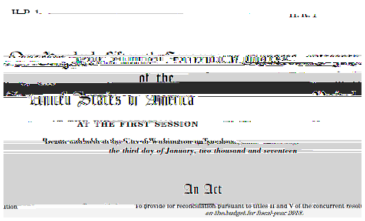
New Favorable Methods for Small Businesses



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IRS-SJSU Small Business Tax Institute
Successfully Navigating the TCJA for Small Business Clients
5/23/18

Review - What is a method of accounting?

- Involves timing
  - Treatment doesn’t affect lifetime income.
  - “when” questions, not “whether” questions

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 rel1 1 Tf69(g)5.4(e)3-0.6(11.4(f)-0.q.7(h)-0.7(.)0 Tw 27.38 0 Td[(.)7(A ma)m6TC.7(e)-1( )-6-7(m)-6

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TCJA

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(x)25.n17(e)-0 cir1817 5 Tw 0.725 0 Td[(S)-4

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 - §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

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

- Little guidance, but see PLR 8911011
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(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-incidental 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-incidental supplies

- Per Rev. Proc. 2001-10:
  - "Under section 1.162-3, materials and supplies that are not incidental 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

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)

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.

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.

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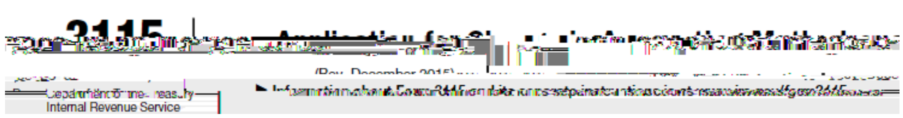
- C corps and p/s with C corp partner with gross receipts over $5 million but under $25 million
  - Change from accrual to cash
- Small taxpayers using unicap (§263A)
- Small taxpayers accounting for inventory and using accrual who prefer cash and other treatment for inventory per §471(c)
- Taxpayers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

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 of taxpayer is a tax shelter (same definition, but more important now).

More TCJA Method Changes



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)

§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.sjsu.edu/people/annette.nellen/451_as_AmendedByHR1_115th.pdf

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More on §

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

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

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).
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