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IRS Issues New Automatic Changes for Taxpayers Meeting the $25 million Gross Receipts Test

On August 3, 2018, the IRS released Rev. Proc. 2018-40, which provides procedural guidance by which a small business taxpayer meeting the $25 million gross receipts test may obtain automatic IRS consent to implement a number of taxpayer-favorable method changes resulting from the "Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," P.L. 115-97 ("Tax Cuts and Jobs Act" or the "Act"). These new method changes include: (1) changing to the overall cash method; (2) exception from the requirement to capitalize costs under Section 263A; (3) exception from the requirement to account for inventories under Section 471; and (4) exception from the requirement to account for certain long-term contracts under Section 460 or to capitalize Section 263A costs for certain home construction contracts. Taxpayers making concurrent changes may file a single combined Form 3115 application for several of the method changes. Effective for taxable years beginning after December 31, 2017, these automatic changes are made by attaching the Form 3115, *Application for Change in Accounting Method*, to the timely filed (including extensions) federal income tax return for the year of the change and mailing a copy of the Form 3115 to the IRS office in Covington, Kentucky, on or before the filing date of that return.

BACKGROUND

The Tax Cuts and Jobs Act amends a number of Internal Revenue code sections for the benefit of small business taxpayers. Affected code sections include Sections 263A, 447, 448, 460, and 471. Small business taxpayers are those taxpayers, other than a tax shelter, that meet the gross receipts test in Section 448(c). This test is met if a taxpayer has average annual gross receipts for the three prior taxable years of $25 million or less (adjusted for inflation). For gross receipts testing purposes, taxpayers should be mindful of whether the aggregation rule of Section 448(c)(2) applies to combine gross receipts of another entity. The aggregation rule provides that all taxpayers treated as a single employer under Section 52(a) or (b), or Section 414(m) or (o), will be treated as a single taxpayer.

Because these favorable tax provisions are effective for taxable years beginning after December 31, 2017, affected taxpayers should evaluate existing accounting methods and identify actionable opportunities for filing accounting method changes. Below is an overview of the new automatic accounting method changes prescribed by Rev. Proc. 2018-40.

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OVERVIEW

1. Small Business Taxpayer Changing to Overall Cash Method

What's new for 2018 and beyond?

- The average annual gross receipts test that exempts C corporations and partnerships with C-corporation partners from the requirement to use the overall accrual method of accounting is increased from $5 million to $25 million. This expands the use of the overall cash method of accounting for a greater number of taxpayers.

Who is eligible for this method change?

- Any taxpayer that (1) meets the $25 million gross receipts test under Section 448(c) and (2) is not otherwise prohibited from using the overall cash method (e.g., tax shelter defined in Section 448(d)(3)) or required to use another overall method of accounting.

What is the new method change?

- Automatic change #233 applies to a small business taxpayer that wants to change its overall method of accounting from the accrual to the cash method for a trade or business. This change is implemented with a Section 481(a) adjustment. For the first, second, or third taxable year beginning after December 31, 2017, the taxpayer can file this change even if it previously changed the overall method of accounting within the past five years. See Section 15.18 of Rev. Proc. 2018-31 for more details.

2. Exception from Requirement to Capitalize Costs under Section 263A

What's new for 2018 and beyond?

- The average annual gross receipts test that exempts small resellers from the requirement to capitalize additional Section 263A costs under the uniform capitalization rules (UNICAP) is increased from $10 million to $25 million as well as expanded to both producers and resellers.

Who is eligible for this method change?

- Any taxpayer that (1) meets the $25 million gross receipts test under Section 448(c) and (2) is not otherwise prohibited from using the overall cash method (e.g., tax shelter defined in Section 448(d)(3)) or required to use another overall method of accounting.

What is the method change?

- Automatic change #234 applies to a small business taxpayer that capitalizes costs under Section 263A (UNICAP) and wants to change to a method of accounting that no longer capitalizes costs under Section 263A, including to self-constructed assets. This change is implemented with a Section 481(a) adjustment. For the first, second, or third taxable year beginning after December 31, 2017, the taxpayer can file this change even if it previously changed the method of accounting for the same item within the past five years. See Section 12.16 of Rev. Proc. 2018-31 for more details.

3. Exception from Requirement to Account for Inventory under Section 471

What's new for 2018 and beyond?

- The average annual gross receipts test that exempts taxpayers from the requirement to account for inventories is increased from $1 million under Rev. Proc. 2001-10 or $10 million under Rev. Proc. 2002-28 to $25 million. This allows small business taxpayers to simplify their tax accounting for inventoriable costs to, in some cases, conform to the financial treatment.

Who is eligible for this method change?

- Any taxpayer that (1) meets the $25 million gross receipts test under Section 448(c) and (2) is not otherwise prohibited from using the overall cash method (e.g., tax shelter defined in Section 448(d)(3)) or required to use another overall method of accounting.

What is the method change?

- Automatic change #235 applies to a small business taxpayer that wants to change its Section 471 method of accounting for inventory items to one of the following:
  a. Treating inventory as non-incidental materials and supplies under Treas. Reg. Section 1.162-3; or
  b. Conforming to the taxpayer's method of accounting reflected in its applicable financial statements with respect to the taxable year (or, if the taxpayer does not have applicable financial statements for the taxable year, the books and records prepared in accordance with the taxpayer's accounting procedures).

Inventory that is treated as non-incidental materials and supplies are deducted in the taxable year in which they are first used in the taxpayer's operations or are consumed in the taxpayer's operations, which is generally when the taxpayer provides the items to the customer.

This change is implemented with a Section 481(a) adjustment. For the first, second, or third taxable year beginning after December 31, 2017, the taxpayer can file this change even if it previously changed the method of accounting for the same item within the past five years. See Section 22.19 of Rev. Proc. 2018-31 for more details.

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4. Exception from Requirement to Account for Certain Long-Term Contracts under Section 460 or to Capitalize Costs under Section 263A for Certain Home Construction Contracts

What's new for 2018 and beyond?

- Taxpayers must generally use the percentage-of-completion method (PCM) to determine the taxable income under a long-term contract, unless the contract is (1) a home construction contract or (2) any other construction contract expected to be completed within two years of the contract commencement and performed by a taxpayer whose average annual gross receipts do not exceed $25 million (up from $10 million).

Who is eligible for this method change?

- Any taxpayer that (1) meets the $25 million gross receipts test under Section 448(c), (2) is not otherwise prohibited from using the overall cash method (e.g., tax shelter defined in Section 448(d)(3)) or required to use another overall method of accounting, and (3) previously adopted the PCM for exempt long-term construction contracts and now wants to change to another permissible exempt contract method of accounting, or previously applies Section 263A to home construction contracts.

What is the method change?

- Automatic change #236 applies to a small business taxpayer that:
    a. Wants to change its method of accounting for exempt long-term construction contracts from PCM to an exempt contract method, or
    b. Chooses to stop capitalizing costs under Section 263A for home construction contracts.

This change applies to exempt long-term contracts described in Section 460(e)(1) that are entered into after December 31, 2017, in taxable years ending after December 31, 2017. Therefore, this change is made on a cut-off basis (thus, no Section 481(a) adjustment). For the first, second, or third taxable year beginning after December 31, 2017, the taxpayer can file this change even if it previously changed the method of accounting for the same item within the past five years. See Section 19.01 of Rev. Proc. 2018-31 for more details.

Taxpayers may file a single Form 3115 for the cash method of accounting (change #233), exemption from UNICAP (change #234), and exemption from Section 471 (change #235). Change #236 for the exemption from PCM must be filed separately.

Rev. Proc. 2018-40 also modifies several sections in Rev. Proc. 2018-31, provides a transition rule, and request comments for future guidance under Sections 263A, 447, 448, 460, and 471.

In summary, the tax reform bill provides a multitude of accounting method planning opportunities that can result in tax savings and simplification for small business taxpayers. Companies are encouraged to begin gathering information and evaluating action items as soon as possible in order to properly comply with the procedural rules for making accounting method changes.

If you have any questions, please contact a member of the Accounting Methods group. The Accounting Methods group within BDO USA's National Tax Office has extensive experience assisting taxpayers of all industries and sizes with their accounting method issues and filing accounting method change requests with the IRS.

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