

Part III - Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding the Cash Method

Notice 2001-76

Pursuant to the discretion granted the Commissioner of Internal Revenue under §§ 446 and 471 of the Internal Revenue Code, this notice provides a proposed revenue procedure that will allow qualifying small business taxpayers with gross receipts of less than \$10 million to use the cash receipts and disbursements method of accounting as described in the proposed revenue procedure with respect to eligible trades or businesses. This proposed revenue procedure is intended to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service (Service) and these taxpayers regarding the requirement to use an accrual method of accounting under § 446 of the Code because of the requirement to account for inventories under § 471. Although this revenue procedure is being issued in proposed form, taxpayers may rely on it for taxable years ending on or after December 31, 2001.

The Service believes that § 263A will have limited applicability to resellers and producers with gross receipts of \$10,000,000 or less because of the exception for resellers in § 263A(b)(2)(B) and the indirect cost exception for producers in § 1.263A-2(b)(3)(iv). However, the Service requests comments on any additional relief that

should be considered for taxpayers with gross receipts of \$10,000,000 or less to relieve any administrative burden of § 263A. The Service also welcomes other comments on the proposed revenue procedure provided in this notice. Comments should be submitted by March 1, 2002, either to:

Internal Revenue Service
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU (ITA)
Room 5529

or electronically via the Service internet site at: Notice.Comments@ml.irs.counsel.treas.gov
(the Service Comments e-mail address).

Rev. Proc. 2001-XX

SECTION 1. PURPOSE

In order to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service (Service) and small business taxpayers regarding the requirement to use an accrual method of accounting (accrual method) under § 446 of the Internal Revenue Code because of the requirement to account for inventories under § 471, this revenue procedure provides that the Commissioner of Internal Revenue will exercise his discretion to allow qualifying small business taxpayers to use the cash receipts and disbursements method of accounting (cash method) as described in this revenue

procedure with respect to eligible trades or businesses. This revenue procedure also provides the procedures for these qualifying small business taxpayers to obtain automatic consent to change to the cash method for such trades or businesses.

SECTION 2. BACKGROUND

.01 Section 446(a) provides that taxable income must be determined under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books.

.02 Section 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, including the cash method and an accrual method, subject to certain restrictions. For example, § 446(b) provides that the selected method must clearly reflect income. In addition, § 1.446-1(c)(2)(i) of the Income Tax Regulations requires that a taxpayer use an accrual method with regard to purchases and sales of merchandise whenever § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under § 1.446-1(c)(2)(ii). Under § 1.446-1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.

.03 Section 447 generally requires the taxable income from farming of a C corporation engaged in the trade or business of farming, or a partnership engaged in the trade or business of farming with a C corporation partner, to be determined using an accrual method, unless the C corporation meets the \$1,000,000 (\$25,000,000 for family

corporations) gross receipts test.

.04 Section 448 generally prohibits the use of the cash method by a C corporation (other than a farming business and a qualified personal service corporation) and a partnership with a C corporation partner (other than a farming business and a qualified personal service corporation), unless the C corporation or partnership with a C corporation partner meets the \$5,000,000 gross receipts test. Section 448 also prohibits tax shelters from using the cash method.

.05 The cash method generally requires an item of income to be included in income when actually or constructively received and permits a deduction for an expense when paid. Section 1.446-1(c)(1)(i). Other provisions of the Code or regulations applicable to cash method taxpayers may change these general rules, including, for example, § 263 (requiring the capitalization of expenses paid out for a new building or for permanent improvements or betterments made to increase the value of any property or estate, or for restoring property or making good the exhaustion of property for which an allowance is or has been made); § 263A (requiring capitalization of direct and allocable indirect costs of real or tangible personal property produced by a taxpayer or real or personal property that is acquired by a taxpayer for resale); § 460 (requiring the use of the percentage-of-completion method for certain long-term contracts); and § 475 (requiring dealers in securities to mark securities to market).

.06 Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. Section 1.471-1 requires a taxpayer to account for

inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

.07 Section 1.162-3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the taxable year.

.08 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. However, resellers with gross receipts of \$10,000,000 or less are not required to capitalize costs under § 263A and certain producers with \$200,000 or less of indirect costs are not required to capitalize certain costs under § 263A. See §§ 263A(b)(2)(B) and 1.263A-2(b)(3)(iv).

.09 Sections 446(e) and 1.446-1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

.10 Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is determined under a method of accounting different from the method used to

determine taxable income for the preceding taxable year.

SECTION 3. SCOPE

.01 Applicability. This revenue procedure applies to a qualifying small business taxpayer. A qualifying small business taxpayer is any taxpayer with “average annual gross receipts” of more than \$1,000,000 but less than or equal to \$10,000,000 that is not prohibited from using the cash method under § 448.

.02 Taxpayers not within the scope of this revenue procedure.

(1) Notwithstanding section 3.01 of this revenue procedure, this revenue procedure does not apply to a farming business (within the meaning of § 263A(e)(4)) of a qualifying small business taxpayer. If a qualifying small business taxpayer is engaged in the trade or business of farming, this revenue procedure may apply to the taxpayer’s non-farming trades or businesses, if any. A taxpayer engaged in the trade or business of farming generally is allowed to use the cash method for any farming business, unless the taxpayer is required to use an accrual method under § 447 or is prohibited from using the cash method under § 448.

(2) Although this revenue procedure does not apply to a taxpayer with average annual gross receipts of \$1,000,000 or less, such taxpayer generally is allowed to use the cash method pursuant to Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

SECTION 4. QUALIFYING SMALL BUSINESS TAXPAYER EXCEPTION

.01 Pursuant to his discretion under §§ 446 and 471, and to simplify the record keeping requirements of a qualifying small business taxpayer, the Commissioner, as a matter of administrative convenience, will allow a qualifying small business taxpayer to

use the cash method as described in this revenue procedure for a trade or business described in this section 4.01 (eligible trade or business). No inference is intended regarding whether a taxpayer that does not satisfy the qualifying small business taxpayer exception of this section 4.01 is permitted to use the cash method.

(1) A qualifying small business taxpayer that reasonably determines that its principal business activity (i.e., the activity from which the taxpayer derived the largest percentage of its gross receipts) for its prior taxable year is described in a North American Industry Classification System (“NAICS”) code other than one of the ineligible codes listed below may use the cash method as described in this revenue procedure for all of its trades or businesses. The ineligible NAICS codes are as follows:

- (a) mining activities within the meaning of NAICS codes 211 and 212;
- (b) manufacturing within the meaning of NAICS codes 31 - 33;
- (c) wholesale trade within the meaning of NAICS code 42;
- (d) retail trade within the meaning of NAICS codes 44 - 45; and,
- (e) information industries within the meaning of NAICS codes 5111 and 5122.

Information regarding the NAICS codes can be found at www.census.gov. Visitors to the site should select “Subjects A to Z,” followed by “N,” and then should select “NAICS (North America).” Taxpayers also may find a partial list of NAICS codes, described as “Principal Business Activity Codes,” in the instructions to their tax return forms.

(2) A qualifying small business taxpayer may use the cash method as described in this revenue procedure for all of its trades or businesses if its principal business activity is the provision of services, including the provision of property incident to those

services. For example, a publisher whose principal business activity is the sale of advertising space in its publications is eligible to use the cash method as described in this revenue procedure, notwithstanding that the taxpayer's principal business activity is described in an ineligible NAICS code.

(3) A qualifying small business taxpayer may use the cash method as described in this revenue procedure (subject to the potential application of § 460) for all of its trades or businesses if its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. For purposes of this rule, tangible personal property is not fabricated or modified in accordance with customer design or specifications if the customer merely chooses among pre-selected options (e.g. size, color, or materials) offered by the taxpayer or if the taxpayer must make only minor modifications to its basic design to meet the customer's specifications.

(4) Notwithstanding the taxpayer's principal business activity, a qualifying small business taxpayer may use the cash method as described in this revenue procedure with respect to any separate and distinct trade or business whose principal business activity is not described in an ineligible NAICS code in section 4.01(1)(a) through (e) or is described in either section 4.01(2) or section 4.01(3). No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business. See §1.446-1(d)(2).

.02 Notwithstanding § 1001 and the regulations thereunder, qualifying taxpayers that use the cash method for an eligible trade or business under section 4.01 of this

revenue procedure include amounts in income attributable to open accounts receivable (i.e., receivables due in 120 days or less) as amounts are actually or constructively received. However, § 1001 may be applicable to other transactions.

.03 Qualifying small business taxpayers that are permitted to use the cash method for an eligible trade or business under section 4.01 of this revenue procedure and that do not want to account for inventories under section 471 must treat all inventoriable items (e.g., items purchased for resale to customers and raw materials purchased for use in producing finished goods) in such trade or business in the same manner as materials and supplies that are not incidental under § 1.162-3. Items that would be accounted for as incidental materials and supplies for purposes of § 1.162-3 may still be accounted for in that manner. Whether an item is purchased for resale (and thus must be accounted for as a non-incidental material and supply) or is purchased to provide to customers incident to services (and thus may be accounted for as either an incidental or a non-incidental material and supply depending on the facts and circumstances) must be determined under general tax principles.

.04 Under § 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer sells the items to a customer. Thus, under the cash method as described in this revenue procedure, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer

actually pays for the goods, whichever is later. A qualifying small business taxpayer may use any reasonable method to determine the amount of the allowable deduction (e.g., first in, first out or average cost) provided that the method is used consistently.

SECTION 5. DEFINITIONS

.01 Average annual gross receipts. A taxpayer has average annual gross receipts of \$10,000,000 or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the 3-taxable-year period ending with the applicable prior taxable year does not exceed \$10,000,000.

.02 Gross receipts. Gross receipts is defined consistent with § 1.448-1T(f)(2)(iv) of the Temporary Income Tax Regulations. Thus, gross receipts for a taxable year equal all receipts derived from all of a taxpayer's trades or businesses that must be recognized under the method of accounting actually used by the taxpayer for that taxable year for federal income tax purposes. For example, gross receipts include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents. However, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. See also § 448(c)(3)(C).

.03 Aggregation of gross receipts. For purposes of computing gross receipts, all taxpayers treated as a single employer under subsection (a) or (b) of § 52 or subsection (m) or (o) of § 414 (or that would be treated as a single employer under these sections

if the taxpayers had employees) will be treated as a single taxpayer. However, when transactions occur between taxpayers that are treated as a single taxpayer by the previous sentence, gross receipts arising from these transactions will not be treated as gross receipts for purposes of the average annual gross receipts limitation. See §§ 448(c)(2) and 1.448-1T(f)(2)(ii).

.04 Taxpayer not in existence for 3 taxable years. If a taxpayer has been in existence for less than the 3-taxable-year period referred to in section 5.01 of this revenue procedure, the taxpayer must determine its average annual gross receipts for the number of years (including short taxable years) that the taxpayer has been in existence. See § 448(c)(3)(A).

.05 Treatment of short taxable years. In the case of a short taxable year, a taxpayer's gross receipts must be annualized by multiplying the gross receipts for the short taxable year by 12 and then dividing the result by the number of months in the short taxable year. See §§ 448(c)(3)(B) and 1.448-1T(f)(2)(iii).

.06 Treatment of predecessors. Any reference to taxpayer in this section 5 includes a reference to any predecessor of that taxpayer. See § 448(c)(3)(D).

SECTION 6. EXAMPLES

Assume for purposes of the following examples that the taxpayers are not prohibited from using the cash method under § 448. Also assume for purposes of examples 2 through 10 that the taxpayers have average annual gross receipts of \$10,000,000 or less.

Example 1. Taxpayer is a calendar year plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer reasonably

determines that its principal business activity is construction, which is described in NAICS code 23. Taxpayer's gross receipts at the end of the three preceding taxable years are:

	<u>Gross receipts</u>
1998:	\$ 6,000,000
1999:	9,000,000
2000:	12,000,000

Taxpayer's average annual gross receipts for the 3-taxable year-period ending in the 2000 taxable year is \$9,000,000 ($\$6,000,000 + \$9,000,000 + \$12,000,000 = \$27,000,000/3$). Taxpayer may use the cash method for all its trades or businesses pursuant to this revenue procedure for its 2001 taxable year because its average annual gross receipts for each prior taxable year ending on or after December 31, 2000, is \$10,000,000 or less and its principal business activity is not described in the ineligible NAICS codes listed in section 4.01(1)(a) - (e).

Example 2. Taxpayer is a plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer also has a store that sells plumbing equipment to homeowners and other plumbers who visit the store. Taxpayer derives 60 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 40 percent of its total receipts from the sale of plumbing equipment through its store. Taxpayer reasonably determines that its principal business activity is plumbing installation, which is included in the construction activities described in NAICS code 23. Taxpayer may use the cash method for both business activities because Taxpayer is a qualifying small business taxpayer whose principal business activity – plumbing installation – is not described in the ineligible NAICS codes listed in section 4.01(a)-(e).

Example 3. Same as *Example 2*, except Taxpayer derives 40 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 60 percent of its total receipts from the sale of plumbing equipment through its store. Taxpayer's principal business activity is described in the ineligible NAICS code 44. Moreover, Taxpayer's principal business activity is neither the provision of services under section 4.01(2) nor the fabrication or modification of tangible personal property under section 4.01(3). Therefore, Taxpayer may not use the cash method under this revenue procedure for its plumbing retail business. Taxpayer may use the cash method for its plumbing installation business if the Taxpayer keeps complete and separate books and records for its plumbing installation business and its plumbing retail business. If Taxpayer keeps one set of books and records for its plumbing installation business and its plumbing retail business, then Taxpayer is required to use an accrual method for both businesses.

Example 4. Taxpayer sells refrigerators. As part of the sale price, Taxpayer will deliver the refrigerator to the customer and confirm that the refrigerator is functioning

properly at the customer's site. Taxpayer's principal business activity is described in the ineligible NAICS code 44. Moreover, taxpayer's principal business activity is not the provision of services under section 4.01(2). Taxpayer does not provide refrigerators incident to the performance of services. Rather, Taxpayer performs certain services (delivery and confirmation of functionality) incident to the sale of refrigerators. In addition, Taxpayer does not fabricate or modify tangible personal property under section 4.01(3). Taxpayer may not use the cash method under this revenue procedure.

Example 5. Taxpayer is a sofa manufacturer that only produces sofas upon receipt of a customer order. Customers are allowed to pick among 150 different fabrics offered by the taxpayer or to provide their own fabric, which the taxpayer will use to finish the customer's sofa. Taxpayer's principal business activity is described in the ineligible NAICS code 33. Taxpayer does not provide sofas incident to the performance of services for purposes of section 4.01(2). Rather, Taxpayer performs certain services (upholstering) incident to the sale of sofas. Taxpayer also does not fabricate or modify tangible personal property for purposes of section 4.01(3) because customers merely choose among pre-selected options offered by Taxpayer and Taxpayer only makes minor modifications to the basic design of its sofa. Taxpayer may not use the cash method under this revenue procedure.

Example 6. Taxpayer makes tools based entirely on specific designs and specifications provided to it by customers in their orders. Taxpayer's principal business activity is described in the ineligible NAICS code 33. However, Taxpayer's principal business activity is the fabrication of tangible personal property for purposes of section 4.01(3). Taxpayer may use the cash method under this revenue procedure (subject to the potential application of § 460).

Example 7. Taxpayer is a roofing contractor that is a qualifying small business taxpayer eligible to use the cash method under sections 3 and 4 of this revenue procedure. Taxpayer, who uses the calendar year, chooses to use the cash method as described in this revenue procedure and to not account for inventories under § 471. Taxpayer enters into a contract with a homeowner in December 2001 to replace the homeowner's roof. Taxpayer purchases roofing shingles from a local supplier and has them delivered to the homeowner's residence. Taxpayer pays the supplier \$5,000 for the shingles upon their delivery later that month. Taxpayer replaces the homeowner's roof in December 2001, and gives the homeowner a bill for \$15,000 at that time. Taxpayer receives a check from the homeowner in January 2002.

Taxpayer deducts the \$5,000 cost of the shingles on its 2001 Federal income tax return (the year the shingles are paid for by Taxpayer and provided to the customer in connection with the performance of roofing services). Taxpayer includes the \$15,000 in income in 2002 when it receives the check from the homeowner.

Example 8. The facts are the same as in *Example 7*, except that Taxpayer does

not replace the roof until January 2002 and is not paid until March 2002. Because the shingles are not used until 2002, their cost can only be deducted on Taxpayer's 2002 Federal income tax return notwithstanding that Taxpayer paid for the shingles in 2001. Thus, on its 2002 return, Taxpayer must report \$15,000 of income and \$5,000 of deductions.

Example 9. Taxpayer, a qualifying small business taxpayer, elects to use the cash method as described in this revenue procedure. Taxpayer is a speculative builder of houses that are built on land it owns. In 2001, Taxpayer builds a house using various items such as lumber, piping, and metal fixtures that it had paid for in 2000. In 2002, Taxpayer sells the house to a buyer. Because the house is real property held for sale by Taxpayer, it is not an inventorable item under section 4.03 of this revenue procedure. Thus, the taxpayer may not account for the items used to build the house as non-incidental materials and supplies under § 1.162-3. Rather, Taxpayer must capitalize the costs of the lumber, piping, metal fixtures and other goods used by Taxpayer to build the house. Upon the sale of the house in 2002, the costs capitalized by Taxpayer will be offset against the house sales price to determine Taxpayer's gain or loss from the sale.

Example 10. The facts are the same as in *Example 9*, except that Taxpayer builds houses on land its customers own. Because Taxpayer does not own the house, the lumber, piping, metal fixtures and other goods used by Taxpayer in the provision of construction services are not real property held for sale. Taxpayer must deduct the cost of the lumber, piping, metal fixtures and other non-incidental materials and supplies that are used by it to build the house in 2001 (the year those items were used by Taxpayer to build the house) notwithstanding that Taxpayer had paid for the items in 2000. Taxpayer will report income it receives from its customer as the income is actually or constructively received.

SECTION 7. CHANGE IN ACCOUNTING METHOD

.01 In general. Any change in a taxpayer's method of accounting pursuant to this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

.02 Automatic change for taxpayers within the scope of this revenue procedure.

(1) Automatic change to the cash method. A qualifying small business taxpayer that wants to use the cash method as described in this revenue procedure for an

eligible trade or business must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 I.R.B. 725 (or its successor) with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply.

However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate;

(b) Taxpayers filing Form 3115 for a change in method of accounting under this revenue procedure must complete all applicable parts of the form but need not complete Part II of Schedule A of Form 3115. Specifically, Part II, line 17 (regarding information on gross receipts in previous years) and Part III (regarding the § 481(a) adjustment) must be completed. Taxpayers should write "Filed under Rev. Proc. 2001-**XX**" at the top of their Form 3115.

(2) Automatic change to section 1.162-3. A qualifying taxpayer that does not want to account for inventories under § 471 of an eligible trade or business must make any necessary change from the taxpayer's current method of accounting for inventorable items in that trade or business to treat such inventorable items in the

same manner as materials and supplies that are not incidental under section 1.162-3. For purposes of such a change, the rules of section 6.02(1) of this revenue procedure apply. Taxpayers may file a single Form 3115 for both changes described in sections 7.02(1) and 7.02(2).

.03 Section 481(a) adjustment. The net amount of the § 481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, the § 481(a) adjustment may include the difference resulting from changing from taking inventory accounts under § 471 to treating the goods as materials and supplies that are not incidental under § 1.162-3.

.04 Taxpayers not within the scope of this revenue procedure. A taxpayer that ceases to qualify for the qualifying small business taxpayer exception described in section 4 of this revenue procedure for any trade or business and otherwise is required to use an accrual method for that trade or business must change to an accrual method (and, if applicable an inventory method that complies with § 471) for that trade or business using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 99-49, if applicable, or the advance consent provisions of Rev. Proc. 97-27, 1997-1 C.B. 680 (or its successor).

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99-49, 1999-2 C.B. 725, is modified and amplified to include this automatic change in section 10 of the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001. However, the Service will not challenge a taxpayer's use of the cash method under § 446, or a taxpayer's failure to account for inventories under § 471, for a trade or business in an earlier year if the taxpayer, for that year, was a qualifying small business taxpayer as described in section 3 of this revenue procedure and the taxpayer was eligible to use the cash method for such trade or business under section 4.01 of this revenue procedure.

CONTACT INFORMATION

For further information regarding this revenue procedure, contact Cheryl Lynn Oseekey of the Office of Associate Chief Counsel (Income Tax and Accounting at (202) 622-4970 (not a toll-free call).