years beginning after 2018 (discussed below)) (Code Sec. 448(c)(1), as amended by the 2017 Tax Cuts Act, and Code Sec. 448(c)(4), as added by the 2017 Tax Cuts Act).

## CAUTION

Tax shelters are not allowed to use the cash method even if they meet the gross receipts test (Code Sec. 448(a)(3)).

The steps for the gross receipts test are:

- determine gross receipts for each year in the three-tax-year period;
- compute the average annual gross receipts for the three-tax-year period; and
- determine if the average annual gross receipts for the three-tax-year period are \$25 million or less (to be adjusted for inflation for tax years beginning after 2018 (discussed below)).

#### **EXAMPLE**

A C corporation wants to determine if it can use the cash method under the expanded gross receipts test for the 2018 tax year. For the three tax years ending with the 2017 tax year, the corporation has gross receipts of \$21 million, \$26 million and \$25 million (tax years 2015, 2016 and 2017, respectively). Its average annual gross receipts for the three-tax-year period are \$24 million ((\$21 million + \$26 million + \$25 million) ÷ 3). The corporation meets the gross receipts test for 2018.



#### COMMENT

Many additional C corporations and partnerships with a corporate partner will be able to use the cash method under the \$25 million gross receipts test since the prior test capped the amount of qualifying annual gross receipts at only \$5 million.

Inflation adjustment. The average annual gross receipts amount of \$25 million is adjusted for inflation for tax years beginning after December 31, 2018 (Code Sec. 448(c)(4), as added by the 2017 Tax Cuts Act). The \$25 million amount will be increased by an amount equal to the \$25 million amount multiplied by the cost-of-living adjustment determined under Code Sec. 1(f)(3) (as amended by the 2017 Tax Cuts Act) for the calendar year in which the tax year begins by substituting "calendar year 2017" for "calendar year 2016" in Code Sec. 1(f)(3)(A)(ii). If the increased amount is not a multiple of \$1 million, the amount is rounded down to the next lowest multiple of \$1 million.

## COMMENT

The other exceptions to the general limitation on the use of the cash method continue to apply for qualified personal service corporations and taxpayers other than C corporations. Thus, 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 meet the \$25 million gross receipts test if the cash method clearly reflects income and the entity is not a tax shelter (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A taxpayer making a change in accounting method under the Code Sec. 448 rules limiting the use of the cash method should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 448(d)(7), as amended by the 2017 Tax Cuts Act). The special Code Sec. 481 adjustment periods for Code Sec. 448 accounting method changes of up to four years and up to 10 years for a hospital have been eliminated for tax years beginning after December 31, 2017 (Code Sec. 448(d)(7), prior to amendment by the 2017 Tax Cuts Act).

## **COMPLIANCE TIP**

Taxpayers make a change of accounting method by filing Form 3115, Application for Change in Accounting Method. The taxpayer should follow the IRS procedures for accounting method changes (Rev. Proc. 2015-13, I.R.B. 2015-5, 419, and Rev. Proc. 2017-30, I.R.B. 2017-18, 1131).

**Use of cash method by large farming corporations expanded.** The exception to the required use of the accrual method by large farming C corporations and farming partnerships with a C corporation partner has been expanded. For tax years beginning after December 31, 2017, a farming C corporation or a farming partnership in which a C corporation is a partner can use the cash method if it meets the \$25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 447(c), as amended by the 2017 Tax Cuts Act).

#### COMMENT

Many additional farming corporations and farming partnerships with a corporate partner will be able to use the cash method under the \$25 million gross receipts test since the prior test capped the amount of qualifying annual gross receipts at only \$1 million.

#### COMMENT

Since the test for *family* farming corporations was already set at average annual gross receipts of \$25 million, the rules in Code Sec. 447 that applied to *family* farming corporations are no longer needed and have been removed (Code Sec. 447(d), (e), (h) and (i), prior to being stricken by the 2017 Tax Cuts Act). However, the rules under former Code Sec. 447(i) for establishing suspense accounts for Code Sec. 481 adjustments from



accounting method changes will continue to apply to any suspense accounts established before the date of enactment (Act Sec. 13102(e)(2) of the 2017 Tax Cuts Act).

A farming corporation or farming partnership with a corporate partner making a change in accounting method under the Code Sec. 447 accounting method rules should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 447(d), as amended by the 2017 Tax Cuts Act).

Exception to required use of inventories expanded for small businesses. The exception to the required use of inventories for taxpayers that qualify as a small business has been expanded. For tax years beginning after December 31, 2017, a business is not required to use inventories if it meets the \$25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 471(c)(1), as added by the 2017 Tax Cuts Act). Any taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 471(c)(3), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the \$25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

## CAUTION

Tax shelters that are not allowed to use the cash method do not qualify as small businesses that can avoid using inventories (Code Sec. 448(a)(3); Code Sec. 471(c)(1), as added by the 2017 Tax Cuts Act).

A business that meets the \$25 million gross receipts test can use a method of accounting for inventory that:

- treats inventory as non-incidental materials and supplies; or
- conforms to the business's financial accounting treatment of inventories (Code Sec. 471(c)(1)(B), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A business's financial accounting treatment of inventories is the method of accounting reflected in an applicable financial statement or, if the business does not have an applicable financial statement, in the business's books and records as prepared in accordance with its accounting procedures (Code Sec. 471(c)(1)(B), as added by the 2017 Tax Cuts Act). An "applicable financial statement" is defined in Code Sec. 451(b)(3) (see ¶580) (Code Sec. 471(c)(2), as added by the 2017 Tax Cuts Act).

A taxpayer making a change in accounting method under the exception to the required use of inventories for small businesses should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 471(c)(4), as added by the 2017 Tax Cuts Act).

**Exception to required use of UNICAP rules expanded for small taxpayers.** The exception to the UNICAP rules for small taxpayers that purchase personal property for resale has been expanded. For tax years beginning after December 31, 2017, a taxpayer is not required to apply the UNICAP rules for the tax year if it meets the \$25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 263A(i)(1), as added by the 2017 Tax Cuts Act). The expanded exception to the UNICAP rules applies to any producer or reseller, other than a tax shelter, that meets the \$25 million gross receipts test (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 263A(i)(2), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the \$25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).



## **CAUTION**

Tax shelters that are not allowed to use the cash method do not qualify as small businesses that can avoid the UNICAP rules (Code Sec. 448(a)(3); Code Sec. 263A(i)(1), as added by the 2017 Tax Cuts Act).

#### COMMENT

The prior exception to the UNICAP rules only applied to small taxpayers that purchase personal property for resale while the expanded exception to the UNICAP rules applies to any *producer or reseller*, other than a tax shelter, that meets the \$25 million gross receipts test (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)). It also appears that the exception will apply to *real property* acquired for resale.

A taxpayer making a change in accounting method under the exception to the UNICAP rules for small businesses meeting the \$25 million gross receipts test should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 263A(i)(3), as added by the 2017 Tax Cuts Act).

**Small construction contract exception expanded.** The small construction contract exception to the required use of the percentage of completion method for long-term contracts has been expanded. For contracts entered into after December 31, 2017, in tax years ending after such date, the exception applies to a construction contract entered into by a taxpayer:

- who estimates at the time the contract is entered into that the contract will be completed within the two-year period beginning on the contract commencement date; and
- who meets the \$25 million gross receipts test of Code Sec. 448(c) (discussed above) for the tax year in which the contract is entered into (Code Sec. 460(e)(1)(B), as amended by the 2017 Tax Cuts Act).

A taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 460(e)(2)(A), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the \$25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

# **CAUTION**

The expanded exception for small contraction contracts cannot be applied by a tax shelter that is not allowed to use the cash method of accounting under Code Sec. 448(a)(3) (Code Sec. 460(e)(1)(B), as amended by the 2017 Tax Cuts Act).

If a taxpayer changes its method of accounting based on the small construction contract exception, then:

- the change is treated as initiated by the taxpayer and made with the IRS's consent; and
- the change is made on a cut-off basis for all similarly classified contracts entered into on or after the year of change (Code Sec. 460(e)(2)(B), as added by the 2017 Tax Cuts Act).

**Effective date.** The amendments made by this section generally apply to tax years beginning after December 31, 2017 (Act Sec. 13102(e)(1) of the Tax Cuts and Jobs Act). The amendments made by this provision for small construction contracts apply to contracts entered into after December 31, 2017, in tax years ending after such date (Act Sec. 13102(e)(3) of the 2017 Tax Cuts Act).