ACCOUNTING METHODS AND CHANGES THERETO: THE BASICS

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I. INTRODUCTION

A. Not So Simple

Whenever tax practitioners think of accounting methods, they tend to focus solely on the "cash vs. accrual" theories of income/expense recognition. The simplistic view is that if it hits the bank account and is recognized for tax purposes, then you are on the "cash" method of accounting. If not, then it's accrual. The reality is that it is much more complicated than that.

B. Over-all Method vs. Specific-Item Analysis

The term "method of accounting" includes not only the over-all method (e.g. cash or accrual) of the taxpayer but also the accounting treatment of any specific item.[1]

C. Paid, Incurred, or Accrued

The terms "paid or incurred" and "paid or accrued" are construed according to the method of accounting used in computing taxable income.[2] See Section VII below for rules regarding payment with a credit card.

II. GENERAL RULES

A. According to Books and Records

Taxable income must be computed under the method of accounting used by a taxpayer in keeping his books.[3]

B. Discrepancy Between Books and Tax Return

A corporation isn't required to report income on the accrual method if its financial statements are accrual while its tax return is on the cash basis. This assumes that no inventories are maintained. For this rule to apply, the corporation's books and records must clearly reconcile between accrual and cash.[4]

C. Permissible Methods

There are three permitted accounting methods:

1. Cash receipts and disbursements (i.e. the "Cash" method)
2. Accrual, and
3. Other.[5]

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[1] Treas. Reg. § 1.446-1(a)(1).
[2] I.R.C. § 7701(a)(25).
[3] I.R.C. § 446(a).
[4] PLR 8028005.
[5] I.R.C. § 446(c).

D. More than One Business

A taxpayer engaged in more than one business can use a different method for each business.[6] No trade or business will be considered separate and distinct unless a complete and separable set of books and records is maintained.[7]

III. SECTION 448 RULES: PROHIBITIONS AGAINST "CASH" METHOD

A. Generally

The Code contains a series of rules setting forth the types of taxpayers that are absolutely forbidden from using the "cash" method of accounting. But as always, there are numerous exceptions to this general rule.

B. Three Forbidden Entities[8]

The three types of taxpayers that may not use the "cash" accounting method are:

1. C Corporations,[9]
2. Partnerships with a C Corporation partner, and
3. Tax shelters.[10]

C. Three Exceptions to the § 448(a) Rule[11]

1. Farming business,[12]
2. Personal Service Corporation (PSC), and
3. An entity with gross receipts of less than $5 million.

D. Gross Receipts Test

For purposes of the $5 million gross receipts test, there is a 3-year average "look-back" test.[13] The gross receipts number is calculated net of returns and allowances.[14]

E. Definition of "PSC"

A personal service corporation is defined as including the following types of services: health, law, engineering, architecture, accounting, actuarial science,

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[6] I.R.C. § 446(d).
[7] Treas. Reg. § 1.446-1(d).
[8] I.R.C. § 448(a).
[9] Planning note: use an S Corporation (regardless of size) or a partnership with no C Corporation as a partner.
[10] See I.R.C. § 461(i)(3) for definition of "tax shelter."
[11] I.R.C. § 448(b).
[12] See Section VII below for accounting method rules for farmers.
[13] I.R.C. § 448(c)(1).
[14] I.R.C. § 448(c)(3)(C).

performing arts, or consulting.[15] A qualified PSC must meet a stock ownership test as well as a functional test.[16]

IV. INVENTORY RULES

A. General Rule

In any case in which it is necessary to use an inventory, the accrual method of accounting must be used with respect to purchases and sales.[17] This rule, contained in the regulations, has generated a great deal of litigated controversy as well as administrative rulings.

B. Administrative Exception

Some taxpayers who use inventories are exempt from the accrual accounting method if their 3-year average gross receipts are less than $10 million. However, this exception to Treas. Reg. § 1.446-1(c)(2) does not apply to businesses falling into certain NAICS codes, like Code 44 (retail trade).[18]

C. General Rule vs. I.R.C. § 448

Treas. Reg. § 1.446-1(c)(2) [general rule, supra] overrides the exception under § 448 that allows certain corporations to use the cash method of accounting. Thus Section 448 does not affect the IRS' authority, under § 446(b), to require a taxpayer to change from the cash method to the accrual method of accounting.[19]

V. CHANGE OF ACCOUNTING METHOD

A. Kinds of Changes

There are two different kinds of changes that can happen to an accounting method. One is voluntary, and the other is involuntary. If the IRS, on audit, recommends a change in order to clearly reflect income, that is considered involuntary.

B. Timing

A change of accounting methods does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of

[15] I.R.C. § 448(d)(2)(A).
[16] I.R.C. § 448(d)(2)(B).
[17] Treas. Reg. § 1.446-1(c)(2).
[18] IRS Notice 2001-76, 2001-2 CB 613.
[19] Cross Oil Co. v. Commissioner, 81 T.C.M. (CCH) 1682 (2001).

income or the taking of a deduction. Thus, if a taxpayer's practice is self-correcting over time, it constitutes a method of accounting.[20]

C. Voluntary Changes

1. Consent required

   If a taxpayer wants to change his accounting method, he must first secure permission of the IRS.[21]

2. Form required

   To secure IRS consent to change a taxpayer's accounting method, it is necessary to file an application on Form 3115 (Exhibit A) during the tax year for which a change is desired.[22] The instructions for Form 3115 are extremely lengthy and complicated.

3. Effect on future years

   When an accounting method is changed, the taxpayer must use the new method in all future years.

4. Year of change

   If a change of accounting method is voluntary (i.e. initiated by the taxpayer) the entire amount of required adjustments under I.R.C. § 481 is generally taken into account in computing taxable income in the year of change regardless of whether the adjustments increase or decrease taxable income.[23]

D. Involuntary Changes

1. General rule

   These are changes that are initiated by an IRS agent. If no method of accounting has been used by the taxpayer, or if the method used doesn't clearly reflect income, IRS has the right to impose a method that **does** clearly reflect income.[24]

2. A lack of IRS' prior consent to change cannot be used by a taxpayer to avoid penalties if the IRS decides to force a change of methods involuntarily.[25]

3. IRS examination

   A change of accounting method required as a result of an audit of a taxpayer's tax return will not be considered as initiated by the taxpayer.[26]

4. Closing agreement

   To implement a Service-imposed change of accounting method, the taxpayer and the IRS should execute a closing agreement under § 7121 in which the taxpayer agrees to the change and the terms and conditions of the change.[27]

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[20] Treas. Reg. § 1.446-1(e)(2)(ii)(b).
[21] I.R.C. § 446(e).
[22] Treas. Reg. § 1.446-1(e)(3(i).
[23] Treas. Reg. § 1.481-1(c)(5); but see § 481(b) for alternative computations available.
[24] I.R.C. § 446(b).
[25] I.R.C. § 446(f).
[26] Treas. Reg. § 481-1(c)(5).

VI. § 481 ADJUSTMENTS

A. General Rule

If there is a change in a taxpayer's method of accounting for any taxable year (i.e. the "year of change") the taxpayer must adjust his taxable income for the year of change by the amount necessary to prevent amounts from being duplicated or omitted.[28]

§ 481 adjustments are not limited to amounts attributable to years that are open under the applicable statute of limitations.[29] Therefore, if, for example, accounts receivable have built up over 20 years and a "cash" method is converted to an "accrual" method, the net effect of the "adjustment" is accelerated into the "year of change."

B. "Year of Change" Defined

1. Year of change. The year of change is the taxable year for which the taxable income is computed under a method different from that used for the preceding taxable year.[30] The "year of change" is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is used, even if no affected items are taken into account for that year. The year of change is also the first taxable year for complying with all the terms and conditions accompanying the change. Ordinarily an examining agent will consider the earliest year under examination as the year of change.[31]

2. Appeals or Counsel discretion. for the government may compromise the year of change by agreeing to a later year of change, or by using the "cut-off" method.[32]

3. The cut-off method. Under the "cut-off" method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting.[33]

C. Components of "Adjustments"

[27] Rev. Proc. 2002-18, 2002-1 CB 678, ¶ 7.02.
[28] I.R.C. § 481(a).
[29] TAM 9640003.
[30] Treas. Reg. § 1.481-1(a)(1).
[31] Rev. Proc. 2002-18, 2002-1 CB 678.
[32] *Id.*
[33] *Id.*

Adjustments referred to in I.R.C. § 481(a) take into account: accounts receivable, accounts payable, etc.[34] Adjustments to inventory, accounts receivable, accounts payable, etc are done as of the beginning of the taxable year of the change.[35]

D. IRS Discretion

The IRS, in its discretion, prescribes the taxable year in which § 481 adjustments are taken into account.[36] But see options available, *supra*, Section VI, B., 2-3.

E. § 481(b) Exceptions

1. If a change of accounting method results in an increase of more than $3,000 then there is a 3-year allocation rule utilizing the current and two preceding tax years.[37] Note that there are a general and two alternative methods in § 481(a) and (b) and that they apply to both voluntary and involuntary method changes. Accelerating the Sec. 481(a) adjustments all in one year can usually result in a Draconian tax deficiency. With § 481(b) Congress tried to lessen the hardship caused by taking a substantial 481(a) adjustment into account in one tax year.[38]
2. First alternative

   If the 3-year rule applies, the tax attributable to the adjustment can't exceed the tax by applying 1/3 of the adjustment to each of the current and two preceding years.[39]
3. Second alternative

   The regulations provide a second alternative calculation to the 3-year equal proration rule of Reg. § 1.481-2(a). This second alternative is calculated by allocating to one or more of the two years preceding the year of change, the adjustment that would result by applying the new accounting method to such preceding year or years, with the balance attributable to the year of change.[40]
4. Summary of 481(b) Exceptions

   To determine whether 481(b) limits the amount of tax resulting from a § 481(a) adjustment, three different computations should be made:
   a. Determine the tax increase that results if all 481(a) adjustments are taken into account in the year of change,
   b. Divide the 481(a) adjustments into three equal parts and allocate them to the year of change and the two preceding years, and

[34] Treas. Reg. § 1.481-1(b).
[35] Treas. Reg. § 1.481-1(c)(1).
[36] Treas. Reg. § 1.481-1(c)(2).
[37] I.R.C. § 481(b)(1).
[38] TAM 9640003.
[39] Treas. Reg. 1.481-2(a).
[40] Treas. Reg. § 1.481-2(b).

c. The two preceding years are recomputed using the new accounting method; then the balance of the 481(a) adjustment is allocated to the year of change.
d. Then recalculating the tax under the smallest change of a., b., or c. is the amount of the tax deficiency.

VII. FARMER RULES

A. <u>General Rule</u>

Some farming taxpayers are required to use the accrual accounting method. These are:[41]

1. C Corporations engaged in the farming business,
2. Farming partnerships with a C Corporation partner,
3. Non-family C Corporations with gross receipts of more than $1 million.
4. Family corporations with gross receipts of more than $25 million.

B. <u>Involuntary Treatment</u>

If a farming taxpayer is required to change its accounting method because of the requirements of § 447, the change will be treated as if the IRS granted its consent.[42] For purposes of I.R.C. § 481(c)(2) [i.e. the "duplication" or "omission" provision] a § 447 change is treated as involuntary (i.e. initiated by the IRS).[43]

C. <u>10-Year Spread</u>

In a § 447 change, the 481(a) adjustments can be spread over 10 future years.[44]

VIII. MISCELLANEOUS RULES

A. <u>Use of Credit Cards</u>

A cash basis taxpayer may use a credit card to pay for medical, etc expenses and get a current deduction on the theory that this is the equivalent of using borrowed

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[41] I.R.C. § 447(a)-(d).
[42] I.R.C. § 447(f)(1).
[43] I.R.C. § 447(f)(2).
[44] I.R.C. § 447(f)(3).

funds.[45] Similarly, a business expense paid with a credit card is deductible when charged, not when the credit card is paid.[46]

B. Estoppel Against the Government

IRS' failure to object to consistent use of an erroneous accounting method will not necessarily constitute approval of that erroneous method. Thus the IRS is not bound by a "duty of consistency" theory in this context, as most taxpayers are.[47]

C. GAAP Accounting

Ordinarily GAAP accounting wil be treated as clearly reflecting income so long as income and expenses are treated consistently from year to year.[48]

D. Authority of Appeals or Counsel to Settle Accounting Method Cases

Appeals of Counsel has the authority to resolve accounting method issues when it is in the interest of the government to do so.[49]

[45] Rev. Rul. 78-39, 79-1 CB 73.
[46] Lawler v. Commissioner, 69 T.C.M. (CCH) 1699 (1995).
[47] *See* Pierce Ditching Company, Inc. v. Commissioner, 73 T.C. 301 (1979).
[48] Treas. Reg. § 1.446-1(a)(2).
[49] Rev. Proc. 2002-18, 2002-1 CB 678, ¶ 6.02.