

March 6, 2001

Dear Partner:

Knowing of your interest in being able to use the cash method of accounting, I want to give you an update on several significant actions the Internal Revenue Service has taken regarding this issue.

As you know, there has been significant controversy over whether small businesses that provide goods in connection with their services should be required to use inventory accounts and an accrual method of accounting. In cases that involved emulsified asphalt, concrete, and flooring contractors, and health care providers that administered chemotherapy drugs, the IRS argued that the taxpayers were in the business of providing merchandise and, therefore, had to use inventory accounts and an accrual method. The courts, however, disagreed and the IRS has listened. We recognize that it is a burden for small businesses to use inventory accounts and an accrual method and we have taken several significant actions to reduce that burden.

First, the IRS published a revenue procedure that permits taxpayers that have average annual gross receipts of \$1 million or less to use the cash method of accounting. This includes taxpayers that provide goods in connection with their services. We hope this change will make a difference to many small firms.

Second, the IRS has issued an action on decision (AOD) in response to the case that involved health care providers who administered chemotherapy drugs. The AOD says that the IRS now agrees that prescription drugs or similar items administered by a health care provider are not merchandise that could prevent the provider from using the cash method of accounting. This AOD would also apply to veterinarians who do not market pet care or other products to their customers. We know that this decision is a relief for those in the health care community.

Third, pending the issuance of future guidance, the IRS has changed its policies in litigation and examination regarding use of the cash method of accounting. The IRS Chief Counsel issued a notice that says the IRS will not assert that taxpayers that provide goods in connection with services are providing merchandise and, therefore, must use inventory accounts and an accrual method of accounting. For example, this would apply to taxpayers such as paving, painting, roofing, drywall, or landscaping contractors. This does not apply, however, to taxpayers that are resellers or manufacturers. Further, the Deputy Commissioner has directed that our examiners in the Small Business/Self-Employed, Wage and Investment, and Large and Mid-Size Business Operating Divisions not propose that taxpayers in similar types of businesses use inventory accounts and an accrual method.

Finally, we have recommended that a project aimed at finally resolving this issue be placed on the 2001 Priority Guidance Plan for publication this year.

I am personally pleased that we have taken these significant steps for our small business partners and have enclosed copies of all the relevant guidance. I hope that these are the first of many actions that the IRS can take to reduce the burden on small businesses in meeting their tax obligations. This letter is hopefully, the start of an improved relationship between you and the IRS. A relationship that is marked by open, honest and frequent communication about issues affecting the small business community.

Sincerely,

/s/ Joseph G. Kehoe
Commissioner
Small Business/Self-Employed Division

