Strafford

FOR LIVE PROGRAM ONLY

New Proposed Regs for Small Business Accounting Methods: Gross Receipts Test, Inventory, Long-Term Contracts

TUESDAY, DECEMBER 8, 2020, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** – if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code**.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE PROGRAM

For Additional Registrations:
-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

For Assistance During the Live Program:
-On the web, use the Chat function to send a message

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

New Proposed Regs for Small Business Accounting Methods: Gross Receipts Test, Inventory, Long-Term Contracts

December 8, 2020

Michael D. Resnick, Attorney
Eversheds Sutherland (US)
michaelresnick@eversheds-sutherland.com

David Strong, CPA, Managing Director
Crowe
david.strong@crowe.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

New Proposed Regs for Small Business Accounting Methods: Gross Receipts Test, Inventory, Long-Term Contracts

December 8, 2020

David Strong, Crowe LLP

Michael Resnick, Eversheds Sutherland (US) LLP

Agenda

- Prior Section 448 Provisions
- 2017 Tax Law Changes to Small Business Treatment
- Proposed regulations issued July 2020
- Tax Shelter Definition and Other Provisions Impacting Eligibility for Simplified Accounting Method Changes
- Making the election, including retroactive provisions
- Handling previously eligible businesses which exceed the threshold

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.

Proposed Regulations issued July 2020

Small Business Taxpayer Exclusions

- Proposed regulations published in the Federal Register on August 5, 2020.
- Addresses small taxpayer provision within IRC sections 263A, 448, 460 and 471.
- Generally rules will be effective when published as final.
  - Taxpayers can rely on the regulations for taxable years beginning after December 31, 2017 until final regulations are issued.
  - If relied upon, proposed regulations must be applied consistently with respect to each code section.

Small Business Taxpayer - Cash Method Under Section 448

- IRC §448 and Prop. Treas. Reg. §1.448-2
  - Gross receipts test now $25 million (indexed for inflation - $26 million for 2020), and taxpayers no longer permanently fail the test.
  - Aggregation still applies under single employer rules, commonly 50% ownership parent/subsidiary or brother/sister.
    - Clarified that aggregation applies for the gross receipts of a C corporation partner of a partnership.
    - Provides guidance regarding C corporation ownership of a partnership.
    - Impact of M&A, application with predecessor entities, and tax year mismatches not addressed.

Small Business Taxpayer - Cash Method Under Section 448

- IRC §448 and Prop. Treas. Reg. §1.448-2
  - Tax Shelters / Syndicate issues
    - Entities other than a C-corporation (e.g. flow-through) if more than 35% of losses incurred by the entity are *allocated* to limited partners or limited entrepreneurs.
    - Limited guidance on active management for purposes of defining limited partners or limited entrepreneurs.
  - A single year's taxable loss can cause a taxpayer to fail this test.
    - Regulations provide an election to make this determination based on the prior year.
    - Can be made with an extended return, but once made, applies for all future years and cannot be revoked for five years.
    - Once revoked, a taxpayer cannot make a new election for five years.

Small Business Taxpayer - Cash Method Under Section 448

- IRC §448 and Prop. Treas. Reg. §1.448-2
  - Procedural issues and Method Changes
    - Cash to Accrual method change is generally automatic, 5 year eligibility does not apply if filed for a "mandatory §448 year", i.e. a year taxpayer goes from eligible to ineligible under IRC §448.
    - Accrual to Cash method change is also generally automatic for small business taxpayers.
      - However, 5 year eligibility rule does apply.
      - Thus, if a taxpayer failing the IRC §448 tests and changes Cash to Accrual, they would need to wait 5 years or file an advance consent change to readopt the overall cash method.

Small Business Taxpayer - Inventory Under Section 471

- IRC §471(c) and Prop. Treas. Reg. §1.471-1
  - Provides rules regarding determination of gross receipts for individual taxpayers that are partners and S corporation shareholders where aggregation rules do not apply.
  - Small business taxpayers can treat inventory as non-incidental materials and supplies as generally covered under Treas. Reg. §1.162-3.
  - Defined as "§471(c) materials and supplies", but still considered "inventory".
  - Considered "used or consumed" after costs are incurred and inventory is provided to the customer.
    - Does not segregate out "used or consumed" raw materials that enter into a production process to be deducted earlier.

Small Business Taxpayer - Inventory Under Section 471

- IRC §471(c) and Prop. Treas. Reg. §1.471-1 materials and supplies, continued.
  - Clarified that the De minimis safe harbor election is not available to deduct §471(c) materials and supplies.
  - Taxpayers cannot use LCM or LIFO methods for inventory costs.
  - Inventory cost must include all direct costs
    - Direct Materials
    - Direct Labor

Small Business Taxpayer - Inventory Under Section 471

- IRC §471(c) and Prop. Treas. Reg. §1.471-1
  - Small business taxpayer may follow their Applicable Financial Statements to determine inventory costs, or the "AFS §471(c) method".
  - AFS defined the same as under IRC §451(b)(3).
  - Inventory costs cannot include amounts otherwise not deductible ("anti-stuffing").
  - Costs cannot be accelerated if not otherwise incurred by nature of these provisions.
  - These anti-abuse provisions may create need to still have book-tax differences.

Small Business Taxpayer - Inventory Under Section 471

- IRC §471(c) and Prop. Treas. Reg. §1.471-1
  - Small business taxpayer without an AFS may follow their books and records to determine inventory costs, or the "non-AFS §471(c) method".
  - Not available if a taxpayer has an AFS.
  - Requires adequate records used for non-tax purposes.
  - Generally includes the same boundaries and anti-abuse provisions as the AFS §471(c) method.

Small Business Taxpayer - Inventory Under Section 263A

- Generally, small business taxpayer not required to capitalize costs under UNICAP.
  - Property produced or acquired for resale.
  - Including interest capitalization provisions.
- Proposed Regulations update several references made obsolete by TCJA (e.g. $10M small reseller).
- Provides rules regarding determination of gross receipts for individual taxpayers that are partners and S corporation shareholders where aggregation rules do not apply.
- Farmers now eligible for the Small Business Taxpayer exclusion from UNICAP can revoke previous elections under IRC §263A(d)(3).
- Consideration of the new definition of IRC §471 under the UNICAP rules in applying the small business taxpayer exception.

Small Business Taxpayer – Revenue Recognition Under Section 460

- Generally, small business taxpayer entities are not required to use the percentage or completion method for long-term contracts.
  - Construction contracts completed in 2 years.

- Small business taxpayers are also not required to apply the rules under IRC §263A.

- Proposed Regulations update several references made obsolete by TCJA (e.g. $10 million small contractor exception).

- Provides rules regarding determination gross receipts for individual taxpayers that are partners and S corporation shareholders where aggregation rules do not apply.

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

Making the Election, including Retroactive Provisions

Small Business Taxpayer – Method Changes

- TCJA provides favorable methods for taxpayers that meet the $25 million average annual gross receipts test (small taxpayers).
    - Overall method of accounting – may use the overall cash method of accounting.
    - Inventory – may account for inventory as follows: (1) treat as non-incidental materials and supplies or (2) conform to the taxpayer's book method of accounting.
    - UNICAP – exempt from requirements to capitalize costs under Sec. 263A.
    - Long-Term Contracts – for contracts expected to be completed in 2 years, may use an exempt contract method. Also not required to capitalize costs under Sec. 263A for certain home construction contracts.
- Generally covered under Revenue Procedure 2019-43 automatic accounting method change list.
- Current listed changes do not reflect changes to the proposed regulations.

Small Business Taxpayer – Method Changes Section 448

- Overall method of accounting – may use the overall cash method of accounting.
- Most impactful for C corporations or partnership with C corporation partners and those required to maintain inventories.
- Reduced filing requirements.
- Allows for concurrent method changes.
- Waives certain eligibility rules for the first, second or third taxable year ending after December 31, 2017.

Small Business Taxpayer – Method Changes Section 471

- Inventory – may account for inventory as follows: (1) treat as non-incidental materials and supplies or (2) conform to the taxpayer's book method of accounting.
- Requires analysis of methodology to be used in determining the value of inventory.
- Reduced filing requirements.
- Allows for concurrent method changes.
- Waives certain eligibility rules for the first, second or third taxable year ending after December 31, 2017.

Small Business Taxpayer – Method Changes Section 263A

- UNICAP – exempt from requirements to capitalize costs under Sec. 263A.
- Reduced filing requirements.
- Allows for concurrent method changes.
- Waives certain eligibility rules for the first, second or third taxable year ending after December 31, 2017.
- Revenue Procedure 2020-13 allows farmers to revoke an election made under IRC §263A(d)(3).

Small Business Taxpayer – Method Changes Section 460

- Long-Term Contracts – for contracts expected to be completed in 2 years, may use an exempt contract method. Also not required to capitalize costs under Sec. 263A for certain home construction contracts.
- Reduced fling requirements.
- Doesn't allow for concurrent method changes.
- Waives certain eligibility rules for the first, second or third taxable year ending after December 31, 2017.
- Implemented on a cut-off basis.

Handling Previously Eligible Businesses which Exceed the Threshold

Ineligible Small Business Taxpayer – Method Changes

- Taxpayers that meet the $25 million average annual gross receipts test (small taxpayers exception).
  - Overall method of accounting – must change to the accrual method of accounting.
  - Inventory – must properly account and value inventory consistent with the rules under IRC Sec 471.
  - UNICAP – must properly capitalize costs under Sec. 263A.
  - Long-Term Contracts – must begin to apply the rules for percentage of completion method to long-term contracts and capitalize costs under Sec. 263A for certain home construction contracts.
- Determination if Revenue Procedure 2019-43 allows for an automatic method change.
- Advance consent method change Revenue Procedure 2015-13.
  - Filing fee $10,800
  - IRS approval required
  - Must be filed by the close of the tax year it will be effective

Thank You

Michael D. Resnick

Eversheds Sutherland (US)

michaelresnick@eversheds-sutherland.com

David Strong

Crowe Horwath

david.strong@crowehorwath.com