# PART XVI: ACCOUNTING

## 8885. What is an accounting period?

An accounting period is the taxable period that is used to determine a taxpayer's income tax liability.[1] An accounting period can be measured as either a calendar year[2] or a fiscal year.[3] In either case, the taxable year cannot exceed a period of 12 months.[4] Despite this, it is not sufficient for a taxpayer who is a business owner to merely begin his accounting period on the date the business began and end it 12 months later. This is because the accounting period does not end on the last day of December to qualify as a calendar year, does not end on the last day of the month to qualify as a fiscal year, and does not satisfy the 52-53 week requirements.[5]

Certain taxpayers are not permitted to choose their accounting period. The regulations require that most entities adopt a specific required tax year in order to prevent the manipulation of the tax year in order to artificially defer a taxpayer's tax liabilities.[6]

A calendar year accounting period is a period of 12 months that starts on January 1st and ends on December 31st. Any taxpayer can adopt the calendar year accounting period, though certain taxpayers are required to adopt a calendar year accounting period if any of the following are true:

(1) the taxpayer keeps no books;

(2) the taxpayer does not have an annual accounting period; or

(3) the taxpayer has an annual accounting period, but such period does not qualify as a fiscal year.[7]

If the taxpayer maintains records that are sufficient to adequately reflect the taxpayer's income on the basis of an annual accounting period, the taxpayer is considered to have "kept books."[8]

A fiscal year is any 12 month period that ends on the last day of any month other than December. The taxpayer must keep accounts and report income and expenses using the same period that corresponds to the chosen fiscal year.[9]

A taxpayer may also elect, as a variation of the fiscal year period, a tax year consisting of 52-53 weeks, where the annual accounting period varies between 52-53 weeks, but always ends on the same day of the week and, additionally, always ends on:

(1) Whatever date this same day of the week last occurs in a calendar month; or

(2) Whatever date this same day of the week falls that is nearest to the last day of the calendar month.[10]

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1. IRC Sec. 441(c), 7701(a)(23), IRS Pub. 538.
2. IRC Sec. 441(d).
3. IRC Secs. 441(e), 7701(a)(24).
4. Treas. Reg. §1.441-1(a)(2).
5. IRC Sec. 441, Rev. Rul. 85-22, (1985)-1 CB 154.
6. Treas. Reg. §1.441-1(b)(2).
7. IRC Sec. 441 (g), IRS Pub. 538.
8. Treas. Reg. §1.441-1(b)(7).
9. IRC Secs. 441(e), 706 (b). See also IRS Pub. 538.
10. IRC Sec. 441(f).

**Planning Point:** Cyclical businesses, like retail stores, may have several months (holiday season) with large sales but many months where expenses exceed sales. Quarterly tax payments still must be made off the entire year's estimated revenues and not increased (for example, in the Holiday season) and decreased as sales decrease. Moving the accounting period forward to the end of January (or later) enables retail stores to recognize the sales, less the returned items, and more accurately prepare for the upcoming year's tax obligations.

## 8886. How is a partnership's accounting period determined?

A partnership is one of the entities that is generally required to adopt a particular accounting period as specified under the regulations.[1] A partnership's accounting period is determined by reference to the partner's required accounting period(s).[2] The partnership's "required taxable year" can either be:

(1) The tax year of the majority partnership interest;

(2) The tax year of all the principal partners; or

(3) If it cannot be established based on the majority partnership interest or principal partners, a calendar year.[3]

For these purposes, when a partnership's accounting period is determined by reference to the majority interest, it means that it is determined based on the tax year of a partner or group of partners having an aggregate interest in partnership profits or capital of more than 50 percent.[4]

A "principal partner" is a partner who has an interest of 5 percent or more in partnership profits or capital.[5] Once it is established that a partner is a principal partner, that principal partner is required to maintain the same calendar year established by the partnership unless that principal partner is able to demonstrate a valid business purpose for the deviation.

See Q 8889 for a discussion of the business purpose test that must be satisfied to allow a principal partner to adopt an alternate accounting period. This business purpose test must also be satisfied in order for the partnership to adopt an accounting period that deviates from the requirements set forth in (1)-(3), above.

## 8887. How is an S corporation's accounting period determined?

An S corporation is generally required to adopt a calendar year accounting period (meaning that its tax year ends on December 31, see Q 8885) unless it can establish a valid business purpose for adopting an alternate accounting period.[6]

The business purpose test, applicable in the context of both partnerships and S corporations, is discussed in Q 8889.

1. Treas. Reg. §1.1441-4(b)(2)(i)(G), IRC Sec. 706.
2. IRC Secs. 444, 706.
3. IRC Sec. 706(b). See also Treas. Reg. §1.706-1(b)(2).
4. IRC Sec. 706(b)(4).
5. IRC Sec. 706(b)(3).
6. IRC Sec. 1378(b).



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## 8888. When can a partnership or S corporation elect an otherwise impermissible accounting period?

Partnerships and S corporations are entities that are generally required to adopt a taxable year in accordance with certain specified requirements, as set forth in the Internal Revenue Code and Treasury Regulations.[1] See Q 8886 (partnerships) and Q 8887 (S corporations) for the general rules applicable in establishing the accounting periods for these entities.

A partnership or S corporation is entitled to adopt an accounting period that varies from the otherwise specified requirements in the following cases:

(1) The entity establishes a valid business purpose for adopting a different accounting period (see Q 8889);[2]

(2) The entity elects a 52-53 week taxable year[3] (see Q 8885);

(3) The entity is entitled to use a grandfathered accounting period.

A grandfathered accounting period is an accounting period that either the partnership or S corporation has received permission to use on or before July 1, 1974 in an IRS letter ruling.[4]

The IRS will consider all of the facts and circumstances when determining whether to permit the adoption of an alternate tax year, including the tax consequences that would result from such a change.

In addition, a partnership or S corporation can elect to adopt a tax year other than its required year under Section 444 as long as the required accounting period is deferred for no more than three months.[5] An entity that makes this election is required to make certain payments under Section 7519 that are based on a formula derived from the entity's income for the year and the highest tax rate currently applicable under IRC Section 1 (39.6 percent for 2013 and beyond).[6]

## 8889. How does a partnership or S corporation establish that it has a valid business purpose for adopting an accounting period that deviates from its required accounting period?

A valid business purpose will generally be found to exist if the requested tax year coincides with the entity's ownership tax year (in the case of an S corporation) or natural business year.[7]

An S corporation can establish an ownership tax year as the tax year that constitutes the tax year of an S corporation shareholder holding more than 50 percent of the corporation's issued and outstanding stock, disregarding certain shareholders who are tax-exempt under IRC

1. IRC Sec. 444(e).
2. IRC Secs. 706(b)(1)(C), 1378(b), Treas. Reg. §1.706-1(b)(2)(ii), (7).
3. Treas. Reg. §1.441-1(b)(2)(ii)(A).
4. Treas. Reg. §1.441-1(b)(6).
5. IRC Sec. 444(b).
6. IRC Sec. 7519(b).
7. Treas. Reg. §1.442-1(b)(2).

Section 501.[1] A partnership or S corporation can establish the term of its natural business year by satisfying one of the tests discussed below.

In general, the IRS has developed three tests that are used in determining whether a valid business purpose has been established:

(1) 25 percent gross receipts test;[2]

(2) Annual business cycle test; and[3]

(3) Seasonal business test.[4]

If the entity is able to establish that its requested accounting period corresponds to a natural business year that is supported by the 25 percent gross receipts test, the IRS will automatically approve the requested accounting period under Revenue Procedure 2006-46. The annual business cycle test and seasonal business test are subject to discretionary approval.

To satisfy the 25 percent gross receipts test, a taxpayer[5] must establish that it has earned at least 25 percent of its gross receipts from sales and services during the last two months of the requested accounting period, using its gross receipts for the preceding three years. The taxpayer must demonstrate that this 25 percent or more threshold is met by calculating the timing of its earnings as though the requested accounting period had been in effect for three years.[6] However, even if the taxpayer's requested accounting period satisfies this 25 percent gross receipts test, the taxpayer must determine whether another accounting period would also satisfy the 25 percent gross receipts test. If any accounting period *other than* the requested accounting period would produce the aggregation of a higher percentage of the entity's earnings in the final two months of the period, then the requested accounting period cannot automatically qualify as the taxpayer's natural business year.[7]

The taxpayer must use the same *method* as is used in filing that taxpayer's current tax return in calculating its gross receipts for purposes of the 25 percent gross receipts test. If an entity does not have at least a 47 month period of gross receipts, then it is not entitled to establish its natural business year under the gross receipts test.[8]

Under the annual business cycle test, a taxpayer must demonstrate that its business operates cyclically, in that it is subject to peak and non-peak periods. The taxpayer's natural business year may be found to end at the conclusion of its highest peak period of business, or soon thereafter.[9] Rev. Proc. 2002-39 provides a safe harbor rule that treats one month after the end

1. Rev. Proc. 2006-46, 2006-45 IRB 859.
2. Rev. Proc. 2006-46.
3. Rev. Proc. 2002-39, 2002-22 IRB 1046.
4. Rev. Proc. 2002-39.
5. Partnerships, S corporations or personal service corporations.
6. Rev. Proc. 2006-46, Rev. Proc. 2002-39.
7. Rev. Proc. 2006-46, Rev. Proc. 2002-39.
8. Rev. Proc. 2006-46, Rev. Proc. 2002-39.
9. Rev. Proc. 2002-39.



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of a business' peak season as "soon after" the close of the peak season. A business that has steady income throughout the year will not be able to satisfy this test.

The seasonal business test applies to entities that operate only during part of the year for one reason or another (for example, because of weather conditions) so that the entity's gross receipts for periods outside of its operational season are found to be insignificant. Under the seasonal business test, the entity's natural business year is deemed to end at the end of, or soon after, its seasonal operation.[1] If the entity earns 10 percent or less of its income outside of its operational season, such amounts are automatically deemed to be insignificant for purposes of this rule. One month after the end of the entity's operational season is deemed to be "soon after" the end of its season.

If a taxpayer is unable to satisfy any of the three tests described above, he may attempt to demonstrate a valid business purpose based on individual facts and circumstances by showing that there are compelling tax or non-tax reasons for adopting an alternative accounting period.[2] However, it is insufficient that the non-tax reasons asserted merely create a tax year that is more convenient for the taxpayer. As such, reasons that are considered insufficient include:

(1) The hiring patterns of the business;

(2) Use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders; or

(3) The fact that the business uses price lists or model years that change on an annual basis.

Further, if the tax consequences of the alternate period result in deferral or distortion, the requested change will often be denied unless the taxpayer is able to demonstrate compelling non-tax reasons for the change. The IRS has found that compelling non-tax reasons for an alternate accounting period exist in situations where the entity closed down operations for ten years for reasons beyond its control or when the entity's business was impacted by a strike, for example.[3]

**Planning Point:** Before changing accounting periods, a business owner should find out what the norm is for the business owner's industry. Changing accounting periods can also have unintended consequences. For example, accounting period changes can affect the calculations that go into the valuation of a business if the owner later chooses to sell it. Changing periods can also cause non-revenue generating paperwork for the acquirer which could affect negotiations.

## 8890. When is it permissible for a taxpayer to adopt an accounting period that is less than 12 months?

A taxpayer may adopt an accounting period that is less than a full 12 month period, known as a short period, in certain limited circumstances.[4] A taxpayer may adopt a short period if:

1. Rev. Proc. 2002-39.
2. Rev. Proc. 2002-39. See also Rev. Rul. 87-57, 1987-2 CB 117, illustrating the application of this test.
3. Rev. Rul. 87-57.
4. IRC Sec. 443(a).



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(1) The taxpayer's short period has been specifically approved by the IRS;[1] or

(2) The taxpayer was only in existence during part of what would otherwise constitute the applicable accounting period.[2]

If a taxpayer obtains approval to adopt a short period under (1), above, the taxpayer must annualize taxable income by determining annual income and dividing that amount by the number of months in the short period.[3] Further, if the taxpayer is an individual, the amount of the taxpayer's personal exemption must be reduced so that it bears the same ratio to the full exemption as the number of months in the short period bears to 12.[4]

Option (2), above generally occurs in situations where a business entity only operated for a portion of the otherwise required tax year. For example, a business that liquidates before the close of its tax year is entitled to use the period of its existence during that accounting period as its short accounting period.[5]

## 8891. Can an accounting period be changed once chosen?

Yes. A taxpayer can change its accounting period if it has obtained the approval of the IRS unless the taxpayer is authorized under the Internal Revenue Code or the regulations to change the accounting period without prior approval.[6]

Individual taxpayers are entitled to change accounting periods (e.g., from a calendar year to a fiscal year) by filing Form 1128 with the IRS.[7] Pass-through entities, such as partnerships and S corporations, are not entitled to change accounting periods using this form.

Partnerships and S corporations can obtain automatic approval to change to an alternate accounting period if the requirements set forth in Revenue Procedure 2006-46 are satisfied, meaning that the entity:[8]

(1) Is changing to a required taxable year (Q 8886 and Q 8887) or to a 52-53 week accounting period ending in reference to its required taxable year (Q 8885);

(2) Satisfies the 25 percent gross receipts test (Q 8889);[9]

(3) Is an S corporation (or is planning to make an S election) changing to its ownership tax year (Q 8889);

(4) Wishes to change from a 52-53-week taxable year to a non-52-53-week taxable year that ends on the last day of the same calendar month that is an otherwise permitted taxable year, and vice versa.[10]

1. IRC Sec. 443(a)(1).
2. IRC Sec. 443(a)(2).
3. IRC Sec. 443(b)(1).
4. IRC Sec. 443(c).
5. See IRC Secs 708 (termination of partnerships) and 1362 (termination of S corporation status).
6. IRC Sec. 442, Treas. Reg. §1.442-1(a).
7. Rev. Proc. 2002-39, Rev. Proc. 2003-62.
8. Rev. Proc. 2006-46.
9. Rev. Proc. 2006-46.
10. Rev. Proc. 2006-46.



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Typically, the IRS will establish conditions that the taxpayer must satisfy in order to change its accounting period when it consents to the change.[1] In addition to any terms established by the IRS, the taxpayer will be required to maintain its records and compute its income based on the requested accounting period.

Generally the taxpayer must use Form 1128, "Application to Adopt, Change or Retain a Tax Year" to file for a change of accounting period. The taxpayer may not request to retroactively change an accounting period even to change to a required accounting period for a prior tax year.[2]

## 8892. What is the cash basis method of accounting?

The cash basis method of accounting is the most widely used accounting method for individual taxpayers, and is often used by many business entities, as well.[3] Cash basis taxpayers recognize all gross income, whether in the form of cash, property or services, in the year that the income is actually or constructively received.[4]

"Constructive receipt" is considered to have occurred when income is made available to a taxpayer without restrictions.[5] For example, a cash basis taxpayer cannot avoid reporting income simply because he refused to deposit a check. Conversely, if a taxpayer's employer provides the taxpayer with a stock bonus, but conditions are imposed so that the bonus is not available to the taxpayer until a future date, the corporation's reporting such bonus on its books does not constitute constructive receipt on the part of the taxpayer-employee.

Similarly, a taxpayer is entitled to claim any deductions for the year in which the expenses that gave rise to the deduction were actually paid.[6] There is no "constructive payment" type doctrine that corresponds to the constructive receipt doctrine discussed above, however.[7]

Though a cash basis taxpayer's receipt of income in the form of cash is simple to recognize, complications may arise when the income is received in the form of non-cash property or a right to receive income based on future services. As such, the IRS has developed the doctrines of "cash equivalence" and "economic benefit" to address the receipt of property and services. When income is received in the form of property, the cash basis taxpayer must include the fair market value of such property in income if rights to the income are (1) freely transferable, (2) readily marketable and (3) immediately convertible into cash.[8]

On the other hand, if a taxpayer contracts to perform services for a specified amount of income that will be received in installments over the period of service, the taxpayer does not report the value of the installment payments in the year the contract is entered. This is because the taxpayer does not receive a cash equivalent at the time of contracting, but rather obtains

1. Rev. Proc. 2002-39.
2. Rev. Proc. 2006-45, 2006-45 IRB 851.
3. IRC Sec. 446(c)(1).
4. Treas. Reg. §1.446-1(c)(1)(i).
5. Treas. Reg. §1.451-2(a).
6. Treas. Reg. §1.461-1(a)(1).
7. See *Massachusetts Mutual Life Insurance Co. v. U.S.*, 288 U.S. 269 (1933).
8. See Rev. Rul. 73-173, 1973-1 CB 40.



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only the right to receive such cash payments in the future dependent on performance of the required services.[1]

Under the economic benefit theory, a taxpayer is required to recognize income if an economic benefit has been conferred upon the taxpayer, even if the taxpayer has no ability to currently access the cash or non-cash property providing such benefit.[2] For the cash basis taxpayer to recognize income under the economic benefit theory, the property must be transferred for the benefit of the taxpayer[3] and confer vested, nonforfeitable rights[4] to the taxpayer. For example, a taxpayer was required to recognize income when his employer transferred certain amounts into a trust for his future benefit where the employer's payment was irrevocable, even though the taxpayer was not currently able to access the funds in the trust.[5] Therefore, unlike the cash equivalence theory, the property that is irrevocably transferred and held for the taxpayer's benefit does not have to be transferrable by the taxpayer.[6] The taxpayer is required to include the fair market value of non-cash property, or present value of any cash, that is transferred in income for the year such property or cash is transferred.[7]

**Planning Point:** Generally speaking, the cash basis method of accounting works best for organizations that prefer simplicity over predictability. Cash basis is like balancing a checkbook; if the money is there, then the money affects the tax obligations. Large and unanticipated increases in revenues can lead to large tax obligations—and potentially large cash outflows—that small business owners may not be prepared for. Quarterly estimated tax payments may be more difficult to predict in a cash basis business with large, infrequent sales.

## 8893. What is the accrual method of accounting?

Taxpayers who use the accrual method of accounting generally report income in the year that it is earned, rather than in the year it is received.[8] Under this method, income is recognized in the year when (1) all events have occurred to fix the taxpayer's right to receive the income and (2) the amount of income that the taxpayer will be entitled to receive can be determined with reasonable accuracy. Because the relevant inquiry is when the income is *earned*, rather than when the income is *received*, compensation agreed upon with respect to the performance of future services is not recognized until those services have actually been performed (at the time the taxpayer has earned the compensation).[9]

Pursuant to the "all events test,"[10] income is recognized when all of the events that are required for the taxpayer's right to the income to be vested have occurred so that the amount

1. Rev. Rul. 73-173, *Shuster v. Helvering*, 121 F.2d 643 (1941).
2. See *Spoul v. Comm.*, 16 TC 244 (1951). See also *Thomas v. U.S.*, 45 F. Supp.2d 618 (1999).
3. Compare *Sproull, and Jacuzzi v. Comm.*, 61 TC 262 (1973) (economic benefit upon transfer to trust), with *Casale v. Comm.*, 247 F.2d 440, 445 (2d Cir. 1957) (no economic benefit), *Centre v. Comm.*, 55 TC 16 (1970), Rev. Rul. 72-25, 1972-1 CB 127 (no economic benefit).
4. See e.g., *Robertson vs. Comm.*, 6 TC 1060 (1946), acq., 1946-2 CB 4.
5. *Jacuzzi v. Comm.*, 61 TC 262 (1973).
6. *Hackett v. Comm.*, 159 F.2d 121 (1st Cir. 1946), *Brodie v. Comm.*, 1 TC 275 (1942).
7. *212 Corp. v. Comm.*, 70 TC 788 (1978), *Bell Est. v. Comm.*, 60 TC 469 (1973).
8. IRC 446(c)(2).
9. Treas. Reg. §1.451-1(a).
10. IRC Sec. 448(h)(4).



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of the taxpayer's entitlement can be determined with reasonable certainty.[1] It is possible for a taxpayer to report income although no payment has yet been received.[2]

Similarly, an accrual basis taxpayer's expenses are deductible for the taxable year in which the liability for payment becomes definite and the amounts payable become ascertainable with reasonable certainty, but only to the extent that economic performance with respect to the item has occurred.[3]

In general, an accrual basis taxpayer will include amounts in income upon the earliest of the following events: (1) payment is actually received, (2) the income amount becomes due to the taxpayer, (3) the taxpayer earns the income, or (4) title to property has passed to the taxpayer.[4]

An accrual basis taxpayer who enters into an agreement to provide future services may postpone reporting advance payments under the agreement if the services relate to property the taxpayer owns, leases, builds or installs, but only if the agreement relates to servicing property the taxpayer ordinarily owns, leases, builds or installs in the ordinary course of business *without* such a service agreement. Recognition of advance payments is not permitted when (1) the taxpayer will perform any part of the service after the end of the tax year immediately following the year of payment or (2) the service will be performed at an unspecified future date that *might* be after the end of the tax year immediately following the year of payment.[5]

> *Example*: Scott owns a computer sales business. In 2014, he receives payment for a one year service contract on a computer that he sold. If Scott normally sells computers without the service contract, he can postpone until 2015 recognition of any income he did not earn in 2014 because, by the terms of the agreement, the services will be performed within one year.

> *Example 2*: Lauren owns a dance studio and, on October 1, 2014, receives payment for a one year contract for 48 dance lessons. The one year period begins on October 1. Lauren gives 8 dance lessons in 2014. She is required to recognize one-sixth (8/48) of the advance payment in 2014, because she has earned that portion. Further, she is required to recognize the remainder of the income in 2015, even if she does not give all of the lessons in 2015.

If the accrual basis taxpayer must give up certain rights in order to receive the agreed upon amounts, accrual of that income will be prevented. For example, the courts have held that, in the case of an insurance claim resulting from property damage where the insured held two different insurance policies, a clause in policy A that prevented the payout unless the taxpayer agreed to forego his right to the proceeds of policy B prevented accrual. Even though all events that would give rise to the taxpayer's rights to the amounts receivable under policy A had occurred and the amount could be determined, attachment of the condition prevented accrual of the amounts involved.[6] The right to receive an amount must be enforceable by the recipient with no strings attached.

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1. Treas. Reg. §1.446-1(c)(1)(ii).
2. *Comm. v Hansen*, 360 U.S. 446 (1959).
3. IRC Sec. 461(h).
4. IRS Publication 538.
5. IRS Pub. 538.
6. *Maryland Ship-building & Drydock Co. v. U.S.*, 409 F.2d 1363 (Ct. Cl. 1969).



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**Planning Point:** Generally speaking, the accrual method of accounting normalizes, or smooths out, the revenues and expenses of a business, making it easier to do year over year comparisons and forecasts. A company that wins a large deal may get paid an up-front cash amount for products that are delivered for years to come. Accrual tax accounting allows the tax obligations to be paid over longer periods of time, giving the business owner more choice and control over how, and when taxes are paid.

## 8894. Are there taxpayers required to use the accrual method of accounting, rather than the cash basis method?

Generally, C corporations, partnerships in which a C corporation is a partner and tax shelter arrangements (see Q 8627) are required to use the accrual basis method of accounting.[1]

However, several exceptions exist to permit certain C corporations and partnerships with C corporation shareholders to use the cash basis method. Farming businesses[2] that are organized as C corporations are permitted to use the cash basis method of accounting. Similarly, small businesses organized as C corporations are permitted to use the cash basis method if the corporation (or partnership with C corporation shareholder) has annual gross receipts that do not exceed $5,000,000.[3]

Certain personal service corporations are also permitted to use the cash basis method of accounting. Further, the IRS has specifically determined that the prohibition on C corporations using the cash basis accounting method does not apply to limited liability companies.[4]

Generally, taxpayers that maintain inventory are required to use the accrual basis method with respect to purchases and sales of that inventory unless the taxpayer obtains the IRS' consent to use the cash basis method. Typically, the IRS will consent to such a change if the cash basis method clearly reflects the taxpayer's income.[5] See Q 8904 for a more specific discussion of the methods that may be used to account for inventory.

The cash basis method may also be used by most other taxpayers whose average annual gross receipts do not exceed $1 million[6] and may be used by select taxpayers whose average annual gross receipts do not exceed $10 million.[7]

## 8895. Can a taxpayer choose to use both the cash basis and accrual methods of accounting?

Under IRC Section 446(c), a taxpayer may use any combination of the permissible accounting methods to compute taxable income if the combination clearly reflects the taxpayer's income and is consistently used. For example, a taxpayer is permitted to use the cash basis method to account for income and expenses, but the accrual method to account for purchases and sales. Despite this, a taxpayer is *not* permitted to use one method to account for income and a different method to account for expenses.[8]

1. IRC Sec. 448(a).
2. IRC Sec. 263A.
3. IRC Sec. 448(b).
4. Let. Ruls. 9328005, 9321007.
5. Treas. Reg. §1.446-1(c)(2)(i).
6. Rev Proc. 2001-10, 2001-2 IRB 272.
7. Rev. Proc. 2002-28, 2002-18, IRB 815.
8. Treas. Reg. §1.446-1(c)(1)(iv), *Grider v Commissioner*, TC Memo 1999-417.



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Though the regulations require that a taxpayer use the accrual method to account for purchases and sales if inventories are maintained, that taxpayer may wish to use the cash basis method for income and expenses because the required calculation may be simpler.[1]

A taxpayer is also permitted to use one accounting method to determine tax liability for income arising from a trade or business and another method to account for income that is not related to a trade or business.[2] Taxpayers engaged in different trades or businesses can also use a different method of accounting for each trade or business in which the taxpayer participates.[3]

## 8896. Can a taxpayer change an accounting method once it has been chosen?

Though a taxpayer does not need IRS consent to choose its initial accounting period, generally, the taxpayer must seek the consent of the IRS to change its accounting method. This is the case even if the taxpayer's current accounting method is an impermissible one (for example, if a partnership with C corporation shareholders has chosen the cash basis method, see Q 8894).[4] The IRS can also require the taxpayer to change its accounting method[5] if it is determined that the chosen accounting method does not clearly and accurately reflect the taxpayer's income.[6]

Certain specific accounting changes do not require IRS consent. Revenue Procedure 2011-14 provides a list of circumstances in which automatic approval for changes in accounting methods will be granted. For example, a taxpayer who is improperly using the reserve method of accounting to account for bad debts may automatically switch to the specific charge-off method (see Q 8696).[7]

In order to obtain IRS approval to change a taxpayer's current accounting method, the taxpayer must file Form 3115, "Application for a Change in Accounting Method" with the IRS. In addition to Revenue Procedure 2011-14, the instructions to Form 3115 provide a brief description of the situations in which a taxpayer may obtain automatic IRS approval for a change in accounting method.[8]

Once the taxpayer either determines that automatic change is available or obtains IRS consent to change from one method of accounting to another, the taxpayer is required to make any adjustments to items of income or expense that are necessary to prevent duplication or omission of amounts based on the change.[9]

Taxpayers may also wish to change the accounting for one or more material items of income or deduction, rather than the overall method of accounting.[10] A "material item" is defined in the

1. Treas. Reg. §1.446-1(a)(4)(i), Treas. Reg. §1.446-1(c)(2)(i). See also *Gustafson v Commissioner*, TC Memo 1988-82.
2. Treas. Reg. §1.446-1(c)(1)(iv)(b).
3. Treas. Reg. §1.446-1(d).
4. Treas. Reg. §1.446-1(e)(2)(i).
5. IRC Sec. 446(e), Treas. Reg. §1.446-1(e)(2)(i).
6. IRC Sec. 446(b).
7. Rev. Proc. 2011-14, 2011-1 CB 330.
8. Instructions to Form 3115, available at http://www.irs.gov/pub/irs-pdf/i3115.pdf (last accessed June 8, 2014).
9. IRC Sec. 481(a).
10. Treas. Reg. §1.446-1(a)(1).



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regulations as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.[1] Changing the accounting method for a material item, rather than the overall method of accounting, also requires that the taxpayer obtain consent if the change is not subject to automatic approval. For example, a taxpayer must obtain consent in order to change the method of depreciation or amortization of items, except for certain changes to the straight-line method depreciation that are subject to automatic approval under Revenue Procedure 2011-14.[2]

## 8897. What is the installment method of accounting and when is it used?

In cases where a taxpayer does not receive payment immediately after a sale, the taxpayer may be able to recognize the income from those sales over a period of time, rather than when the sale is made. The installment method may be used to account for gains (but not losses) if the taxpayer has sold property and will receive at least one payment with respect to that sale after the close of the tax year in which the sale occurs.[3] Under the installment method, for each year in which payments are due, the taxpayer will recognize a proportionate amount of the payments as they are actually received over the payment term.[4]

Despite this, a taxpayer is not entitled to use the installment method of accounting if the transaction is a dealer disposition or involves the sale of property that is held as inventory in the ordinary course of the taxpayer's trade or business (see Q 8904 for a discussion of inventory accounting).[5] A dealer disposition is a sale of personal property by a person who regularly sells or otherwise disposes of property using an installment plan or a disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of a trade or business.[6] Certain farm property and the sale of timeshares and residential lots are excluded from the definition of dealer disposition.[7]

Section 453 only affects the timing of income recognition and does not impact the characterization of the income (for example, as a capital gain or ordinary income).[8]

See Q 8819 for more information on using the installment method of accounting in the context of small business dispositions. Q 8852 discusses the special rules that apply in the context of related party sales under the installment method.

## 8898. What interest requirements apply when a taxpayer uses the installment method of accounting?

Generally, when a taxpayer uses the installment method of accounting (see Q 8897), if the sale price is over $3,000 and any payment is deferred for more than one year, interest must be charged on payments due more than six months after the sale. Interest must be charged at a rate

1. Treas. Reg. §1.446-1(e)(2)(ii).
2. See IRS Pub. 538.
3. IRC Sec. 453(b)(1).
4. IRC Sec. 453(c).
5. IRC Sec. 453(b)(2).
6. IRC Sec. 453(l).
7. IRC Sec. 453(l)(2).
8. *Murray v. United States*, 192 Ct Cl 63 (1970).



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that is at least 100 percent of the "applicable federal rate," (AFR) compounded semiannually, or interest will be imputed at that rate.[1] However, the following exceptions to this general rule apply:

(1) If less than 100 percent of the AFR, a rate of no greater than 9 percent, compounded semiannually, will be imputed in the case of sales of property (other than new IRC Section 38 property) if the stated principal amount of the debt instrument does not exceed $5,557,200 in 2014 (as indexed annually for inflation);[2]

(2) If less than 100 percent of the AFR, a rate of no greater than 6 percent, compounded semiannually, is imputed on aggregate sales of land during a calendar year between an individual and a member of the individual's family (i.e., brothers, sisters, spouses, ancestors, and lineal descendants) to the extent the aggregate sales do not exceed $500,000 (the general rule of 100 percent of the AFR, compounded semiannually, applies to the excess);[3] and

(3) A rate of 110 percent of the AFR, compounded semiannually, applies to sales or exchanges of property if, pursuant to a plan, the transferor or any related person leases a portion of the property after the sale or exchange ("sale-leaseback" transactions).[4]

The applicable federal rate applied will be the lowest of the AFRs in effect for any month in the 3-month period ending with the first calendar month in which there is a binding contract in writing.[5]

All interest received by the taxpayer is taxed as ordinary income.[6] In some cases, depending on the property and amount involved, the interest (or imputed interest) to be paid over the period of the loan must be reported as "original issue discount" that accrues in daily portions; in other cases the interest is allocated among the payments and that much of each payment is treated as interest includable and deductible according to the accounting method of the buyer and seller.

## 8899. What special accounting rules apply in the installment context of related party sales?

Under IRC Section 453(e)(1), if a taxpayer ("first seller") disposes of property to a related person in an installment sale ("first sale"), and the related party in turn sells the property in a second sale before the first seller receives all payments under the first sale, the amount realized in the second sale will be treated as received by the first seller. This is the case even though the first seller has actually not received all payments due with respect to the first sale.[7]

1. IRC Sec. 483.
2. IRC Sec, 1274A, Rev. Rul. 2013-23, 2013-48 IRB 590.
3. IRC Sec. 483(e)(3).
4. IRC Sec. 1274(e).
5. IRC Sec. 1274(d)(2)(B).
6. Treas. Reg. §1.483-1.
7. IRC Sec. 453(e).



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Essentially, the payments received from the second sale are treated as though they were used to pay off the first sale even if, in reality, the second seller has made no payments. The purpose of this treatment is to prevent a taxpayer from improperly deferring gain on the sale of property by using the installment method of accounting.

In order for the related party rules to apply, the second sale must occur within two years of the first sale unless the property at issue consists of marketable securities.[1]

For purposes of the installment sale rules, "related party" includes the seller's siblings, ancestors, lineal descendants, certain controlled corporations (see Q 8833) and estates, trusts and partnerships in which the seller has an interest.[2]

If the second sale occurs as a result of an involuntary conversion under IRC Section 1033 (see Q 8611), the second sale will not be treated as a "second sale" under these rules if the first sale was made before the threat of the involuntary conversion arose.[3] Further, a second sale will not be deemed to have occurred for purposes of these rules if the sale occurs after the death of either the first seller or the related party who acquires the property in the first sale.[4] If the parties are able to prove that the sales were not motivated by tax avoidance, the related party rules will not apply.[5]

## 8900. Is a taxpayer required to use the installment method to account for an installment sale?

In situations where the installment method applies, the taxpayer is required to use the installment method unless an election is made to opt out of this treatment. If the taxpayer does not affirmatively elect out, the installment method is the default method of accounting for transactions covered by the installment sale rules (see Q 8897 and Q 8899). The opt-out election must be made on or before the due date for filing the taxpayer's return for the year. Once the election is made, the taxpayer may only revoke the election with the IRS' consent.[6]

## 8901. What types of contracts are considered "long-term contracts" for purposes of determining the proper method of accounting?

A long-term contract is any contract that provides for the manufacture, building, installation, or construction of property that will not be completed within the taxable year that the contract was executed.[7]

Despite this general definition, a manufacturing contract is only treated as a long-term contract if it provides for the manufacture of:[8]

1. IRC Sec. 453(e)(2).
2. IRC Secs. 453(f), 318(a), 267(b).
3. IRC Sec. 453(e)(6).
4. IRC Sec. 453(e)(6)(C).
5. IRC Sec. 453(e)(7).
6. IRC Sec. 453(d).
7. IRC Sec. 460(f)(1), Treas. Reg.§1.460-1(b)(1).
8. IRC Sec. 460(f)(2), Treas. Reg.§1.460-2(a).

(1) Unique items which are not normally carried as finished goods inventory; or

(2) Items which would normally require more than a 12 month production period to complete (regardless of the duration of the actual contract).[1]

An item is considered "unique" if it was designed to meet the needs of a specific customer and is generally not suitable for the use of other customers without significant modification.[2] A taxpayer can use the IRS' safe harbor to show that a product is not unique in the following circumstances:

(1) *Short production period*. If an item could normally be manufactured within 90 days or less, then it is not considered to be a unique item. If multiple orders are involved, this test is satisfied if each unit can be manufactured within 90 days;[3]

(2) *Customized item*. An item is not considered unique if 10 percent or less of the total contract cost is attributed to the cost of customizing the item;[4]

(3) *Inventoried item*. An item that might otherwise be considered unique ceases to be unique when the taxpayer begins to normally include similar items in its finished goods inventory.[5]

The item's production period begins when the taxpayer has incurred at least 5 percent of the total contract cost and ends when the item is ready for sale and all reasonably expected production activities have been completed.[6]

Construction contracts, for this purpose, include the improvement or building of a real property, reconstruction or rehabilitation of real property, contracts for the installation of an integral component to real property, and contracts for the improvement of real property.[7]

See Q 8902 for the rules governing accounting for long-term contracts.

## 8902. How does a taxpayer account for revenue and costs under a long-term contract?

If the contract is found to be a long-term contract (see Q 8901), the taxpayer will be required to use the percentage of completion method to account for revenue under that contract, unless an exception applies to allow use of the completed contract method. Generally, the completed contract method may only be used for certain home construction and other real estate construction contracts (see Q 8903), so the exception is very limited.[8]

1. IRC Sec. 460(f)(2)(B), Treas. Reg. §1.460-2(a)(2).
2. Treas. Reg. §1.460-2(b)(1), *Sierracin Corp. v. Comm.*, 90 TC 341 (1988).
3. Treas. Reg. §1.460-2(b)(2)(i).
4. Treas. Reg. §1.460-2(b)(2)(ii).
5. Treas. Reg. §1.460-2(b)(2)(iii).
6. Treas. Reg. §1.460-2(c)(1).
7. Treas. Reg. §1.460-3(a).
8. IRC Sec. 460 (a), Treas. Reg. §1.451-3(b).



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The percentage of completion method requires the taxpayer to include the portion of the total contract price that corresponds to the percentage of the entire contract that has been completed during that tax year.[1] The aim of this method is to include a portion of income during each year as the work under the contract progresses.

To determine the income that must be recognized under a long-term contract, a taxpayer uses the following steps:[2]

(1) The completion factor for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract, is computed;

(2) The amount of cumulative gross receipts from the contract is computed by multiplying the completion factor by the total contract price;

(3) The amount of current-year gross receipts is computed, which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (whether positive or negative); and

(4) Both the current-year gross receipts and the allocable contract costs incurred during the current year are taken into account in computing taxable income.

If this method does not result in the taxpayer including the total contract price in income by the time the contract is completed, the taxpayer must include any remaining amounts in income for the tax year following the year of completion.[3]

A de minimis rule allows a taxpayer to defer recognition of income under a long-term contract for any year in which less than 10 percent of the estimated contract costs have been incurred by the end of the year. This income and related costs must then be recognized in a later year in which at least 10 percent of the contract has been completed.[4]

## 8903. Are there any exceptions to the rule that a taxpayer must use the percentage of completion method in accounting for long-term contracts?

Yes. The percentage of completion method (Q 8902) is not required to be used in the case of (1) construction contracts entered into by small contractors and (2) home construction contracts.[5]

1. IRC Sec. 460(b)(1), Treas. Reg. §1.460-4(b)(1).
2. Treas. Reg. §1.460 -4(b)(2).
3. Treas. Reg. §1.460-4(b)(3).
4. IRC Sec. 460(b)(5).
5. IRC Sec. 460(e).

The exemption for small contractors will apply if the following criteria are met:[1]

(1) The long-term contract must be a construction contract;[2]

(2) At the time the contract was entered into, it estimated that the contract will be completed within two years. However, if the contract takes longer than two years to complete due to factors beyond the taxpayer's control, the small contractor's exception may still be used;[3] and

(3) The contractor or its predecessor's average annual gross receipts for the three years preceding the year in which the construction contract was entered into is $10 million or less.[4]

The home construction contract exemption applies to any construction contract under which at least 80 percent of the estimated total contract costs are reasonably attributed to the building construction, reconstruction or rehabilitation of: (1) dwelling units[5] in a building containing four or fewer dwelling units or (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.[6] If the construction involves both dwelling units and commercial units, costs must be reasonably allocated to determine the contract costs attributable to the dwelling units in order to determine whether the contract will qualify for the exemption.

## 8904. What is inventory accounting? What methods are generally used by taxpayers to account for inventory?

Inventory accounting is generally required in any case where the IRS feels it is necessary in order to accurately reflect a taxpayer's income. Inventory accounting usually becomes important in cases where the taxpayer's business involves the production and sale of goods or the purchase and resale of goods.

As a general principle, IRC Section 471 requires that a taxpayer's inventory accounting method must: (1) conform as closely as reasonably possible to the best accounting practice used in the taxpayer's business[7] and (2) clearly reflect the taxpayer's income.[8] Under the regulations, therefore, there is no one particular accounting method that must be used in all circumstances to account for inventory. Instead, the method chosen must reflect the realities of the taxpayer's business. As such, greater weight is given to consistency than to the actual valuation method chosen.[9]

1. IRC Sec. 460(e)(1)(B), Treas. Reg. §1.460-3(b)(1).
2. IRC Sec. 460(e)(4), Treas. Reg. §1.460-3(a).
3. Treas. Regs.§§1.460-3(b)(1)(ii), 1.460-1(f)(4).
4. IRC Sec. 460(e)(1)(B)(ii), Treas. Reg. §1.460-3(b)(3).
5. Dwelling unit is defined in IRC Sec. 168(e)(2)(A)(ii)(I).
6. IRC Sec. 460(e)(6)(A); Treas. Reg. §1.460-3(b)(2)(i).
7. See *Geometric Stamping Co. v. Comm.*, 26 TC 301 (1956), acq., 1958-1 CB 4 (re: importance of consistency).
8. Treas. Reg. §1.471-2(c). See also *Walmart v. Comm.*, TC Memo 1997-1 (8th Cir. 1998) (upholding the estimate for inventory shrinkage).
9. Treas. Reg. §1.471-2(b).



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There are various methods of inventory accounting, including first-in, first-out (FIFO), last-in, first-out (LIFO) and specific identification methods.

The FIFO method of accounting assumes that the first items of inventory purchased by the taxpayer are the first items that are sold. As such, the inventory that remains at the end of the taxpayer's accounting period is valued based on the most recent purchase price.[1]

Conversely, under the LIFO method, the most recent items of inventory that are purchased are considered to be the first items sold. Under the LIFO method, inventory is valued based on its cost, rather than its market value.[2]

Rather than focusing on the flow of inventory, the specific identification method requires that the taxpayer keep records so that it may assign a specific cost to each item of inventory.[3]

Certain taxpayers are either prohibited or are given the option to not use the inventory method of accounting. They include:

(1) Real estate dealers – A tax payer that is in the business of selling real properties is not permitted to use the inventory method;[4]

(2) Farmers – A taxpayer engaged in a farming business may use either the inventory or the cash method in reporting income;[5]

(3) Real estate investment mortgage units are exclusively governed by Sections 860A through 860G.[6] These entities are not permitted to use the inventory methods under Section 471.

Though greater weight is given to consistency than to the method of inventory accounting chosen, certain inventory accounting methods are specifically prohibited under Treasury Regulation Section 1.471-2(f), including the following:

(1) Deducting a reserve for price changes or an estimated depreciation in the value of inventory;

(2) Carrying inventory at a nominal price or at less than its proper value;

(3) Omitting portions of the inventory;

(4) Using a base-stock method based on a normal quantity and constant price;

(5) Including in-transit goods in inventory where title to such goods is not yet vested in the taxpayer;

1. See Treas. Reg. §1.471-2(d); ARB No. 43, Chapter 4, Statement 4 (AICPA, 1953) (FASB Accounting Standards Codification 330-10-30).
2. IRC Sec. 472(b)(2).
3. Treas. Reg. §1.471-2(d).
4. Rev. Rul. 69-536, 1969-2 CB 109, amplified in Rev. Rul. 86-149, 1986-2 CB 67; *Atlantic Coast Realty Co. v. Comm.*, 11 BTA 416 (1928), *Miller Development Co. v. Comm.*, 81 TC 619 (1983).
5. Treas. Reg. §1.471-6(a).
6. Rev. Rul. 95-81.



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(6) Using a direct cost method by a manufacturer, under which only direct production costs and variable overhead costs are allocated to inventory; and

(7) Using a prime cost method by a manufacturer, under which only direct production costs are allocated to inventory.

If a taxpayer has used a prohibited inventory method, IRS consent is still required to change the method unless automatic approval is available under Revenue Procedure 2011-14 (see Q 8891).[1]

**Planning Point:** FIFO or LIFO? Choosing LIFO is enticing in a capital-heavy business when the costs of the goods sold are increasing. This will reduce the current tax burden. However, LIFO often increases administrative time and paperwork. LIFO can affect valuation in the sale of a business as it postpones the inevitable until the sale of the business. Technology businesses often exist in a deflationary world, where the costs of their inventory decrease as computing power (and other technologies) increase year over year. FIFO is also accepted by the International Financial Reporting Standards Board (IFRS), and LIFO is not.

1. See Treas. Reg. §1.446-1(e)(2)(i).



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