Inventory / 263A & MAT Practice Network

October 22, 2019

Tax Cuts and Jobs Act (TCJA) Inventory and Accounting Method Changes

IRS Large Business & International

IRS Front Matter Items

- The IRS Mission Statement
- 14 General Principles of Ethical Conduct for Federal Employees
- Your Rights as a Taxpayer

Provisions Covered

- Small Business Accounting Method Reform and Simplification (Section 13102)
- Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty (Section 13207)
- Production Periods for Beer, Wine and Distilled Spirits (Section 13801)

Objectives

At the end of this presentation, you will be able to:

1) Identify significant changes to Internal Revenue Code (IRC) §§ 446, 447, 448, 471, 263A and 460 as required by Tax Cuts and Jobs Act (TCJA) §§ 13102, 13207 and 13801.

2) Compare the Tax Cuts and Jobs Act (TCJA) law changes with prior law for each section listed above.

CPA Question 1

Do you want CPA credit for attending this event?

Yes

No

TCJA § 13102
Small Business Accounting Method Reform and Simplification

TCJA § 13102

Small Business Accounting Method Reform and Simplification

For tax years beginning after 12/31/17, the TCJA:

- Expands the eligibility of small business taxpayers to use the cash method.
- Exempts small business taxpayers from the requirement to account for inventories.
- No longer requires small business taxpayers to capitalize costs under IRC § 263A.
- Exempts certain construction contracts from the requirement to use the percentage of completion method.

TCJA § 13102
Small Business Taxpayer

- A small business taxpayer is a taxpayer that:
  - has average annual gross receipts of $25 million or less (indexed for inflation) for the prior 3 tax years, and
  - is not a tax shelter.

§ 13102: Cash Method of Accounting Current and Prior Law – IRC § 448

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	**2017 Tax Reform Act (Tax Years beginning after December 31, 2017)**
❖ The cash method of accounting is not a permissible method of accounting for corporations and partnerships with a corporate partner unless their average annual gross receipts for the prior three taxable years is \$5 million or less. ❖ Once taxpayers exceeded the \$5 million threshold, they were prohibited from using the cash method of accounting in all subsequent years even if their average went below the \$5 million threshold.	❖ The cash method of accounting is not a permissible method of accounting for corporations and partnership with a corporate partner unless their average annual gross receipts for the prior three taxable years is \$25 million or less (indexed for inflation). ❖ Removes the requirement that taxpayers must satisfy the average annual gross receipts requirement for <u>all</u> prior taxable years.

§ 13102: Cash Method of Accounting

Current and Prior Law – IRC § 448
Certain entities when not required to maintain inventory

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017)
❖ These companies may use the cash method regardless of gross receipts unless their business requires them to maintain inventory: • S corporations • Qualified Personal Service Corps • Partnerships without corporate partners	❖ The new tax law continues to permit the following entities to use of the cash method regardless of gross receipts unless their business requires them to maintain inventory: • S corporations • Qualified Personal Service Corps • Partnerships w/o corporate partners

§ 13102: Cash Method of Accounting

Current and Prior Law – IRC § 448

Certain entities when they are required to maintain inventory

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017)
❖ If the following taxpayers are required to maintain inventory, the cash method is not permissible: • S corporations • Qualified Personal Service Corp • Partnerships without corp partners <u>Exceptions:</u> ❖ Rev. Proc. 2001-10: Allows cash method for qualifying taxpayers with average gross receipts of \$1 million or less. ❖ Rev. Proc. 2002-28: Allows cash method for qualifying taxpayers with average gross receipts of \$10 million or less (based on NAICS code).	❖ If the following taxpayers are required to maintain inventory, the cash method is not permissible. • S corporations • Qualified Personal Service Corp • Partnerships without corporate partners <u>Exceptions</u>: ❖ Small business taxpayers (taxpayer with average annual gross receipts of \$25 million or less (indexed for inflation) for the prior 3 tax years).

§ 13102: Cash Method of Accounting Current and Prior Law – IRC § 447

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017)
❖ Prohibited farming corporations and farming partnerships with corporate partners from using the cash method if gross receipts for any prior taxable year exceeds $1 million. . ❖ Prohibited family farm corporations from using the cash method if gross receipts for any prior taxable year exceeds $25 million.	❖ Permits farming corporations and farming partnerships with corporate partners with average annual gross receipts of $25 million or less (indexed for inflation) for the prior three taxable years to use the cash method. ❖ No separate rule for family farm corporations.

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CPA Question 2

The new tax law defines a small business taxpayer as having average annual gross receipts of $25 million or less (indexed for inflation) for the prior 3 tax years, and is not a tax shelter?

True

False

CPA Question 2 – **Answer**

True

- The new tax law defines a small business taxpayer as having:
  - Average annual gross receipts of $25 million or less (indexed for inflation) for the prior 3 tax years, and is
  - Not a tax shelter.

§ 13102 Accounting for Inventories Current and Prior Law (IRC § 471)

Pre-Reform Law (Tax Years beginning on or before December 31, 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017)
❖ Inventories are required when necessary to clearly reflect income. ❖ Where the production, purchase, or sale of merchandise is a material income-producing factor, taxpayers must account for inventories and must also use the accrual method as their overall method of accounting.	❖ Taxpayers, other than tax shelters, with average annual gross receipts of $25 million or less (indexed for inflation) for the prior three taxable years, are not required to account for inventories under §471(a). ❖ Such taxpayers may use a method of accounting that treats inventories: (i) in the same manner as materials and supplies that are non-incidental, or (ii) conforms to their method of accounting in an applicable financial statement , or if they do not have applicable financial statements, the method of accounting used in their books and records.

§ 13102 Accounting for Inventories Current and Prior Law (IRC § 263A)

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017)
❖ A reseller with average annual gross receipts of $10 million or less for the three years before the current year is not required to capitalize IRC § 263A costs allocable to the resale activities.	❖ Taxpayers, other than tax shelters, with average gross receipts of $25 million (indexed for inflation) or less for the prior three taxable years (small business taxpayers), are not required to capitalize costs under IRC § 263A.

CPA Question 3

A reseller with average gross receipts of $15 million for the three prior years is not required to capitalize costs under Section 263A for tax years beginning after 12/31/2017?

True

False

CPA Question 3 – **Answer**

True

- Section 13102 of the TCJA increased the limitation to $25 million (small business taxpayers) and doesn't distinguish between resellers and producers.

§ 13102 Accounting for Long-term Contract Current and Prior Law (IRC § 460)

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	**2017 Tax Reform Act (Tax Years beginning after December 31, 2017)**
❖ IRC § 460 generally requires the Percentage of Completion method (PCM) for any contract for the manufacture, building, installation or construction of property not completed in same taxable year contract is entered. ❖ Two exceptions to the required use of PCM for long-term contracts: 1. Any home construction contract 2. Any other construction contract that a taxpayer expects to complete within 2 years and the average annual gross receipts for the prior three years is $10 million or less.	❖ IRC § 460 generally requires the Percentage of Completion method (PCM) for any contract for the manufacture, building, installation, or construction of property not completed within same taxable year contract is entered. ❖ Two exceptions to the required use of PCM for long-term contracts: 1. Any home construction contract 2. Any other construction contract that a taxpayer expects to complete within 2 years and the average annual gross receipts for the prior three years is $25 million or less (indexed for inflation).

§ 13102 Accounting for Long-term Contract Current and Prior Law (IRC § 460)

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	**2017 Tax Reform Act (Tax Years beginning after December 31, 2017)**
❖ Taxpayers can elect another permissible method to account for those exempt contracts (i.e. completed contract method). .	❖ To comply with the new law, the taxpayer begins using their exempt contract method (i.e. completed contract) for contracts started after 12-31-2017. This is done on a cut-off basis. An IRC 481(a) adjustment is not permitted.

CPA Question 4

Under IRC § 460, a long-term contract is one that lasts more than 12 months.

True

False

CPA Answer 4 – **Answer**

False

- Under IRC § 460, a long-term contract is one that is started in one year and completed in a subsequent year.
- The contract does not have to be more than 12 months, it just has to span 2 tax years.

CPA Question 5

On February 1, 2018 a taxpayer (with average annual gross receipts for the prior 3 years of $20 million) enters into a construction contract that is expected to be completed within 2 years. This change in method is made on the cut-off basis; therefore, for tax year 2018, the taxpayer may account for this contract under an exempt method of accounting (such as completed contract method).

True

False

CPA Question 5 – **Answer**

True

- Under the TCJA, a taxpayer which meets one of the exceptions to the required use of IRC § 460 must implement this change in method under the cut-off basis. An IRC § 481(a) adjustment is neither required nor permitted.

Change in Accounting Methods

- Rev. Proc. 2018-40 provides the procedures for a small business taxpayer to obtain automatic consent to change its accounting method to reflect the changes made by TCJA § 13102.
- For some changes, certain eligibility rules in Rev. Proc. 2015-13 § 5.01 are temporarily inapplicable for the first, second and third tax year beginning after 12/31/2017.
- Reduced filing requirements.
- Single Form 3115 for some concurrent automatic changes.

TCJA § 13207

Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty

§ 13207: Expensing of casualty loss Current and Prior Law (IRC § 263A)

Pre-Reform Law	2017 Tax Reform Act
❖ In general, IRC § 263A requires capitalization of certain costs of producing property. ❖ There are special rules for certain property produced by farmers and for the replanting costs of plants lost by reason of casualty.	❖ Added a special temporary rule specifically for citrus plants lost or damaged because of freezing temperatures, disease, drought, pests, or casualty. ❖ Section 13207 of the TCJA added new IRC § 263A(d)(2)(C) for certain costs paid or incurred to replant citrus plants after the loss or damage of citrus plants.

§ 13207: Expensing of casualty loss Current and Prior Law (IRC § 263A)

Pre-Reform Law	2017 Tax Reform Act
❖ A majority owner of certain plants lost by reason of casualty were not required to follow IRC § 263A for the replanting costs of the plants lost. The rule also applied to a minority owner if they met material participation rules.	❖ The exception also applies to persons other than the taxpayer if: 1) the taxpayer has an equity interest of at least 50% in the replanted plants at all times during the year and the other person owns any of the remaining interest, OR 2) the other person acquired the taxpayer's entire equity interest in the land on which the plants were located and the replanting is on such land.

Change in Accounting Methods

- Rev. Proc. 2018-35 provides the procedures for citrus growers to obtain automatic consent from the IRS to change their accounting method from applying 263A to citrus plant replanting cost to not applying 263A to those cost.
- This provision applies to costs paid or incurred after December 22, 2017, and on or before December 22, 2027.

CPA Question 6

Section 13207 of the TCJA is a permanent provision.

True

False

CPA Question 6 – **Answer**

False

- Section 13207 of the TCJA is a temporary provision that only applies to amounts paid or incurred after 12/22/2017 and on or before 12/22/2027.

TCJA § 13801

Production Periods for Beer, Wine and Distilled Spirits

§ 13801 Production Period For Beer, Wine and Distilled Spirits

Current and Prior Law (IRC § 263A(f))

Pre-Reform Law (Tax Years beginning on or before December 31. 2017)	2017 Tax Reform Act (Tax Years beginning after December 31, 2017
❖ UNICAP requires taxpayers to capitalize interest paid or accrued during the production period of property they produce, which: 1) has a class life of at least 20 years, 2) has an estimated production period exceeding 2 years, or 3) has an estimated production period exceeding 1 year and a cost exceeding $1 million. ❖ Property that is customarily aged before it is sold must include the aging period in the production period.	❖ The UNICAP rules now exclude the aging period of beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest calculation. ❖ The exclusion applies to interest costs paid or accrued in calendar years beginning after Dec. 31, 2017 and on or before Dec. 31, 2019.

§ 13801 Production Period For Beer, Wine and Distilled Spirits

Current and Prior Law (IRC § 263A(f))

- Not all production activities, related to the production of beer, wine and distilled sprits, are excluded from the calculation of the production period for purposes of the interest capitalization rules under section 263A(f).
- Only the aging period is excluded from the production period for the purposes of the interest capitalization rules.
- For distilled spirits, the aging period is the period after distillation and before bottling, when distilled spirits are stored in oak containers.

§ 13801 Production Period For Beer, Wine and Distilled Spirits

Current and Prior Law (IRC § 263A(f))

- For wine, the aging period occurs between fermentation and bottling, typically in barrels.
- The aging process for wine varies based on the type of wine. If aging for wine occurs after bottling, but before it is held for sale, then the aging period also includes the period the wine is aged in the bottle. (See TAM9327007)
- For beer, the aging period occurs between the fermentation period and bottling (or other types of packaging, such as kegs). The aging period for beer can vary based on the type of yeast and the strength of the beer.

CPA Question 7

The UNICAP rules now exclude the aging period from the production period for purposes of the UNICAP interest calculation for:

A. Beer
B. Wine
C. Distilled Spirits
D. All of the above

CPE Question 7 – **Answer**

D.

- All of the above

Summary

- The TCJA expands the eligibility of small business taxpayers to use the cash method.
- Exempts small business taxpayers from the requirement to account for inventories under IRC § 471(a).
- No longer requires small business taxpayers to capitalize costs under IRC § 263A.
- Exempts certain construction contracts from the requirement to use the percentage of completion method.
- Citrus replanting costs caused by reason of casualty are no longer required to be capitalized under IRC § 263A.
- Exempts the aging period for beer, wine, and distilled spirits from the production period for interest capitalization.

Questions