Current Federal Tax Developments

Week of August 3, 2020

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SECTION: 446
SMALL BUSINESS ACCOUNTING METHOD PROPOSED REGULATIONS RELEASED

Citation: REG-132766-18, 7/29/20

The IRS has issued proposed regulations to implement the various small business optional accounting rules added to IRC §§263A, 448, 460 and 471 by the Tax Cuts and Jobs Act (TCJA).[1] These rules are generally available to small businesses that are not tax shelters and have average annual gross receipts in the preceding three years not in excess of an amount annually adjusted for inflation. For 2020 the revenue limit is $26 million.[2]

Qualifying entities are:

- Allowed to use the cash basis of accounting (any change of method is treated as a change initiated by the taxpayer and made with the consent of the IRS). [IRC §448(b)(3), (d)(7)]
- Allowed to be exempt from the application of the uniform capitalization rules of IRC §263A [IRC §263A(i)]
- Allowed to be exempt from the requirement to keep inventories under the rules of §471(a) (though such items must either be tracked as if they were non-incidental supplies or treated in conformity with the entity's applicable financial statement/books and records if no AFS exists). [IRC §471(c)]
- Treated as meeting the gross receipts requirement to be treated as a small contractor exempt from the percentage of completion method (this does not impact the second requirement that the expected length of contracts must also be less than 2 years to be exempt from percentage of completion). [IRC §460(e)(1)(B)]

Any change of method required for the above is treated as a change initiated by the taxpayer and made with the consent of the IRS for purposes of IRC §481.

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[1] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf (retrieved July 30, 2020)

[2] Revenue Procedure 2019-44, November 6, 2019, Section 3.21, https://www.irs.gov/pub/irs-drop/rp-19-44.pdf (retrieved July 30, 2020)

Taxpayers May Rely on Proposed Regulations

Although the regulations are issued in proposed form, Treasury provides that taxpayers may rely on these regulations in the interim. The preamble to the proposed regulations provides:

> However, for taxable years beginning after December 31, 2017, and before the date the Treasury Decision adopting these regulations as final regulations is published in the Federal Register, a taxpayer may rely on these proposed regulations, provided that the taxpayer follows all the applicable rules contained in the proposed regulations for each Code provision that the taxpayer chooses to apply.[3]

The IRS had previously issued preliminary guidance for taxpayers qualifying for and adopting these optional methods, as well as a request for comments, in Revenue Procedure 2018-40. This procedure will continue to contain the automatic accounting method change procedures under these regulations.

Some of the key items in these proposed regulations are discussed in this article.

Entities Qualifying for Special Small Business Accounting Methods (IRC §448(c))

To qualify to use these special small business methods, a taxpayer must meet requirements outlined in IRC §448(c) and not be a tax shelter as defined in IRC §448(d)(2).

IRC §448(c) provides the following gross receipts test:

> (c) Gross receipts test
>
> For purposes of this section—
>
> (1) In general
>
> A corporation or partnership meets the gross receipts test of this subsection for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000.[4]

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[3] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf, p. 42

[4] For 2020 this is set at $26,000,000 under the inflation adjustment provided for at IRC §448(c)(4) and published in Revenue Procedure 2019-44 noted earlier.

(2) Aggregation rules

All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).

(3) Special rules

For purposes of this subsection—

> (A) Not in existence for entire 3-year period
>
> If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.
>
> (B) Short taxable years
>
> Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.
>
> (C) Gross receipts
>
> Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.
>
> (D) Treatment of predecessors
>
> Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

(4) Adjustment for inflation

In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—

> (A) such dollar amount, multiplied by
>
> (B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000,000, such amount shall be rounded to the nearest multiple of $1,000,000.

The IRS has proposed the creation of a new regulation (Proposed Reg. §1.448-2) to apply to years beginning after December 31, 2017, with Reg. §1.448-1 retained to deal with years beginning prior to that date.

The IRS summarized the key differences in the preamble to the proposed regulations as follows:

> These rules are generally similar to the existing regulations under §1.448-1 and §1.448-1T of the Temporary Income Tax Regulations, including the short taxable year rule and the aggregation rule. However, for taxable years beginning after December 31, 2017, the proposed regulations update the rules to reflect the post-TCJA Section 448(c) gross receipts test. These proposed regulations also clarify that the gross receipts of a C corporation partner are included in the gross receipts of a partnership if the aggregation rules apply to the C corporation partner and the partnership.[5]

Gross Receipts Test

Proposed Reg. §1.448-2(c)(2) contains the details of the gross receipts test. The proposed regulation provides generally:

> A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of paragraph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.[6]

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[5] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf, p. 13

[6] Proposed Reg. §1.448-2(c)(2)(i)

Related entities are aggregated for purposes of this test. Proposed Reg. §1.448-1(c)(2)(ii) provides that the aggregation rules remain the same as they were, referencing Reg. §1.448-1T(f)(2)(ii). That rule provides:

> (ii) Aggregation of gross receipts.
>
> For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52(a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisfied.[7]

The proposed regulations also keep the prior rules for treatment of short taxable years[8] found in Temporary Regulation §1.448-1T:

> (iii) Treatment of short taxable year.
>
> In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.[9]

Finally, the same rules for the determination of gross receipts are retained,[10] also coming from Temporary Regulation §1.448-1T:

> The term "gross receipts" means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2)

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[7] Reg. §1.448-1T(f)(2)(ii)

[8] Proposed Reg. §1.448-2(c)(iii)

[9] Temp. Reg. §1.448-1T(f)(2)(iii)

[10] Proposed Reg. §1.448-1(c)(iv)

> (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (e.g., a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.[11]

The proposed regulations provide the following example of the application of their provisions:

EXAMPLE, PROPOSED REG. §1.448-2(C)(2)(V)(B)

Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017- 2019 taxable years are $20 million, $16 million, and $30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is $22 million (($20 million + $16 million + $30 million) / 3 = $22 million. A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is $26 million for 2020.

Some of the special rules on the gross receipts test are found outside of the regulations under IRC §448, especially as they apply to individuals. Proposed Reg. §1.263A-1(j)(2) provides the following for testing the gross receipts of individuals to qualify under the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.[12]

[11] Temp. Reg. §1.448-1T(f)(2)(iv)

[12] Proposed Reg. §1.263A-1(j)(2)(ii)

The regulation continues to provide that individuals also take into account their proportionate share of gross receipts of partnerships and S corporations for purposes of the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).[13]

The proposed regulation gives two examples of applying these rules to individuals:

EXAMPLE 1, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, Profit or Loss from Business, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

EXAMPLE 2, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

The above provisions are also found in Proposed Reg. §1.460-3(b)(3) and Proposed Reg. §1.471-1(b)(2).

Tax Shelters

But it's not just the gross receipts test that must be taken into account—even if the prior three years' average gross receipts are below the level for the tax year in question, the taxpayer may still be denied access to these accounting methods if the entity is a tax shelter as defined at IRC §448(d)(3).

[13] Proposed Reg. §1.263A-1(j)(2)(iii)

That definition reads:

> The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.[14]

The proposed regulations provide the following list of tax shelters for this purpose:

- An enterprise, other than a C corporation, if at any time (including taxable years beginning before January 1, 1987) 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;
- A tax shelter (which seems a circular definition, but this "tax shelter" is a subset of the larger §448(d)(3) tax shelter, this one defined at §6662(d)(2)(C), so we'll refer to this as a *§6662 tax shelter*); or
- A syndicate.[15]

An enterprise other than a C corporation is considered to be one that had a requirement of registration if it meets the following requirements:

> …[A]n offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or state law; this rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.[16]

A *§6662 tax shelter* is defined to include:

- A partnership or other entity,

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[14] IRC §448(d)(3)

[15] Proposed Reg. §1.448-2(b)(2)(i)

[16] Proposed Reg. §1.448-2(b)(2)(ii)

- 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.[17]

The proposed regulations provide for a special presumption of a principal purpose of tax avoidance for certain farming activities:

> …[M]arketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (for example, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).[18]

The presumption means the burden will be on the taxpayer to clearly demonstrate that there was not a principal purpose of tax reduction in this arrangement. Note that a *principal purpose* is generally regarded as being a more important purpose than a *significant purpose*. It's not clear why the proposed regulation used that term rather than a presumption of a *significant* purpose.

The category that has traditionally been the most challenging has been the *syndicate* category. IRC §448 refers to the definition found at IRC §461(i)(3) which then references IRC §1256(e)(3)(B). However, the proposed regulation provides a generally self contained definition that draws from those sections.

The basic definition of a *syndicate* is provided as follows by the proposed regulation:

> …[T]he term syndicate means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs.[19]

In these proposed regulations the IRS has opted to continue to use the *allocated* test found in the prior §448 regulations even though §1256(e)(3)(B) itself uses the term *allocable*. Thus, if there is no loss generated for a tax year, the entity will not be a syndicate for that year. But if the entity has both profitable and unprofitable years, it may move in and out of syndicate status depending on the percentage of amounts allocated in loss years to equity holders qualifying as limited entrepreneurs or who are limited partners.

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[17] IRC §6662(d)(2)(C)(ii)

[18] Proposed Reg. §1.448-2(b)(2)(iv)

[19] Proposed Reg. §1.448-2(b)(2)(iii)(A)

The proposed regulation goes on to define the term *limited entrepreneur*, providing:

> …[T]he term limited entrepreneur has the same meaning given such term in section 461(k)(4).

IRC §461(k)(4) has the actual definition, which provides that a *limited entrepreneur* is a person who:

- Has an interest in an enterprise other than as a limited partner, and
- Does not actively participate in the management of such enterprise.[20]

The 35% loss rule is tested without regard to the limitation on the deduction of business interest found in §163(j).[21] In a separate set of proposed regulations issued a day earlier with regard to the business interest rule, the IRS provided for a similar proposed change in Proposed Reg. §1.1256(3)-2[22] and gave the following example of how to compute whether an undertaking has a loss as follows:

EXAMPLE, PROPOSED REG. §1.1256(3)-2(E)(2)(C)

Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of $5,000,000, non-interest expenses of $4,500,000, and interest expense of $600,000.

Under the tax syndicate loss testing rules, Entity has a net loss of $100,000 ($5,000,000 minus $5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

In the preamble to the proposed regulations under §163(j) the IRS noted the reason why this special rule is necessary that was cited in comments received by the IRS:

> One commenter asked for clarification on how to compute the amount of losses to be allocated for purposes of determining syndicate status under section 1256(e)(3)(A). The commenter provided a particular fact pattern in which a small business would be caught in an iterative loop of (a) having net losses due to an interest deduction, (b) which would trigger disallowance of the exemption in section 163(j)(3), (c) which would trigger the application of section 163(j)(1) to reduce the amount of the interest deduction, (d) which would then lead to the taxpayer having no net losses and therefore being eligible for the application of section 163(j)(3). To address this fact pattern, the Treasury Department and

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[20] IRC §461(k)(4)

[21] Proposed Reg. §1.448-2(b)(2)(v)

[22] REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf (retrieved July 30, 2020)

> the IRS have added rules providing that, for purposes of section 1256(e)(3)(B), losses are determined without regard to section 163(j). See proposed §§1.163(j)-2(d)(3) and 1.1256(e)-2(b).[23]

Even with this change, it clearly is possible an undertaking that has been profitable could suddenly become a tax shelter for §448 purposes if it generates a loss for the year. The proposed regulations provide that an entity must change its accounting method for the year it becomes a tax shelter.[24]

Note that this will be true even if the loss is a one-time special event (such as due to an accounting method change adjustment under IRC §481(a)). Taxpayers may need to consider making elections that may be available opting out of claiming certain tax benefits once the total consequences of becoming a syndicate are considered.[25]

While by default a taxpayer tests for tax shelter status by using the current year's return to see if 35% of losses have been allocated to limited partners or limited entrepreneurs, for purposes of the small business accounting method rules a taxpayer can elect to perform the test based on the prior year's activity:

> …[T]o determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, instead of using the current taxable year's allocation of losses, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation.[26]

Such an election is binding on the taxpayer unless the permission of the IRS is received to change the election—and even then the proposed regulations provide for limits on the IRS's ability to grant the permission in some cases:

> An election under this paragraph (b)(2)(iii)(B) applies to the first taxable year for which the election is made and to all subsequent taxable years, unless the Commissioner of Internal Revenue or his delegate (Commissioner) permits a revocation of the election in accordance with this paragraph. An election under this paragraph (b)(2)(iii)(B) may never be revoked earlier than the fifth taxable year following the first taxable year for which the election was made unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner. Once an election has been revoked, a new election under this paragraph (b)(2)(iii)(B) cannot be made until the fifth taxable year following the taxable year for which the previous election

[23] REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf, p. 111

[24] Proposed Reg. §1.448-2(b)(2)(v)

[25] The same syndicate test is applied for purposes of determining if otherwise exempt small taxpayer will nevertheless have to apply the §163(j) limitation rules in the final and proposed §163(j) regulations issued the day before these proposed regulations.

[26] Proposed Reg. §1.448-2(b)(2)(iii)(B)

> was revoked unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner.[27]

Obtaining that permission will require applying and paying for a private letter ruling:

> An election made under this paragraph (b)(2)(iii)(B) may only be revoked with the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures for requesting a letter ruling (for example, see Revenue Procedure 2020-1, 2020-01 IRB 1 (or its successor)).[28]

The proposed regulations provide the requirements and limitations for a taxpayer making this election:

> A taxpayer making this election must attach a statement to its timely filed Federal income tax return (including extension) that this election is made beginning with that taxable year. If such a statement is not attached, the election is not valid and has no effect for any purpose. No late elections will be permitted. Further, an election cannot be made by filing an amended Federal income tax return. [29]

The election to determine tax shelter status based on the prior year applies for *all* purposes under the IRC where it is relevant, not just these small business accounting methods. That would include taxpayers to whom the §163(j) business limitation rules would apply should they be treated as a tax shelter.

> In addition to section 448, this election also applies for purposes of all provisions of the Code that refer to section 448(a)(3) to define tax shelter.[30]

The proposed regulations provide the following example of applying these rules:

EXAMPLE, PROPOSED REG. §1.448-2(B)(2)(III)(B)

Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. In 2019, B is profitable and allocates 80 percent of its profits to its general partner and 20 percent of its profits to its limited partner. In 2020, B has a loss and allocates 60 percent of losses to its general partner and 40 percent of its losses to its limited partner. In 2020 B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. For 2020, B is not a syndicate because B is treated as having allocated 20 percent of its profits to its limited partner in 2020 for purposes of paragraph (b)(2)(iii) of this

[27] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[28] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[29] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[30] Proposed Reg. §1.448-2(b)(2)(iii)(B)

section. For 2021, B is a syndicate because B is treated as having allocated 40 percent of its losses to its limited partner for purposes of paragraph (b)(2)(iii) of this section.

Cash Basis of Accounting Under IRC §446

While the major change to the optional use of the cash method of accounting was the simple increase in the dollar limit from $5 million to a much higher inflation adjusted number (now $26,000,000) and granting protection to all entity types, the proposed regulations contain items that taxpayers should be aware of if the entity has revenues that float above and below the limit.

Previously, a covered taxpayer who had ever had average revenue above the limit was permanently barred from using the cash method of accounting. As the preamble notes, that requirement was removed from the IRC and has been removed from the proposed regulations.

> The TCJA removed the requirement under section 448(c) that all prior taxable years of a taxpayer must satisfy the Section 448(c) gross receipts test for the taxpayer to qualify for the cash method for taxable years beginning after December 31, 2017. Thus, section 448 no longer permanently prevents a C corporation or a partnership with a C corporation partner from using the cash method for a year subsequent to a taxable year in which its gross receipts first exceed the dollar threshold for the Section 448(c) gross receipts test. Accordingly, the proposed regulations do not require taxpayers to meet the gross receipts test for all prior taxable years in order to satisfy the Section 448(c) gross receipts test.[31]

Taxpayers who find their average revenue for the prior three years has now grown above the limit for the year in question and had previously been using the overall cash method of accounting will be forced to change their accounting method at that time:

> Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448 (mandatory section 448 year). A taxpayer may have more than one mandatory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to

[31] REG-132766-18, July 29, 2020, pp. 16-17

> obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see §601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.[32]

If a taxpayer later falls below the limit, special rules apply if it has been less than five year since the change to the overall accrual method of accounting was mandated due to the average revenue rule:

> A taxpayer that otherwise meets the requirements of paragraph (c) of this section, and that had during any of the five taxable years ending with the taxable year changed its overall method of accounting from the cash method because it no longer met the gross receipts test of section 448(c) provided under paragraph (c) of this section or because it was a tax shelter as provided under paragraph (b)(2) of this section, may not change its overall method of accounting back to the cash method without the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures to obtain the written consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see also §601.601(d)(2) of this chapter). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.[33]

The preamble suggests that the IRS may not be likely to grant this relief if a taxpayer requests it, as the preamble notes:

> A taxpayer that makes multiple changes in its overall method of accounting within a short period of time may not be treating items of income and expense consistently from year to year, and a change back to the cash method within the five year period may not clearly reflect income, as required by §1.446-1(a)(2), even if section 448 otherwise does not prohibit the use of the cash method.[34]

Inventories Under IRC §471

The proposed regulations provide some additional explanations of how a taxpayer who opts to use the provisions of §471(c) to avoid the standard inventory rules of §471 will handle the accounting for items that are normally in inventory.

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[32] Proposed Reg. §1.448-2(g)(1)

[33] Proposed Reg. §1.448-2(g)(3)

[34] REG-132766-18, July 29, 2020, p. 17

Proposed Reg. §1.471-1(b)(3) describes the small business inventory options as follows:

> A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:
>
> > (i) Accounting for its inventory items as non-incidental materials and supplies, as described in paragraph (b)(4) of this section; or
> >
> > (ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the taxpayer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method).

Inventory Treated as Non-Incidental Materials and Supplies

If the taxpayer opts to treat inventory as non-incidental materials and supplies, the taxpayer initially capitalizes the items that would have made up inventory and then recovers the costs in the *later* of the taxable year when:

- Such inventory is actually used or consumed in the taxpayer's business, which is the the taxable year in which the taxpayer provides the items to its customer; or

- The taxable year in which the taxpayer pays for (for a taxpayer using the overall cash method of accounting) or incurs (for a taxpayer using the overall accrual method of accounting) the costs of the items.[35]

The *Blue Book* for the Tax Cuts and Jobs Act had suggested a taxpayer electing the option to treat inventory items as materials and supplies could use the *de minimis* election provisions found at Reg. §1.263(a)-1(f) to immediately write off formerly inventory items that cost less than $2,500 (or $5,000 if the taxpayer had an applicable financial statement).[36] However, the proposed regulations provide for just the opposite, barring the use of the Reg. §1.263(a)-1(f) *de minimis* election to achieve zero inventories.

As the IRS explains in the preamble to the proposed regulations:

> Two commenters asked for clarification on whether a taxpayer using the nonincidental materials and supplies method under section 471(c)(1)(B)(i) may use the de minimis safe harbor election of §1.263(a)-1(f). As discussed in part 4.B of this Explanation of Provisions, the Treasury Department and the IRS continue to interpret

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[35] Proposed Reg. §1.471-1(b)(4)(i)

[36] Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS 1-18, December 2018, p. 113

> inventory treated as non-incidental materials and supplies as remaining characterized as inventory property. Consequently, proposed §1.471-1(b)(4)(i) provides that inventory treated as section 471(c) non-incidental materials and supplies is not eligible for the de minimis safe harbor election under §1.263(a)-1(f). Extending the regulatory election under §1.263(a)-1(f) to encompass section 471(c) materials and supplies is outside the intended scope of the election and runs counter to section 471(c), which indicates section 471(c) materials and supplies are inventory property.[37]

As promised in the preamble, Proposed Reg. §1.471-1(b)(4)(i) provides, in part, "[i]nventory treated as nonincidental materials and supplies under this paragraph (b)(4) is not eligible for the de minimis safe harbor election under §1.263(a)-1(f)(2)."

The proposed regulations provide that taxpayers identify the costs of the deemed non-incidental materials and supplies under this method as follows:

> A taxpayer may determine the amount of the section 471(c) materials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See §1.471-2(d). A taxpayer that uses the section 471 materials and supplies method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify section 471(c) materials and supplies, or to value those section 471(c) materials and supplies. The inventory costs includible in the section 471(c) materials and supplies method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code.[38]

The regulation goes on to provide the following options for a taxpayer to allocate the various costs to items of material and supplies:

> The section 471 materials and supplies method may allocate the costs of such inventory items by using specific identification or using any reasonable method.[39]

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[37] REG-132766-18, July 29, 2020, p. 30

[38] Proposed Reg. §1.471-1(b)(4)(ii)

[39] Proposed Reg. §1.471-1(b)(4)(iii)

The proposed regulations provide the following example of applying the non-incidental materials and supplies option for taxpayers opting to use the small business option under IRC §471(c):

EXAMPLE, PROPOSED REG. §1.471-1(B)(4)(IV)

Taxpayer D is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return, and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than $100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) non-incidental materials and supplies method. D purchases $50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells the peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b)(4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

Taxpayers may have hoped that the IRS would have allowed the taxpayers to treat the item as "used" when incorporated into the product, but the agency has decided that it only counts when the product incorporating the item is in the hands of a customer.

Taxpayers Using the AFS Method

If a taxpayer does not wish to use the materials and supplies option and has an applicable financial statement, the taxpayer's only other option under IRC §471(c) is to use what is referred to in the regulations as the *AFS Section 471(c) Method.*

An *applicable financial statement* (AFS) has the same meaning for these purposes as it does under IRC §451(b)(3). Proposed Reg. §1.451-3(c)(1) defines an applicable financial statement as follows:

> [An] *applicable financial statement* (AFS) means the taxpayer's financial statement listed in paragraphs (c)(1)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (c)(1)(i)(B) and (c)(1)(ii)(B) of this section. The financial statements are, in order of descending priority:
>
> (i) *GAAP Statements.* A financial statement that is certified as being prepared in accordance with generally accepted accounting principles (GAAP) and is:
>
> > (A) A Form 10–K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);
> >
> > (B) An audited financial statement of the taxpayer that is used for:
> >
> > > (1) Credit purposes;

(2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(3) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service;

(ii) *IFRS Statements*. A financial statement that is certified as being prepared in accordance with international financial reporting standards (IFRS) and is:

(A) Filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(1) Credit purposes;

(2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(3) Any other substantial non-tax purpose;

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service, or a foreign government or agency of a foreign government, other than an agency that is equivalent to the SEC or the Internal Revenue Service; or

(iii) *Other Statements*. A financial statement, other than a tax return, filed with the Federal government or any Federal agency, a state government or state agency, or a self-regulatory organization (for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority). Additional financial statements included in this paragraph (c)(1)(iii) may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(iv) *Additional rules for determining priority*. If a taxpayer restates revenue in an AFS prior to the date that the taxpayer files its Federal income tax return for such taxable year, for purposes of determining priority, the restated AFS must be used instead of the original AFS. A taxpayer with different financial accounting and taxable years that is required to file both annual financial statements and periodic financial statements covering less than a year with a government agency must use the annual statement filed with the agency to determine priority.

The *AFS Section 471(c) Method* is described in general terms as follows:

> A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) method described in this paragraph to account for its inventory costs for the taxable year. For purposes of the AFS section 471(c) method, an inventory cost is a cost that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) method recovers its inventory costs in accordance with the inventory method used in its AFS.[40]

However, the proposed regulations do impose an additional timing limitation, so that the timing of inclusion of an item in cost of sales in an AFS may not control when it appears on the tax return:

> Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See §1.446-1(c)(1)(ii) and section 461 and the accompanying regulations.[41]

The proposed regulations provide the following example of the application of the AFS Section 471(c) Method:

EXAMPLE, PROPOSED REG. §1.471-1(5)(IV)

H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) method of accounting. In H's 2019 AFS, H incurred $2 million in purchases of office supplies held for resale and recovered the $2 million as cost of goods sold. On January 5, 2020, H makes payment on $1.5 million of these office supplies. For purposes of the AFS section 471(c) method of accounting, H can recover the $2 million of office supplies in 2019

[40] Proposed Reg. §1.471-1(b)(5)(i)

[41] Proposed Reg. §1.471-1(b)(5)(iii)

because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

Taxpayers Using the Non-AFS Section 471(c) Method

If a taxpayer does not have an AFS for the taxable year in question, the taxpayer's option other than using the non-incidental materials and supplies method is to use the *Non-AFS Section 471(c) Method* defined at Proposed Reg. §1.471-1(b)(6).

The regulation provides the following general discussion of the method:

> A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) method is the method of accounting used for inventory in the taxpayer's books and records that properly reflect its business activities for non-tax purposes and are prepared in accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) method, an inventory cost is a cost that the taxpayer capitalizes to property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. In lieu of the inventory method described in section 471(a), a taxpayer using the non-AFS section 471(c) method recovers its costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) method.[42]

One point that a reader may miss in initially reading the provision is the requirement that the method must *properly reflect* the entity's business activities for *non-tax purposes*. Thus, the IRS has left open the option to challenge the taxpayer's book method by arguing the arrangement is purely for tax purposes and the reporting is not appropriate for non-tax purposes.

Taxpayers should be ready to demonstrate actual use of the statements generated unadjusted from the books and records using this method for non-tax purposes. Conversely, if the taxpayer provides lenders with financial statements that use another method to report inventory costs (such as one that is GAAP compliant), the IRS would likely argue the method does not meet the requirements noted in the regulation. In fact, the first example the IRS offers in the regulations for the Non-AFS Section 471(c) Method (reproduced later) specifically deals with this sort of situation.

As with the AFS Section 471(c) Method, the regulations also contain a similar timing rule:

> Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not deduct or recover any costs that have

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[42] Proposed Reg. §1.471-1(b)(6)(i)

> not been paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1), or that are neither deductible nor otherwise recoverable but for the application of this paragraph (b)(6), in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g) or 274). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See §1.446-1(c)(1)(ii), and section 461 and the accompanying regulations.[43]

The proposed regulations provide two examples of the application of these provisions:

EXAMPLE 1, PROPOSED REG. §1.471-1(B)(6)

Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of less than $15 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) method of accounting. E uses the overall cash method, and the non-AFS section 471(c) method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E also makes representations to its creditor of the amount of inventory on hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity. E must use the physical inventory count taken at the end of 2019 to determine its ending inventory. E may include in cost of goods sold for 2019 those inventory costs that are not properly allocated to ending inventory.

EXAMPLE 2, PROPOSED REG. §1.471-1(B)(6)

F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxableyears of less than $25 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F's financial statements show $500,000 of direct and indirect material costs. F pays its

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[43] Proposed Reg. §1.471-1(b)(6)(ii)

supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

Section 471(c) Does Not Impact Other IRC Provisions

The proposed regulations also provide that these §471(c) rules do not override any IRC provisions other than the rules at §471(a). The proposed regulations provide:

> Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, a taxpayer that includes inventory costs in its AFS is required to satisfy section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section.[44]

Accounting Method Issues

The proposed regulations provide that a taxpayer opting to move away from using §471(a) to the provisions found at §471(c) is undergoing a change of accounting methods and must seek the IRS's permission to make the change.[45]

Taxpayers may find they have an AFS in some years and don't have an AFS in other years. If a taxpayer merely changes from the AFS Section 471(c) Method to the Non-AFS Section 471(c) Method or vice versa related to years with/without an AFS, that is not considered to be an accounting method change and IRS permission does not have to be sought.[46]

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[44] Proposed Reg. §1.471-1(b)(7)

[45] Proposed Reg. §1.471-1(b)(8)

[46] Proposed Reg. §1.471-1(b)(8)

Uniform Capitalization Rules Under IRC §263A

The IRS has made various changes to the regulations to take into account the small taxpayer's ability to "opt-out" from the application of the uniform capitalization rules of §263A (often referred to as UNICAP).

Small Reseller Exception

The IRS did decide to remove the small reseller gross receipts test from the regulations as being no longer relevant. As the preamble to the proposed regulations note:

> Prior to the TCJA, the Section 263A small reseller exception in section 263A(b)(2)(B) exempted from section 263A resellers with gross receipts of $10 million or less (small reseller gross receipts test). The TCJA removed the Section 263A small reseller exception provided in section 263A(b)(2)(B).
>
> Consistent with the TCJA, these proposed regulations remove existing §1.263A- 3(a)(2)(ii) and modify existing §1.263A-3(b) by removing the small reseller gross receipts test. The Treasury Department and the IRS expect that most taxpayers who previously satisfied the small reseller gross receipts test will meet the Section 448(c) gross receipts test due to the increased dollar threshold in section 448(c), and therefore would be eligible to apply the small business taxpayer exemption under section 263A(i).[47]

However, the IRS notes that this definition was cross-referenced, triggering changes in other regulations due to the above change:

> The definition of gross receipts used for the small reseller gross receipts test under existing §1.263A-3(b) is applied for purposes of other simplifying conventions under the existing section 263A regulations. Since the TCJA removed the small reseller gross receipts test and added the Section 263A small business taxpayer exemption that refers to section 448(c), these proposed regulations update those simplifying conventions by cross referencing to the definition of gross receipts set forth in the proposed regulations under section 448 where applicable.
>
> Specifically, proposed §1.263A-3(a)(5) modifies the definition of gross receipts that is used to determine whether a reseller has de minimis production activities and proposed §1.263A-1(d)(3)(ii)(B)(1) modifies the definition of gross receipts used to permit certain taxpayers to use the simplified production method under §1.263A-2(b) by cross

[47] REG-132766-18, July 29, 2020, p. 8

> referencing to the definition of "gross receipts" for purposes of the Section 448(c) gross receipts test.[48]

Capitalization of Interest Impact

The proposed regulations also provide that the small business exception under IRC §263A will also apply to cases where interest is required to be capitalized under the provision (such as for self-constructed property) and the preamble to the proposed regulations notes regulatory changes proposed to deal with this issue:

> Prior to the TCJA, section 263A(f)(1) required the capitalization of interest if the taxpayer produced certain types of property (designated property). The Section 263A small business taxpayer exception applies for all purposes of section 263A, including the requirement to capitalize interest under section 263A(f). Accordingly, these proposed regulations modify §1.263A-7 and §1.263A-8 to add new paragraphs to implement the Section 263A(i) small business taxpayer exemption for purposes of the requirement to capitalize interest.
>
> Additionally, existing §1.263A-9 contains an election that permits taxpayers whose average annual gross receipts do not exceed $10 million to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt. Again, the Section 263A small business taxpayer exception applies for all purposes of section 263A, including the election for small business taxpayers who choose to capitalize interest under section 263A(f). Therefore, these proposed regulations modify §1.263A-9 to remove the $10 million gross receipts test in the definition of eligible taxpayer and replace it with the Section 448(c) gross receipts test. The Treasury Department and the IRS have determined that the use of a single gross receipts test under the section 263A (other than the pre-existing higher $50 million threshold for testing eligibility to apply the simplified production method) simplifies application of the UNICAP rules for taxpayers.[49]

In response to a comment asking for additional guidance on what would now be required to be capitalized for self-constructed assets when a qualified taxpayer takes advantage of the ability to opt-out of §263A, the IRS has decided to ask for comments on what type of guidance is needed in this area:

> One commenter stated that the costing rules for self-constructed property used in a taxpayer's trade or business prior to the enactment of section 263A, which would apply to small business taxpayers choosing to apply the Section 263A small business taxpayer exemption, are not clear. The commenter asked for clarification of what costs a small business taxpayer is required to capitalize to its depreciable property if the taxpayer has chosen to apply the Section 263A small business taxpayer exemption. The Treasury Department

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[48] REG-132766-18, July 29, 2020, pp. 8-9

[49] REG-132766-18, July 29, 2020, pp. 9-10

> and the IRS request further comments on specific clarifications needed regarding the costing rules that existed prior to the enactment of the UNICAP rules under section 263A.[50]

Farming Trade or Business Issues

The IRS discusses special issues impacting farming trades or businesses under these new provisions. First the agency discusses the pre-existing election under IRC §263A(d)(3), noting the pre-existing election and the conditions for using it:

> Prior to the TCJA, section 263A(d)(3) permitted certain taxpayers to elect not to have the rules of section 263A apply to certain plants produced in a farming business conducted by the taxpayer. An electing taxpayer and any related person, as defined in §1.263A-4(d)(4)(iii), are required to apply the alternative depreciation system, as defined in section 168(g)(2), to property used in the taxpayer's and any related persons' farming business and placed in service in the taxable years in which the election was in effect.[51]

Now small farmers may find that, rather than having to live with those restrictions, they would prefer to make use of the small taxpayer accounting method option instead to bypass §263A. The IRS notes:

> The Treasury Department and the IRS are aware that taxpayers that made an election under section 263A(d)(3) may also qualify for the Section 263A small business taxpayer exemption, and may prefer to apply that exemption rather than the election under section 263A(d)(3). Proposed §1.263A-4(d)(5) permits a taxpayer to revoke its section 263A(d)(3) election for any taxable year in which the taxpayer is eligible for and wants to apply the Section 263A small business taxpayer exemption by following applicable administrative guidance, such as Revenue Procedure 2020-13 (2020-11 IRB 515). In addition, some taxpayers may be eligible to apply the election under section 263A(d)(3) in a taxable year in which they cease to qualify for the Section 263A small business taxpayer exemption. Therefore, proposed §1.263A-4(d)(6) permits such a taxpayer to change its method of accounting from the exemption under section 263A(i) by making a section 263A(d)(3) election in the same taxable year by following applicable administrative guidance, such as Revenue Procedure 2020-13.[52]

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[50] REG-132766-18, July 29, 2020, p. 11

[51] REG-132766-18, July 29, 2020, p. 10

[52] REG-132766-18, July 29, 2020, p. 10

The IRS also notes that they are taking this opportunity to clean up what they now refer to as a drafting error in prior regulations:

> Proposed §1.263A-4(d)(3)(i) is modified to remove the requirement that the election under section 263A(d)(3) by a partnership or S corporation be made by the partner, shareholder or member. The Treasury Department and the IRS believe that the inclusion of this requirement was a drafting error, as sections 703(b) and 1363(c) require the election to be made at the entity level.[53]

As well, the IRS is taking this opportunity to publish regulations on a provision related to citrus plants added by TCJA:

> The TCJA added new section 263A(d)(2)(C), which provides a special temporary rule for citrus plants lost by reason of casualty. The provision, which expires in 2027, provides that section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner if certain conditions are met. Proposed §1.263A-4(e)(5) is added to incorporate this special temporary rule.[54]

SECTION: 446
DUPLICATE COPY OF FORM 3115 TO BE FILED VIA FAX WITH THE IRS FROM JULY 31, 2020 UNTIL FURTHER NOTICE

Citation: "Temporary procedure to fax automatic consent Forms 3115 due to COVID-19," IRS website, 7/29/20

The IRS announced[55] that the agency is going to be accepting the duplicate copy of Form 3115, *Application for Change in Accounting Method*, a taxpayer is required to file as part of a request for an automatic method change via fax beginning on July 31, 2020.

The website provides the following general information:

> Until further notice, the IRS is implementing the temporary procedure described below for fax transmission of the duplicate copy of Form 3115, Application for Change in Accounting Method.
>
> Starting on July 31, 2020, the IRS will accept the duplicate copy of Form 3115, Application for Change in Accounting Method, via fax to

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[53] REG-132766-18, July 29, 2020, p. 11

[54] REG-132766-18, July 29, 2020, p. 11

[55] "Temporary procedure to fax automatic consent Forms 3115 due to COVID-19," IRS website, July 29, 2020, https://www.irs.gov/newsroom/temporary-procedure-to-fax-automatic-consent-forms-3115-due-to-covid-19 (retrieved July 29, 2020)

> 844-249-8134. **Important note: This change applies only to taxpayers requesting consent to make a change in accounting method under the automatic change procedure.** This temporary procedure is in effect until further notice.
>
> Taxpayers will still need to submit two copies of the Form 3115 to the IRS. Taxpayers must continue to file Form 3115 with their tax return (including extensions). However, instead of mailing the duplicate paper copy of Form 3115 to the IRS in Ogden, Utah, taxpayers can now fax it to 844-249-8134.

Who Does This Change Affect?

The IRS provides the following information about specifically who this change will affect:

> **1. Does this change affect me?**
>
> This change applies only to taxpayers filing Form 3115 for an automatic change in accounting method under the provisions of Rev. Proc. 2015-13, 2015-5, I.R.B. 419. For a definition of an automatic change in accounting method see the instructions for Form 3115. For the List of Automatic Changes, refer to Rev. Proc. 2019-43, 2019-48, I.R.B. 1107 (or any successor).

Submitting the Duplicate Copy

One of the key requirements of obtaining permission to change a taxpayer's accounting method under an automatic change procedure is that two copies of the Form 3115 must be submitted—one with the taxpayer's income tax return and one sent to an IRS processing center listed in form instructions.

The IRS provides the following information regarding filing a method change:

> **2. If I want to file for an automatic change in accounting method, how do I file the duplicate copy of the Form 3115?**
>
> Until further notice, you may fax your duplicate copy of Form 3115 for an automatic change in accounting method to the IRS at 844-249-8134. You must also file the original Form 3115 with your tax return.
>
> **3. How was Form 3115 submitted to the IRS prior to this change?**
>
> Previously, taxpayers mailed the paper duplicate copy of Form 3115 to the IRS and filed the original Form 3115 with their tax return.

The fax cover sheet submitted with the Form 3115 should contain the following information:

- Subject: Form 3115
- Sender's name, title, phone number, address

- Taxpayer's name
- Date
- Number of pages faxed (including cover sheet)[56]

The IRS will **not** provide a fax transmission confirmation or receipt, suggesting taxpayers check their fax transmission log to verify that all Form 3115 pages were sent.[57]

The page provides that if a taxpayer has previously mailed the duplicate copy of the Form 3115 to the IRS, the taxpayer should **not** send a fax of that form to this fax number.[58]

Non-Automatic Method Changes

The IRS guidance notes that the fax submission system does **not** cover non-automatic changes:

> **7. Does this temporary procedure cover Form 3115 for a non-automatic method change?**
>
> This temporary procedure does not apply to requests for a non-automatic change in accounting method. For information regarding temporary electronic submission to request a non-automatic change in accounting method, see Rev. Proc. 2020-29.

Revenue Procedure 2020-29[59] provides a temporary method to electronically submit "requests for letter rulings, closing agreements, determination letters, and information letters under the jurisdiction of the Internal Revenue Service (IRS) Office of Chief Counsel, and for determination letters issued by the IRS Large Business and International Division (LB&I)."

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[56] "Temporary procedure to fax automatic consent Forms 3115 due to COVID-19," IRS website, July 29, 2020, Q&A 8

[57] "Temporary procedure to fax automatic consent Forms 3115 due to COVID-19," IRS website, July 29, 2020, Q&A 5

[58] "Temporary procedure to fax automatic consent Forms 3115 due to COVID-19," IRS website, July 29, 2020, Q&A 4

[59] Revenue Procedure 2020-29, April 30, 2020, https://www.irs.gov/pub/irs-drop/rp-20-29.pdf (retrieved July 29, 2020)