

Part IV -- Items of General Interest

Changes in Method of Accounting

Announcement 2002-45

PURPOSE

Beginning with the publication of Rev. Proc. 2001-10, 2001-2 I.R.B. 272, superseding Rev. Proc. 2000-22, 2000-1 C.B. 1008, the Internal Revenue Service (IRS) and Treasury Department have been working to reduce the administrative and tax compliance burdens on small business taxpayers and to minimize disputes between the IRS and these taxpayers regarding the requirement to use an accrual method of accounting under § 446 of the Internal Revenue Code because of the requirement to account for inventories under § 471. Rev. Proc. 2001-10 permits any small business taxpayer having average annual gross receipts of \$1 million or less (other than tax shelters) to use the cash receipts and disbursements method of accounting (the cash method), regardless of the nature of its trade or business. Rev. Proc. 2001-10 also permits these businesses to treat as non-incidental materials and supplies under § 1.162-3 of the Income Tax Regulations items that otherwise would be accounted for as inventory.

In December 2001, the IRS published Notice 2001-76, 2001-52 I.R.B. 613, proposing a revenue procedure (the proposed revenue procedure) that would allow qualifying small business taxpayers with average annual gross receipts of \$10 million or less to use the cash method with respect to eligible trades or businesses. Notice 2001-

76 also requested comments from the public regarding the proposed revenue procedure. This announcement discusses certain issues raised by those comments and the manner in which those issues are addressed in the final revenue procedure.

The final revenue procedure appears in this Internal Revenue Bulletin as Rev. Proc. 2002-28.

CHANGES TO THE PROPOSED REVENUE PROCEDURE

General Application of Rev. Proc. 2002-28

Several commentators asked for assistance in understanding which taxpayers are eligible to elect the cash method under the revenue procedure. In response, a flow chart has been added as an appendix to Rev. Proc. 2002-28. This flow chart provides a short-hand explanation of the scope and application of the final revenue procedure and helps explain the interaction of the revenue procedure with other authorities (such as § 448). Taxpayers should keep in mind that it is less detailed than the actual provisions of the revenue procedure and should be used only as a guide.

Many commentators asked whether the proposed revenue procedure waives the statutory restrictions placed on the use of the cash method in § 448. Rev. Proc. 2002-28 clarifies that the provisions of § 448 are not affected by the revenue procedure.

Many commentators requested clarification of the options available to qualifying small businesses under the proposed revenue procedure in choosing their overall method of accounting as well as their method of accounting for inventoriable items. In response to this request, Rev. Proc. 2002-28 lists the three options available under the revenue procedure to qualifying small business taxpayers who choose not to use an overall accrual method and an inventory method of accounting.

Determination and Qualification of a Taxpayer's Principal Business Activity

The proposed revenue procedure allowed any taxpayer whose principal business activity is not described in a prohibited North American Industry Classification System (“NAICS”) code to use the cash method for all of its trades or businesses. Several commentators expressed concern that because the proposed revenue procedure looks only to the gross receipts of the taxpayer’s most recent taxable year in determining a taxpayer’s principal business activity, temporary fluctuations in the nature of the taxpayer’s trades or businesses could change its principal business activity for purposes of the revenue procedure and thus its continued ability to use the cash method for all of its trades or businesses. In response, the final revenue procedure adopts a two-prong principal business activity test. A taxpayer may determine its principal business activity using either (i) the gross receipts for its prior taxable year, or (ii) the average annual gross receipts for its three most recent prior taxable years.

Rev. Proc. 2002-28 also clarifies that the revenue procedure may be used only by those taxpayers who did not previously change (and were not required to have previously changed) from the cash method to an accrual method for any trade or business as a result of their trade or business becoming ineligible to use the cash method under the revenue procedure. Such taxpayers may, however, apply the revenue procedure to separate trades or businesses with complete and separable books and records that are not described in an ineligible NAICS code in section 4.01(1)(a), that are service businesses under section 4.01(1)(b), or that are custom manufacturers under section 4.01(1)(c).

A few commentators requested additional guidance regarding how the proposed

revenue procedure would apply to a taxpayer in its first year of business, given that it would not have any prior year gross receipts for purposes of the principal business activity test. Rev. Proc. 2002-28 provides that a taxpayer in its first year of business may use its current year gross receipts to determine its principal business activity.

Commentators requested guidance on the interaction of the service provider safe harbor in section 4.01(1)(b) and the custom manufacturer safe harbor in section 4.01(1)(c) with the NAICS code safe harbor of section 4.01(1)(a). In response to this request, Rev. Proc. 2002-28 clarifies that a taxpayer may qualify to apply the revenue procedure to all of its trades or businesses by meeting the requirements of either the NAICS code safe harbor in section 4.01(1)(a), the service provider safe harbor in section 4.01(1)(b), or the custom manufacturer safe harbor in section 4.01(1)(c). A taxpayer's principal business activity must qualify under only one of these three provisions for all of the taxpayer's trades or businesses to be eligible to use the revenue procedure.

Inventoriable Items Treated as Materials and Supplies that Are Not Incidental under § 1.162-3

In Rev. Proc. 2001-10, the IRS determined that, for reasons of administrative convenience and reduction of taxpayer burden, taxpayers need not apply the uniform capitalization rules of § 263A to inventoriable items treated as non-incidental materials and supplies under § 1.162-3 for purposes of that revenue procedure. Several commentators suggested that the provisions of § 263A similarly should not apply to inventoriable items treated as non-incidental materials and supplies for purposes of the proposed revenue procedure. The IRS and Treasury Department agree with this

comment and have included this provision in Rev. Proc. 2002-28.

Commentators requested additional guidance regarding when the costs of materials and supplies that are not incidental may be deducted. In response to this request, Rev. Proc. 2002-28 provides additional examples to illustrate the appropriate timing of such deductions under § 1.162-3. One of these examples clarifies that under the cash method, the cost of raw materials may not be deducted until the product is provided to the customer (the costs must be added to the basis of a manufactured item rather than currently deducted). In addition, Rev. Proc. 2002-28 clarifies that in determining the amount of the deduction for inventorable items that are treated as non-incidental materials and supplies, the taxpayer may use a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, but that other methods, such as a last-in, first-out (LIFO) method, may not be used.

Other Issues

Several commentators requested clarification of the open accounts receivable (that is, for purposes of Rev. Proc. 2002-28, a receivable due in full in 120 days or less) rule in section 4.03 of the proposed revenue procedure. In response to this request, Rev. Proc. 2002-28 contains an additional example to illustrate the rule.

Several commentators requested additional guidance on the treatment of specific methods of accounting for particular items (such as specific methods for long-term contracts) for taxpayers using one of the options under Rev. Proc. 2002-28. In response, the final revenue procedure clarifies that taxpayers may, in some cases, be able to retain their specific method of accounting even when they use one of the options under the revenue procedure.