July 15, 2019

Mr. John Moriarty
Deputy Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Revenue Procedure 2018-40 – Request for Comments and Impact of Pub. L. No. 115-97 on Accounting Methods for Small Business Taxpayers

Dear Mr. Moriarty:

The American Institute of CPAs (AICPA) commends the Internal Revenue Service (IRS) on the automatic accounting method change guidance issued in Rev. Proc. 2018-40. The automatic method changes and the simplified filing procedures are welcome provisions benefiting small business taxpayers.

The AICPA is pleased to submit recommendations as requested in Rev. Proc. 2018-40 on the small business taxpayer accounting method issues. We recommend that the IRS:

I. Provide guidance related to how to apply the gross receipts test to each trade or business of a taxpayer that is not a corporation or partnership;

II. Confirm the ability to change to the overall cash method for taxpayers meeting the gross receipts test;

III. Interpret "books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures" under Internal Revenue Code section 471(c)(1)(B)[1];

IV. Clarify section 460(e)(2)(B) in the context of Rev. Rul. 92-28; and

V. Modify the definition of "tax shelter" for purposes of section 448 to exclude syndicates.

The AICPA submitted comments on July 23, 2018, with respect to the impact of Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)) on accounting method changes

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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for small business taxpayers. Several of those recommendations not addressed in Rev. Proc. 2018-40 are restated below and include the following requests:

VI. Clarify that taxpayers exceeding the threshold for small business taxpayers in the future must file accounting method changes and provide procedures for such taxpayers to file these accounting method changes with automatic consent;

VII. Provide relief for small business taxpayers, who meet the $25 million gross receipts test, that are currently using improper accounting methods;

VIII. Provide guidance regarding tax consequences of the cash method of accounting; and

IX. Clarify that the definition of "tax shelter" for purposes of section 448 does not include an entity with negative taxable income as a result of a negative section 481(a) adjustment.

The AICPA is the world's largest member association representing the accounting profession, with more than 429,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Connie Cunningham, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (310) 557-8544, or CCCcunningham@bdo.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071 or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Ms. Ellen Martin, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury

AMERICAN INSTITUTE OF CPAs

Comments on the Impact of Pub. L. No. 115-97 on Accounting Methods for Small Business Taxpayers

July 15, 2019

BACKGROUND

The TCJA contains numerous simplifying provisions allowing small business taxpayers to streamline their tax accounting methods for years beginning after December 31, 2017. The TCJA defines a small business taxpayer as a taxpayer with average annual gross receipts in the prior three-year period of $25 million or less. The threshold of $25 million is a welcome change for many taxpayers, as previous simplifying provisions with respect to certain accounting methods were generally applicable to taxpayers with average annual gross receipts of $1 million, $5 million, or $10 million or less.

For purposes of determining whether a taxpayer qualifies as a small business taxpayer, the TCJA references the existing gross receipts test under section 448(c)(2) and increases the dollar threshold from $5 million to $25 million. Thus, the $25 million gross receipts test is determined by averaging a taxpayer's gross receipts for the three prior taxable years. For example, if a taxpayer is assessing whether it may qualify for the simplifying provisions under the TCJA for its 2018 tax year, it would compute its average gross receipts using amounts from its 2015, 2016 and 2017 tax years (assuming no short taxable years and the taxpayer was in existence for the entire three-year period). If the average of the taxpayer's gross receipts from its 2015, 2016 and 2017 tax years does not exceed $25 million, the taxpayer may apply the small business accounting method provisions under the TCJA for 2018. A qualifying small business taxpayer must then compute its prior three-year average gross receipts for each taxable year after 2018 to ensure that it may continue to utilize the simplifying provisions. If the taxpayer fails the $25 million gross receipts test for a given taxable year, it may not apply any of the simplifying provisions for that taxable year.

In addition, prior to the TCJA, certain taxpayers that sought to use the cash method of accounting were required to satisfy the $5 million gross receipts test for all prior taxable years beginning after December 31, 1985. If a taxpayer failed the gross receipts test for any prior taxable year, it was ineligible for the $5 million gross receipts test exception and, therefore, not eligible to use the cash method. The TCJA modified section 448(b)(3) to allow the gross receipts test to apply to any taxable year the gross receipts test is satisfied.

SPECIFIC COMMENTS

I. Provide guidance related to how to apply the gross receipts test to each trade or business of a taxpayer that is not a corporation or partnership

Recommendations

For purposes of applying the gross receipts test to each trade or business of a taxpayer that is not a partnership or corporation, the AICPA requests that the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) provide additional guidance defining gross receipts under section 448. Guidance exists in Treas. Reg. § 1.448-1T(f)(2) defining gross receipts, and we recommend clarifying that this definition continues to apply. We recommend clarifying that the current definition found in Treas. Reg. § 1.448-1T(f)(2) continues to apply with respect to:

- The aggregation of gross receipts, particularly the last sentence in Treas. Reg. § 1.448-1T(f)(2)(ii) regarding transactions between persons who are treated as a common employer (see below);
- The treatment of a short taxable year; and
- The determination of gross receipts.

The AICPA also recommends disregarding the trade or business gross receipts associated with a partnership or S corporation reported on the individual's return (on Schedule E, Part II) in the calculation of the gross receipts of an individual with income from a pass-through entity where the individual is not a common employer of the pass-through trade or business.

In addition, the AICPA recommends that the IRS provide additional examples illustrating the application of this rule.

Analysis

Guidance exists for corporations and partnerships defining gross receipts for purposes of section 448(c). However, guidance does not exist related to defining gross receipts for other types of taxpayers. New sections 471(c)(3), 263A(i)(2) and 460(e)(2)(A) each state that for purposes of the gross receipts test under section 448(c), each trade or business should be treated as a corporation or partnership and each have similar language stating:

> "any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership."

In the case of a sole proprietorship, it is currently unclear whether the individual owner is required to include the owner's share of gross receipts from a pass-through business in the sole proprietorship's gross receipts for purposes of the $25 million gross receipts test under section 448(c). Including the receipts of a pass-through trade or business in the gross receipts test of an individual that is not a common employer of the pass-through trade or business could unfairly distort the accounting method decisions of the individual's other trades or businesses reported on

Schedules C (including disregarded entities), E and F and could lead to a taxpayer being forced to adopt a method of accounting which may not clearly reflect income in accordance with section 446(b). Disregarding the trade or business gross receipts associated with a partnership or S corporation reported on the individual's return in the calculation of the gross receipts of an individual with income from a pass-through entity is consistent with the definition of gross receipts under Treas. Reg. § 1.448-1T(f)(2)(iv)(A), which does not explicitly include in gross receipts the gross receipts of a pass-through trade or business in the gross receipts test of a partner or shareholder.

Administrative simplification is also needed for small taxpayers who typically do not have access to the underlying gross receipts detail of pass-through entities (other than the information presented on the Schedule K-1) and are unlikely to influence the income amounts reported on their Schedules K-1.

II. Confirm the ability to change to the overall cash method for taxpayers meeting the gross receipts test

Recommendation

The AICPA recommends that the IRS clarify the application of the gross receipts test by stating that in general, taxpayers satisfying the gross receipts test under section 448(c) may use the overall cash method. We recommend that the description of this change in section 15.18(1) of Rev. Proc. 2018-31 is clarified to state that all taxpayers, with the exception of tax shelters, may change to the cash method of accounting if they satisfy the gross receipts test.

Analysis

Under the TCJA, all taxpayers, with the exception of tax shelters, may use the cash method of accounting if they meet the $25 million gross receipts test, even if the purchase, production, or sale of merchandise is an income producing factor. Taxpayers not subject to section 448 (such as individuals and S corporations) may use the cash method.[2] However, if the purchase, production, or sale of merchandise is an income producing factor and the $25 million gross receipts test is not met, such excepted taxpayers may not use the cash method for the purchase and sale of merchandise.

The AICPA has received a number of questions from its members representing small taxpayers expressing concern regarding their ability to change to the overall cash method pursuant to section 15.18(1) of Rev. Proc. 2018-31, which allows a taxpayer to change to an overall cash method if the taxpayer "is otherwise not prohibited from using the overall cash method or required to use another overall method of accounting." Many small taxpayers may incorrectly interpret this provision to exclude them from the cash method – for instance, if their financial statements are prepared under the accrual method of accounting, or if the sale of inventory is an income-producing factor.

[2] The legislative history (both the House and Conference reports) emphasize that a taxpayer not subject to section 448 can use a cash method of accounting. See pages 379-381 of the TCJA Conference Report Pub. L. No. 115-466 - https://www.congress.gov/115/crpt/hrpt466/CRPT-115hrpt466.pdf.

Taxpayers have also expressed concern about the ability to use the automatic accounting method change in Rev. Proc. 2018-31, section 15.18(1) to adopt the overall cash method of accounting, asserting that the following language is interpreted to not apply to taxpayers with inventory or where their financial statements are prepared under the accrual method of accounting:

> "This change applies to a small business taxpayer, as defined in section 15.18(5)(a) of this revenue procedure, that wants to change its overall method of accounting from an overall accrual method of accounting to the overall cash method of accounting for a trade or business and is otherwise not prohibited from using the overall cash method or required to use another overall method of accounting."

III. Interpret "books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures" under section 471(c)(1)(B)

Recommendations

For taxpayers without an applicable financial statement (AFS), we recommend that the IRS and Treasury provide guidance to confirm that accountants' workpapers (whether recorded on paper, electronically or other media) are part of the books and records of the taxpayer.[3] To the extent a taxpayer's books and records adequately substantiate the amount of costs incurred or paid by the taxpayer for inventory items and reflect the immediate expensing of such amounts (e.g., through journal entries or a prepared profit and loss statement), the AICPA recommends that the IRS and Treasury clarify that taxpayers without an AFS may expense amounts for tax purposes even if a physical count of inventory is performed at any point during the taxable year.

Further, the AICPA recommends the IRS and Treasury clarify that a taxpayer without an AFS is not required to have written accounting procedures in order to comply with section 471(c)(1)(B). Accordingly, the IRS and Treasury should provide guidance stating that if a taxpayer can demonstrate it has applied consistent treatment to costs that are otherwise subject to section 471 and has supporting documentation to reflect the treatment, the taxpayer may utilize such documentation for purposes of section 471(c)(1)(B).

The AICPA also recommends that the IRS and Treasury clarify that a taxpayer presently accounting for inventory as non-incidental materials and supplies under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 can use section 22.19 of Rev. Proc. 2018-31 to change from treating the amounts as non-incidental supplies to either conform to their AFS treatment, or, if there is no AFS, per their books and records prepared in accordance with their accounting procedures. If such taxpayers wish to remain on their present method of accounting for inventory as non-incidental materials and supplies, the AICPA recommends that the IRS and Treasury clarify that taxpayers can continue to follow their present method without having to file an accounting method change, even though Rev. Proc. 2001-10 and Rev. Proc. 2002-28 are no longer applicable after 2017.

[3] See Treas. Reg. Sec. 1.446-1(a)(4), which states that a taxpayer satisfies the section 446 book-tax conformity requirement if it can reconcile the results obtained under the method of accounting used in keeping its records and accounts and the method used for federal income tax purposes and maintains sufficient records to support that reconciliation. For additional support also see *Patchen v. Comm*, 258 F.2d 544 (1958) and *American Fletcher Corp v. U.S.*, 832 F.2d 436 (1987).

However, should the IRS and Treasury issue future guidance clarifying or changing the "used and consumed" definition for non-incidental materials and supplies in a manner that deviates from the interpretation set forth in Rev. Proc. 2002-28, the AICPA recommends clarifying that section 22.19 of Rev. Proc. 2018-31 can be used by such taxpayers to conform to the new definition.

Analysis

For those taxpayers that do not have an AFS, books and records of the taxpayer can also include receipts or invoices from transactions undertaken by the taxpayer, canceled checks, accounting journals and ledgers, spreadsheets, account statements, and exported data from electronic accounting software programs, such as QuickBooks. Also, in order to maintain consistency with the application of the de minimis safe harbor for taxpayers without an AFS under Treas. Reg. § 1.263(a)-1(f), taxpayers without an AFS are not required to have written accounting procedures but must expense amounts in accordance with a consistent accounting procedure or policy existing at the beginning of the year.[4]

In addition, taxpayers currently accounting for their inventory as non-incidental materials and supplies should have clarity with regard to whether they may continue to stay on their current method without filing an accounting method change. Alternatively, if taxpayers elect to change from treating the amounts as non-incidental material and supplies (or change to conform to a new definition of "used and consumed" if addressed in future guidance), clarification from the Treasury and the IRS that such taxpayers can use the automatic method change procedures provided for in Rev. Proc. 2018-31 would be beneficial.

IV. Clarify section 460(e)(2)(B) in the context of Rev. Rul. 92-28

Recommendations

Given the potential discrepancy between the conclusions set forth in Rev. Rul. 92-28 and section 460(e)(2)(B), the AICPA recommends that the IRS and Treasury clarify that section 460(e)(2)(B) applies only to the following situations:

- A taxpayer that has historically accounted for all of its long-term contracts using the percentage-of-completion method (PCM) but is now exempt under section 460(e)(1)(B)(ii) should file a method change to use an alternative method *for any taxable year except for the first taxable year that it qualifies for the exception from PCM*. If it is the taxpayer's first taxable year qualifying for exemption from PCM under the $25 million gross receipts threshold, the taxpayer should adopt a different method without filing a Form 3115, *Application for Change in Accounting Method*. The exempt contract is considered a new item for purposes of establishing an accounting method. However, if the taxpayer could have used an alternative method in a prior year, but continued applying PCM to exempt contracts, it must file a Form 3115 to implement a method change, to keep consistent with the language provided under section 19.01(3) of Rev. Proc. 2018-31.

[4] This information is also noted on the IRS's Tangible Property Regulations, Frequently Asked Questions resource page.

- To maintain consistency with the conclusion in Situation 2 of Rev. Rul. 92-28, if a taxpayer previously established a non-PCM method with respect to exempt contracts and subsequently became subject to section 460 under pre-TCJA rules (e.g., if gross receipts exceeded $10 million but not $25 million) and the taxpayer desires to revert back to the same historical non-PCM method under section 460(e)(1)(B)(ii), the taxpayer should not have to file Form 3115. However, if the taxpayer desires to use a different method other than its historical non-PCM method for exempt contracts under section 460(e)(1)(B)(ii), a Form 3115, *Application for Change in Accounting Method*, must be filed in order to change to a different method from the prior non-PCM method.

- To promote voluntary compliance and reduce the compliance burden on small taxpayers, the AICPA recommends allowing a small taxpayer to change its method of accounting for exempt contracts to any permissible exempt contract method of accounting under the automatic consent procedures.

Analysis

Prior section 460(e)(1)(B) rules and Rev. Rul. 92-28

In the case of a long-term contract, taxable income from the contract is generally determined under PCM. Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of the gross contract price and the percentage of the contract completed during the taxable year. The percentage of the contract completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities. The allocation of costs to a contract is made in accordance with regulations. Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.

Section 460(e)(1)(B) exempts small construction contracts from the requirement to use the PCM. Prior to the enactment of the TCJA, small construction contracts were defined as contracts for the construction or improvement of real property if:

- Completion of the contract is expected (at the time such contract is entered into) within two years of commencement of the contract; and
- Performance of the contract is by a taxpayer whose average annual gross receipts for the prior three taxable years does not exceed $10 million.

In Rev. Rul. 92-28, the IRS examined two fact patterns involving taxpayers changing to or from the PCM under section 460(e). The first fact pattern involved a taxpayer previously exempt from PCM adopting that method in the year it exceeded the $10 million threshold. The second fact pattern addressed a taxpayer who was required to use PCM because it exceeded the $10 million threshold in prior years, but subsequently was able to meet the threshold in 1992. In both instances, the IRS concluded that a Form 3115 was unnecessary.
In Situation 1 of Rul. Rul. 92-28, taxpayer X never exceeded the gross receipts threshold of $10 million until 1992 and all of its long-term contracts were completed within a two-year period.

Thus, until 1992, the taxpayer was permitted to use the completed contract method for all of its long-term contracts. When the taxpayer exceeded the gross receipts threshold in 1992, the IRS noted that the taxpayer's adoption of PCM for all long-term contracts entered into in 1992 did not require a change in method of accounting. As section 460(e)(1) permits taxpayers to use different methods of accounting for exempt and nonexempt contracts and the taxpayer had never entered into a nonexempt contract prior to 1992, it was able to adopt PCM for its first nonexempt contract in 1992. This conclusion is consistent with the general principle that a taxpayer may adopt an accounting method for an item in the first year the item is incurred.[5]

In Situation 2, taxpayer Y previously used the completed contract method of accounting prior to the enactment of section 460. Once it became subject to the requirements to use PCM for contracts entered into after February 28, 1986, taxpayer Y used the percentage-of-completion-capitalized cost method and PCM in the taxable years for which it exceeded the gross receipts threshold. Once taxpayer Y disaffiliated from its controlled group and fell under the $10 million gross receipts threshold in 1992, it qualified for exemption from PCM. As taxpayer Y had previously used the completed contract method for its pre-section 460 years, the IRS concluded that taxpayer Y could revert back to its historical method of accounting for its exempt contracts without filing a method change. Otherwise, it could use a different method if it obtained the consent of the Commissioner.

Section 460(e)(1)(B) under TCJA

Under the TCJA, the exemption from PCM was expanded to include contracts for the construction or improvement of real property if:

- Completion of the contract is expected (at the time such contract is entered into) within two years of commencement of the contract; and
- Performance of the contract is by a taxpayer that (for the taxable year in which the contract was entered into) meets the $25 million gross receipts test.

Thus, a taxpayer with gross receipts in excess of $10 million but under $25 million may now qualify to use a method other than PCM for its long-term contracts entered into beginning in 2018.

Section 460(e)(2)(B) under the TCJA provides that "any change in method of accounting made pursuant paragraph (1)(B)(ii) shall be treated as initiated by the taxpayer and made with the consent of the Secretary. Such change shall be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change."

Rev. Proc. 2018-31 as amended by Rev. Proc. 2018-40

Rev. Proc. 2018-40 added section 19.01 to Rev. Proc. 2018-31, which permits a small business taxpayer that previously adopted PCM for exempt long-term contracts to change to an exempt contract method of accounting described in Treas. Reg. § 1.460-4(c). Therefore, any small taxpayer that had previously adopted an exempt contract method other than PCM and desires to change to a different exempt contract method must utilize the non-automatic consent procedures.

[5] *Federated Department Stores v. Commissioner*, 51 T.C. 500, 513-14 (1968), *nonacq*. 1971-2 C. B. 4, *aff'd* 426 F.2d 417 (6th Cir. 1970).

Many small taxpayers are facing challenges in determining their existing exempt contract method prior to the use of PCM. In some cases, a taxpayer may have exceeded the previous exempt long-term contract threshold of $10 million many years ago, such that its original exempt contract method is not known or readily determinable based on available information. These small taxpayers are concerned about (a) utilizing the automatic consent procedures without proper documentation of their previous exempt contract method; (b) unknowingly making an unauthorized method change to a different method for their exempt contracts by not appropriately applying the legacy exempt method; or (c) being forced to return to an improper method of accounting for exempt contracts that the taxpayer used historically prior to changing to PCM.

Further, small taxpayers that are able to identify their exempt contract method may want to change to a different exempt contract method. Most automatic accounting method changes are focused on the method of accounting that the taxpayer is changing to and are generally less focused on the existing method of accounting of the taxpayer. This same philosophy should apply to the method of accounting for exempt contracts of small taxpayers to allow them to use the streamlined automatic procedures to change to any proper exempt contract method.

If a small taxpayer does not want to file a non-automatic accounting method change for its exempt contract method because of the burden and cost of the filing, it may be faced with undue tax complexity in its tax accounting. These taxpayers are generally permitted to adopt the cash method for their short-term contracts under section 15.18 of Rev. Proc. 2018-31. Accordingly, many small taxpayers may be required to maintain three separate accounting methods for their three categories of contracts: (1) short-term contracts (e.g., cash method); (2) exempt contracts (e.g., completed contract method); and (3) non-exempt long-term contracts exceeding two years (e.g., PCM).

Section 460(e)(1)(B) was intended to reduce the compliance burden on small taxpayers. Providing an automatic accounting method change to adopt any permissible exempt contract method will reduce administrative burden, reduce costs, and better promote voluntary compliance for small taxpayers.

V. Modify the definition of tax shelter for purposes of section 448 to exclude syndicates

Recommendations

The AICPA previously submitted a comment letter on February 13, 2019, which urged Treasury and the IRS to provide relief to certain small businesses from the definition of a syndicate, which if unaddressed, would result in their treatment as a tax shelter. To allow these businesses to avoid treatment as a syndicate and utilize the simplifying provisions under TCJA, the AICPA urged that guidance must provide that the interests in these entities are attributable to active management. Specifically, the guidance should provide that if an entity:

- Qualifies under the gross receipts test of section 448(c);
- Meets the definition of a syndicate under section 1256(e)(3)(B); and
- Does not qualify "for making an election under section 163(j)(7)(B) to be an electing real

property trade or business"[6] or "an election under section 163(j)(7)(C) to be an electing farming business,"[7]

the Secretary should determine (by regulations or otherwise) that all interests in the entity are treated as held by individuals who actively participate in the management of such entity[8] provided that the entity and the interests were not used for tax avoidance purposes.

We recommend that Treasury and the IRS use their authority under section 1256(e)(3)(C)(v) to provide relief from the definition of syndicate to small business entities that meet certain conditions. The first condition is that an entity must qualify under the gross receipts test. Secondly, an entity must meet the definition of a syndicate. Finally, an entity must not qualify to make an election as an electing real property business or electing farming business.[9] If a small business satisfies these three conditions, the Secretary should determine that all interests in the entity are treated as held by individuals who actively participate in the management of such entity.

Analysis

Tax shelters under section 448(a)(3) are not eligible for the $25 million gross receipts test and therefore cannot use the simplifying accounting method provided under the TCJA. The current definition of a tax shelter may result in the erosion of Congressional intent to reduce administrative compliance burden for small businesses.

To date, the AICPA has received numerous questions from its members representing small businesses expressing concern with the specific definition of a syndicate. As there are a considerable number of small business pass-through taxpayers allocating losses generated from their normal business operations to limited partners, the present definition of a syndicate erodes Congressional intent to reduce uncertainty and complexity for small businesses by disallowing the simplifying provisions for entities that should otherwise qualify for relief. If an entity is able to meet the $25 million gross receipts test, the entity should benefit from the simplifying provisions, regardless of whether the entity has taxable income or a loss for the year.

Businesses that fluctuate between having taxable income and loss are eligible for the simplifying provisions in some years but not others. The fluctuation between income and loss would require small businesses to frequently change methods of accounting. This inconsistency creates unnecessary administrative burdens for small businesses and the IRS.

The Secretary has the authority to provide exceptions from the definition of a syndicate. Section 1256(e)(3)(C) lists several examples of interests in an entity that "shall not be treated as held by a

[6] Proposed Reg. § 1.163(j)-(9)(a).
[7] *Id.*
[8] Section 1256(e)(3)(C)(v).
[9] Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 248 (December 28, 2018). *Federal Register: The Daily Journal of the United States*. Web. 28 December 2018; page 67520. Proposed Reg. § 1.163(j), pg. 31, "The Treasury Department and the IRS also have determined that small businesses that are exempt under section 163(j)(3) and proposed Treas. Reg. § 1.163(j)-2(d)(1) may not make an election under proposed §1.163(j)-9." Proposed Treas. Reg. § 1.163(j)-9 is the "Elections for Excepted Trades or Businesses" regarding section 163(j)(7)(B) to be an electing real property trade or business and an election under section 163(j)(7)(C) to be an electing farming business.

limited partner or a limited entrepreneur," therefore, resulting in exclusion of the entity from the definition of a syndicate. In particular, section 1256(e)(3)(C)(v) allows the Secretary to determine (by regulations or otherwise) "that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes." Accordingly, the AICPA urges the IRS and Treasury to use their authority under section 1256(e)(3)(C)(v) to address this issue and provide relief to many small business taxpayers.

VI. Clarify that taxpayers exceeding the threshold for small business taxpayers in the future must file accounting method changes and provide procedures for such taxpayers to file these accounting method changes with automatic consent

Recommendations

With respect to taxpayers that are required to use the overall accrual method of accounting, and/or become subject to sections 263A, 471 and 460, we recommend that the IRS and Treasury clarify that the change to no longer use the simplifying provisions of the TCJA is considered an accounting method change for purposes of section 481.

The IRS and Treasury should update Rev. Proc. 2018-31 to specifically allow taxpayers that no longer meet the $25 million gross receipts test to file automatic accounting method change(s) for the following situations:

- Overall Cash to Accrual – Waive the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13, for former small business taxpayers under the TCJA that previously filed an overall change in accounting method.
- Section 263A – Update sections 12.01 and 12.02 of Rev. Proc. 2018-31 to allow a former small business taxpayer under the TCJA to change from a permissible non-UNICAP inventory method to a permissible UNICAP method in the first taxable year that it does not qualify as a small business taxpayer. We also recommend waiver of the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 for taxpayers that previously filed an accounting method change to use a permissible non-UNICAP inventory method under the provisions of the TCJA.
- Section 471 – Provide guidance permitting taxpayers that were previously exempt from the requirements of section 471 under the TCJA to change to a permissible method of accounting for identifying and valuing inventories. We also recommend waiver of the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 for taxpayers that previously filed an accounting method change for exemption from section 471 under the provisions of the TCJA.
- Section 263A(f) - The AICPA recommends that Treasury and the IRS update sections 12.13 and 12.16 of Rev. Proc. 2018-31, as modified by Rev. Proc. 2018-40, specifically to allow a taxpayer to change from a permissible non-interest capitalization method to a permissible interest capitalization method under section 263A(f) (or vice versa) in the first taxable year that it no longer qualifies as a small taxpayer (or in the first taxable year of qualifying as a small taxpayer) using an optional cut-off method. Further, we recommend waiver of the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 for taxpayers

that previously filed a method change to use another permissible interest capitalization method.

Analysis

If a taxpayer's gross receipts exceed the $25 million gross receipts threshold, it may not apply any of the simplifying provisions for the taxable year in which it no longer qualifies as a small business taxpayer (other than for taxpayers not subject to section 448).

- Overall Cash to Accrual – Presently, section 15.01 of Rev. Proc. 2018-31 allows taxpayers to file an automatic accounting method change to change from cash to accrual and waives the prior change eligibility rule for any prior change to the cash method made under the provisions of Rev. Procs. 2001-10 and 2002-28.
- Section 263A – The existing language in section 12.01(1)(a)(ii) of Rev. Proc. 2018-31 allows a former small reseller to change to permissible UNICAP methods under the automatic provision.
- Section 471 – Sections 22.11 and 22.18 of Rev. Proc. 2018-31 allow taxpayers to file automatic accounting method changes to change to permissible methods of identifying and valuing inventories.
- Section 263A(f) – Using an optional cut-off method is consistent with existing language in section 22.14(2) of Rev. Proc. 2018-31, which allows an eligible taxpayer to make a change on a cut-off basis or compute a section 481(a) adjustment if sufficient information to do so exists.

Currently, a taxpayer may have to file an advance consent accounting method change to adopt a different overall method of accounting from the cash method, begin capitalizing costs under section 263A or accounting for inventories under section 471. As described above, certain fact patterns may preclude a taxpayer from filing an automatic accounting method change to change from methods of accounting permitted to small taxpayers when the taxpayer no longer satisfies the $25 million gross receipts test. Waiving the eligibility rules under section 5.01(1) of Rev. Proc. 2015-13 for these changes would ensure that small business taxpayers may utilize the automatic consent procedures if they no longer satisfy the gross receipts test under section 448(c).

VII. Provide relief for small business taxpayers who meet the $25 million gross receipts test that are currently on improper accounting methods

Recommendations

The IRS should direct examiners to suspend current examination activity for taxpayers with average annual gross receipts of $25 million or less for the year(s) under examination on certain issues involving:

- Whether the taxpayer is required to use the accrual method of accounting due to the taxpayer failing to meet the pre-TCJA $5 million of average annual gross receipts test under section 448;

- Whether the taxpayer is required under section 263A to capitalize certain direct and indirect costs (including interest expense, if applicable) to inventory or to the basis of real or tangible personal property produced by the taxpayer;
- Whether the taxpayer is required to maintain an inventory method under section 471; and
- Whether the taxpayer is required to account for contracts under the PCM method of accounting under section 460.

Additionally, the IRS should provide prior year audit protection for each of the small business accounting method reforms and simplification provisions listed above and for examination of years beginning before January 1, 2018:

- Examination agents should discontinue current examination activity with regard to the small business reforms and simplification provisions of TCJA;
- Examination agents should not begin any new examination activity; and
- If a taxpayer has filed Form 3115 or is deemed to have adopted certain provisions of TCJA, the examination agent may risk assess the section 481(a) adjustment and determine whether to examine the adjustment.

Analysis

Small business taxpayers, when reviewing the applicability of the TCJA small business accounting method reform and simplification provisions, could find that their historical methods of accounting are not in compliance with the IRC and regulations thereunder.

The AICPA requests both a suspension of current year examination activity and prior year audit protection for each of the small business accounting method reforms and simplification provisions listed above. This approach is appropriate given the uncertainty as to whether audit protection (provided as part of consent to change a method of accounting) would cover certain situations for which the new method of accounting is an exemption to certain methods of accounting required under previous law.

For example, section 263A(i) provides that a taxpayer that meets the gross receipts test is exempt from the requirement to compute tax inventory adjustments under the UNICAP requirements. If the taxpayer did not previously meet any of the various UNICAP exceptions, and was otherwise required to compute tax inventory adjustments, it is unclear whether the exemption from UNICAP requirements in the TCJA, and a change to that method of accounting, provide adequate audit protection to the taxpayer for historical years.

The IRS has a history of providing methods to ease administrative burden, especially for small business taxpayers. The adoption of the tangible property regulations is a recent example. In Rev. Proc. 2015-20, the IRS provided procedures for a small business taxpayer, defined as a separate and distinct trade or business with total assets of less than $10 million or average annual gross receipts of $10 million or less for the prior three taxable years, to make certain tangible property changes in method of accounting with an adjustment under section 481(a) that takes into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after January 1, 2014. Revenue Proc. 2015-20 modified certain procedures provided in Rev. Proc. 2015-14 to

allow small business taxpayers to effectively elect to make tangible property related changes on a cut-off basis. However, the adoption of certain tangible property changes under Rev. Proc. 2015-20 did not provide audit protection to a small business taxpayer for taxable years beginning prior to January 1, 2014.

A stand down or suspension of current examination activity surrounding the provisions described above is in the interest of the IRS to both further ease the administrative burden of small business taxpayers and its own administrative burdens. Adjustments with respect to the timing of deductions and income for taxpayers that meet the gross receipts test will reverse within one or two years. The taxpayer, by then, will qualify under the revised gross receipts test. In addition, any simplified procedures provided to adopt the small business taxpayer reforms and simplification provisions of the TCJA should provide audit protection for previous tax years for a taxpayer's overall method of accounting, the UNICAP requirements, the requirement to maintain inventory under section 471, and the use of the PCM method under section 460.

VIII. Provide guidance regarding tax consequences of the cash method of accounting

Non-Incidental Materials and Supplies Accounting Method

Recommendation

The AICPA recommends that the IRS and Treasury provide guidance explaining the tax consequences that result for a small business taxpayer that purchases or produces merchandise for sale to customers, which adopts the cash method of accounting and the non-incidental materials and supplies method to account for its inventory.

Analysis

Under the TCJA, a small business taxpayer adopting the cash method may treat inventory as non-incidental materials and supplies. The consequence of treating inventory as a non-incidental material and supply is that the cost of the inventory is deductible when the inventory is used or consumed (assuming it has been paid for as required under the cash method of accounting). However, no explanation is provided on how the cost basis of inventory items treated as non-incidental materials and supplies is determined.

De minimis election, under Treas. Reg. § 1.263(a)-1(f)

Recommendation

The AICPA recommends that the IRS and Treasury permit small business taxpayers to make a *de minimis* election under Treas. Reg. § 1.263(a)-1(f) to enable the taxpayer to expense the cost of any purchased raw materials or finished merchandise purchased for resale, if those costs otherwise satisfy the requirements for a *de minimis* election in Treas. Reg. § 1.263(a)-1(f).

Analysis

Prior to the enactment of section 263A, the cost of non-incidental materials and supplies included the costs incurred by a taxpayer in acquiring the materials and supplies. However, Treas. Reg. § 1.263(a)-1(f)(1) offers taxpayers the option to elect to apply a *de minimis* safe harbor with respect to the acquisition or production of depreciable property costing less than $5,000/unit (or $2,500/unit in the case of a taxpayer without an applicable financial statement). The *de minimis* election is applied to eligible non-incidental materials and supplies pursuant to the requirements in Treas. Reg. § 1.263(a)-1(f)(1). Treasury Reg. § 1.263(a)-1(f)(1) provides that a taxpayer must apply any safe harbor *de minimis* election to any type of eligible property that is treated as a material or supply within the meaning of Treas. Reg. § 1.162-3.

Treasury Reg. § 1.263(a)-1(f)(2) provides that the *de minimis* safe harbor election for materials and supplies does not apply to any property that is considered as inventory. However, the determination of whether a material or supply is or is not considered as inventory is based on whether the property is subject to the provisions in section 471. Treasury Reg. § 1.263(a)-1(f)(1) does not contain its own separate definition of whether a material or supply is considered as inventory.

Production Labor and Overhead Costs

Recommendation

The AICPA recommends that the IRS and Treasury issue guidance that states that a small business taxpayer that adopts the cash method of accounting may deduct all of the labor and overhead costs associated with the purchase or production of the inventory items.

In addition, the AICPA recommends that the IRS and Treasury clarify that a taxpayer that meets the gross receipts test need not capitalize into the basis of the inventory any of the taxpayer's production labor and overhead costs. Thus, the only capitalized costs are the costs of any raw materials purchased or any finished merchandise purchased for resale. Further, capitalizing these costs is not needed if the expenditures are not capitalized in the taxpayer's AFS or its books and records prepared in accordance with the taxpayer's accounting procedures, if the taxpayer does not have an AFS.

Analysis

To date, the AICPA has received numerous questions from members representing small business taxpayers regarding the ability to deduct labor and overhead costs to the extent the taxpayers no longer wish to account for inventory under section 471.

If the taxpayer meets the gross receipts test, the taxpayer's determination of the cost of any inventory that it produces is governed by section 471(c)(1)(B). Notice 88-86[10] provides insight on the law that existed prior to the enactment of section 263A with respect to the determination of non-incidental materials and supplies produced by a taxpayer.

[10] Notice 88-86 explained the scope of section 263A prior to the issuance of regulations under that section.

Section D of Notice 88-86 discusses the intended application of section 263A to non-incidental materials and supplies and notes that such treatment depends on whether the materials and supplies are subject to section 263A by a taxpayer that is not engaged in a business with inventories. The Notice indicates that section 263A is intended to apply in that type of situation only if the materials and supplies are significant in amount. This rule was later codified in the provisions in Treas. Reg. § 1.263A-1(b)(11). As non-incidental materials and supplies, the items are not significant in amount.

In example 1 in section D of Notice 88-86, the IRS provides an illustration involving an architect providing design services. The Notice concludes that the blueprints and drawings that the architect supplies to its clients are not subject to section 263A. The architect is not subject to section 263A; therefore, the architect is not required to capitalize the salaries of any employees that worked on the drawings and blueprints into the cost of the blueprints and drawings. Also, the architect is not required to capitalize any of the architectural firm's overhead into the cost of the drawings and blueprints. Presumably, the same conclusion would apply, for example, to an attorney that supplies legal documents to a client as part of the legal services provided by the attorney. The same result should apply to a taxpayer that meets the gross receipts test that treats inventory as non-incidental materials and supplies. By virtue of meeting the gross receipts test, the taxpayer is exempted from the requirements in section 263A and is placed in the same position as the architect in the first example in section D of Notice 88-86.

IX. Clarify that the definition of a tax shelter for purposes of section 448 does not include an entity with negative taxable income as a result of a negative section 481(a) adjustment

Recommendation

The IRS should clarify that a negative section 481(a) adjustment that arises for a small business taxpayer, which results in negative taxable income, will not result in the classification of the taxpayer as a tax shelter in that tax year, thus making it ineligible for adopting accounting method changes allowed by the TCJA.

Analysis

Taxpayers are concerned with the definition of tax shelter under section 448 as it applies to the new small business methods of accounting, including the exception from the interest expense limitation. In particular, the term "tax shelter" includes a syndicate, which is defined in section 1256(e)(3)(B) as any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs. Under Treas. Reg. § 1.448-1T(b)(3), an entity is only a syndicate in years with a taxable loss. For business that have losses in some years and income in others, this definition could result in eligibility for the special methods in some years and not other years, thereby requiring small business taxpayers to change from methods of accounting allowed by the TCJA.

In addition, the AICPA is concerned that if a small business taxpayer changes its method(s) of accounting, the change(s) could result in a negative section 481(a) adjustment. The inclusion of the negative section 481(a) adjustment in the computation of taxable income could result in consideration of the taxpayer as a tax shelter in that tax year and render the taxpayer ineligible to use certain accounting methods allowed by the TCJA. Thus, the AICPA recommends that the IRS and Treasury clarify that if a small business taxpayer reports negative taxable income, as a result of a negative section 481(a) adjustment, it is not considered a tax shelter that is otherwise ineligible to use the methods of accounting allowed by the TCJA.