The IRS Expands Use of the Cash Method: Help for Small Business Taxpayers

THE IRS HAS GUIDELINES THAT MUST BE followed in choosing an accounting method. But recent changes have potentially simplified the bookkeeping requirements for small business taxpayers, offering those who qualify the option to use the cash method.

Effect of Changes

Rev. Proc. 2002-28 provides qualifying taxpayers with limited relief from IRC §263A, more commonly known as UNICAP (uniform capitalization rules), which requires taxpayers to capitalize direct and allocable indirect costs of real or tangible personal property they produce or acquire for resale to a customer. With the implementation of the cash method, inventoriable items that are treated as non-incidental materials and supplies are considered to be consumed and used in the year that the qualifying taxpayer provides the items to a customer. As a result, the cost of such items is deductible in the year that the items are used and consumed in operations or in the year the taxpayer actually pays for the items, whichever is later.

The following summary of Example 15 from Rev. Proc. 2002-28 demonstrates the benefit of this new rule. A small business taxpayer who meets the requirements to use the cash method is hired to replace a customer's roof. The taxpayer purchases, pays for, and receives the shingles for the job in December 2002 and replaces the customer's roof and bills the customer later that same month. The taxpayer receives payment for the roof in January 2003. Because the cash method is being used, the taxpayer should include the customer's payment for the roof replacement in income in 2003—the taxable year in which the money was actually received—but is allowed to deduct the cost of the shingles at the latter of the payment date or the date of usage, in this case in 2002. Basically, the taxpayer has been able to defer income into the following taxable year (compared to the accrual method) but take the deduction in the current year by the use of the new method.

In determining the amount of the allowable deduction, the qualifying taxpayer is not permitted to use the LIFO (last in, first out) method. Whichever reasonable method is chosen (FIFO (first in, first out), Specific ID, Average) to determine the deduction, the method must be used consistently.

By allowing certain small business taxpayers to use the cash method, the IRS has simplified the record-keeping requirements of qualifying taxpayers. As a result, there should be substantially fewer disputes between such qualifying taxpayers and the IRS regarding the requirement to use the accrual method of accounting, in turn lowering the amount of time and money the IRS spends to enforce compliance. In short, this new tax policy is a matter of administrative convenience for the IRS, while it simultaneously makes bookkeeping less complicated for qualifying small business taxpayers.

Change in Tax Policy

In general, the IRS has permitted taxpayers to choose the method of accounting in computing taxable income, provided they adhere to certain requirements. Traditionally, whenever a taxpayer produces, purchases, or sells merchandise to generate income, the taxpayer is required to account for inventories (IRC §471) and is therefore required to use the accrual method of accounting (IRC §446).

As of December 31, 2001, this requirement to use the accrual method no longer applies to certain qualifying small business taxpayers (Rev. Proc. 2002-28). The IRS will now allow taxpayers with average annual gross receipts between $1 million and $10 million for the prior three taxable years to use the cash method of accounting, provided that the taxpayer satisfies three requirements. First, the taxpayer cannot be an entity specified in the Internal Revenue Code as one that cannot use the cash method (IRC §448). Second, the taxpayer cannot have previously switched from the cash method to the accrual method because Rev. Proc. 2002-28 made the business ineligible to use the cash method. Third, the taxpayer's principal business activity must fall within the scope of eligibility.

The first requirement eliminates the use of the cash method to all tax shelters as well as most C corporations or partnerships with a C corporation as a partner if their gross receipts are more than $5 million. Essentially, the IRS is simply maintaining the old test of whether a corporation has to operate under the accrual method. This rule will appear to result in two types of qualifying taxpayers: proprietorships and partnerships with gross receipts of under $10 million and C corporations with gross receipts of under $5 million. The second requirement is straightforward. If the taxpayer is moved off the cash method under Rev. Proc. 2002-28, they will not be allowed to return to it later. The third requirement is really the key to qualification. To qualify, the taxpayer cannot have what is described as an ineligible NAICS code as its principal business activity. Specifically, the taxpayer cannot principally be involved in mining, manufacturing, wholesale trade, retail trade, or information industries (such as publishing). This eliminates most businesses that the UNICAP rules were designed to hit the hardest. The taxpayer can have some involvement in one of these areas if its principal activity is the provision of services or the fabrication of tangible personal property to specification.

In addition, a taxpayer can segregate its business activities if its principal activity is in a prohibited code but other activities aren't. The principal business activity can be determined using either the prior year or the average of the prior three years. Note that the rule is the principal (or predominant) activity. The activity doesn't have to constitute more than 50% of the overall business activity.

Taxpayers that satisfy these requirements are given the option to use the overall cash method rather than the accrual method to report income and expenses. Qualifying small business taxpayers, therefore, don't have to keep a "traditional" inventory account. Instead, they are allowed to account for inventoriable items in the same way they treat nonincidental materials and supplies under Treas. Reg. 1.162-3. The IRS previously allowed taxpayers whose annual gross receipts did not exceed $1 million to use the cash method. These new rules likewise require qualifying taxpayers to "hold" inventory costs so the taxpayer is not on a true cash basis, per se, when it comes to inventory. Rather, the taxpayer has a simplified method in that the taxpayer can simply look to remaining items at year-end and back into the related expense amounts. Rev. Proc. 2002-28 contains 26 easy-to-follow examples that detail many of the rules discussed here.

Changing Accounting Methods

A qualifying small business taxpayer that wants to change accounting methods under this new procedure can make an automatic change to the cash method. To do so, the taxpayer must follow the automatic change provision described in Rev. Proc. 2002-9 (as modified) and must also file Form 3115, "Application for Change in Accounting Method." Likewise, these taxpayers must also make the necessary changes to alter the treatment of inventoriable items to make them consistent with the new method. ■

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