Gross Relief

TAX LAW: To ease the burden on small businesses, the IRS exempts those qualified from some accounting requirements.

By Boyd D. Hudson and Louis E. Michelson

The Internal Revenue Code generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. Internal Revenue Code Section 446(c). The Internal Revenue Service can impose an accounting method upon a taxpayer if the taxpayer does not use a regular method, or if the taxpayer chooses an accounting method that does not clearly reflect income. Code Section 446(b).

There are several permissible accounting methods, the simplest of which is probably the cash method. The cash method generally requires an item of income to be included in income when cash is actually or constructively received. A deduction is permitted for an expense when the item is paid. Treas. Reg. Section 1.446-1 (c) (1) (i). In other words, recognition of income depends on the receipt of cash, and recognition of an expense follows the payment of cash.

On the other hand, the accrual method of accounting looks to the timing of the transaction rather than the receipt or disbursement of cash. Under the accrual method, the taxpayer includes income for the taxable year when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Under the accrual method, the IRS recognizes a liability for tax purposes when, it is incurred, when all events have occurred that establish the fact of the liability, when the amount incurred can be determined with reasonable accuracy and when economic performance has occurred with respect to the liability. Treas. Reg. Section 1.446-1 (c) (1) (ii).

Thus, with an accrual method, a taxpayer recognizes a utility expense when he receives an electric or gas bill, not when he pays it. A cash-method taxpayer will recognize the expense when the taxpayer actually pays the bill.

The accrual method generally is preferred because the recognition of income and expense does not depend upon the movement of cash that can easily be manipulated to defer taxation. Most businesses of any significant size and all publicly traded companies use the accrual method. However, the accrual method is more complex than the cash method and requires better-trained accounting and bookkeeping personnel along with more-sophisticated accounting systems.

Although taxpayers can select their accounting method when they establish their business, many taxpayers are forced to use the accrual method because of the nature of their businesses. When the production, purchase or sale of merchandise is an income-producing factor in a taxpayer's business, the taxpayer is required to use inventory accounting at the beginning of the year and at the end of the year to determine income. Treas. Reg. Section 1.471-1.

The regulations further provide that a taxpayer must use the accrual method of accounting with regard to the purchases and sales of merchandise whenever the taxpayer is required to use inventories. Treas. Reg. Section 1.446-1 (c) (2).

Thus, the average small business that purchases or produces merchandise for resale must not only keep track of that merchandise using inventory accounting - it must also use the accrual method, at least with regard to the purchase and sale of merchandise. This requirement can be quite burdensome to the average small business.

Recognizing this burden and in an attempt to simplify bookkeeping requirements, the Internal Revenue Service has provided some relief. Under Revenue Procedure 2000-22,2000-20 I.R.B. 1008, and Revenue Procedure 2001-10, 2001-2 I.R.B. 272, the IRS exercised its discretion to exempt certain qualifying taxpayers from the requirements that they account for inventories and use the accrual method of accounting for the purchase and sale of merchandise.

To qualify for this relief, the taxpayer must have average annual gross receipts of $1 million or less. "Gross receipts" for a tax year equals all receipts derived from all of the taxpayer's trade or business that must be recognized under the accounting method actually used by the taxpayer for federal income tax purposes. In addition to total sales (net of returns and allowances), gross receipts includes all amounts received from services, interest, dividends and rents. Gross receipts does not include amounts received by the taxpayer with respect to sales taxes or where the taxpayer merely serves as a conduit

The determination of average annual gross receipts is made by a three tax-year look-back analysis. A taxpayer has average annual gross receipts of $1 million or less if for each prior tax year ending on or after Dec. 17, 1998, the taxpayer's average annual gross receipts for the three-tax-year period ending with the applicable prior tax year does not exceed $1 million.

For example, a calendar-year taxpayer has gross receipts of $400,000 in 1996, $900,000 in 1997 and $1.1 million in 1998. To determine whether the taxpayer qualifies for the small taxpayer's exception beginning with the 1999 tax year, one looks to the average annual gross receipts for the three tax years 1996, 1997 and 1998. The three-tax-year average annual gross receipts is $800,000 [$400,000 (1996) + $900,000 (1997) + $1.1 million (1998) = $2.4 mil-divided by 3]. The taxpayer qualifies in 1999.

The availability of the small-taxpayer exception must be redetermined each year. Thus, in the above example, if gross receipts in 1999 were $1.6 million, the taxpayer would not qualify in 2000 because the average annual gross receipts would be $1.2 million [$900,000 (1997) + $1.1 million (1998) + $1.6 million (1999) = $3.6 million divided by 3]. Because the taxpayer ceased to qualify for the small taxpayer exception, it must change to an inventory method and the accrual method of accounting.

Qualifying taxpayers who do not wish to account for inventories must treat "inventoriable" items – i.e., merchandise purchased for resale and raw materials purchased for use in providing finished goods - in the same manner as a material or supply that is not incidental. This means that the items are deductible only in the year that the taxpayer consumes or uses them in operations. Thus, under the cash method, the cost of such inventoriable items is deductible only in the year the taxpayer sells the inventoriable items, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later. Rev. Proc. 2001-10, Section 4.02.

Generally, the Internal Revenue Code requires a taxpayer to obtain the permission of the IRS to change its accounting method. For certain common accounting-method changes, the IRS has created automatic change procedures. Periodically, the IRS-publishes revenue procedures providing guidelines to on how to request automatic accounting method changes that provide the criteria for qualifying for the change, the terms and conditions of the change and the procedural rules for making the change. The latest guidance for automatic changes is found in Revenue Procedure 99-49,1999-52 I.R.B. 725.

A taxpayer who qualifies for relief under Rev. Proc. 2001-10 is eligible to make the change of accounting method automatically. However, the taxpayer is still required to apply for the automatic change by filing IRS Form 3115 with the IRS. Taxpayers who wish to change to the cash method should carefully review Revenue Procedure 2001-10 and Form 3115 to make sure he takes all required steps to implement the accounting-method change.

Taxpayers and their advisers should note that under legislation pending before Congress, small businesses with average annual gross receipts of less than $5 million would be permitted to use the cash method of accounting and would not be required to use inventory accounting.

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