PRESENTED AT

66th Annual Taxation Conference

November 14-15, 2018
Austin, TX

Recent Developments in Federal Income Taxation

Bruce A. McGovern

Author Contact Information:
Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, TX

bmcgovern@stcl.edu
713.646.2920

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

"Recent developments are just like ancient history, except they happened less long ago."

By

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

University of Texas Taxation Conference
November 14, 2018

Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA.

This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

On December 22, 2017, the President signed legislation that makes significant amendments to the Internal Revenue Code of 1986. This legislation, which became Pub. L. No. 115-97, is colloquially referred to as the Tax Cuts and Jobs Act ("TCJA"). On February 9, 2018, the President signed the Bipartisan Budget Act of 2018, Pub. L. No. 115-123, which also amended certain provisions of the Code. On March 23, 2018, the President signed the Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, which provides technical corrections to the new centralized partnership audit regime. This outline summarizes the changes in these Acts that, in our judgment, are the most important. The outline does not attempt to list the provisions of these Acts comprehensively or to explain them in detail. Readers should note that many of the TCJA changes affecting individual taxpayers are temporary and sunset for taxable years beginning after December 31, 2025, and that many provisions of the Bipartisan Budget Act of 2018 apply retroactively to 2017.

I. ACCOUNTING

A. Accounting Methods

1. Many more taxpayers now can use the cash method of accounting. The 2017 Tax Cuts and Jobs Act, § 13102, made several amendments to expand the universe of C corporations, partnerships, and businesses with inventory that can use the cash method of accounting. These amendments apply to taxable years beginning after 2017.

General Rules for C Corporations. Code § 448(a) provides as a general rule that a C corporation, or a partnership with a C corporation as a partner, cannot use the cash method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, an exception in § 448(b)(3) provided that this prohibition did not apply to an entity that met a gross receipts test for *all* prior tax years, and § 448(c)(1) provided that an entity met the gross receipts test for a year if its average annual gross receipts (measured over the three preceding tax years) did not exceed $5 million. The legislation made two significant changes. *First,* the legislation removed the requirement that an entity must meet the gross receipts test for all prior tax years in order to use the cash method. Instead, under amended § 448(b)(3), the inquiry is simply whether the entity's average annual gross receipts, measured over the three preceding tax years, were below a specified limit. *Second*, the legislation increased the $5 million limit to $25 million. Accordingly, a C corporation, or a partnership with a C corporation as a partner, can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed $25 million.

Farming C Corporations. Under Code § 447(a), taxable income from farming of a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming must be determined using the accrual method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 447(c)(2) provided that that this requirement did not apply if the C corporation met the gross receipts test specified in § 447(d). This gross receipts test required that, for all prior tax years, the C corporation's gross receipts must not have exceeded $1 million ($25 million in the case of family corporations). The legislation amended § 447(c)(2) to apply the same gross receipts test (in § 448(c)) that applies to C corporations generally. Pursuant to this amendment, a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed $25 million.

Businesses with Inventory. Under § 471(c)(1)(A) as amended by the 2017 Tax Cuts and Jobs Act, a business that meets the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million) can use the cash method of accounting *even if inventories are a material income-producing factor*. Thus, even if a C corporation has inventory, as long as it meets the gross receipts test, it can use the cash method of accounting.

Inflation Adjustment. According to § 448(c)(4), as amended by the 2017 Tax Cuts and Jobs Act, the $25 million figure used for purposes of the average gross receipts test will be adjusted for inflation (rounded to the nearest million) for taxable years beginning after 2018.

Change in Method of Accounting. A business that changes from the accrual method to the cash method to take advantage of the new rules will have a change in method of accounting. According to §§ 447(d) and 448(d)(7), these changes in method of accounting are treated as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- *Guidance on changing from accrual to cash method*. In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as "small business taxpayers") may obtain automatic consent to change their method of accounting from the accrual to the cash method pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

2. Congress has expanded the small construction contract exception to the percentage-of-completion method of accounting. Generally, § 460(a) requires taxpayers to account for long-term contracts using the percentage-of-completion method of accounting. An exception exists, commonly known as the "small construction contract" exception, pursuant to which a taxpayer need not use the percentage-of-completion method for construction contracts if (1) at the time the contract is entered into, the taxpayer expects the contract to be completed within the two-year period beginning on the contract commencement date, and (2) the taxpayer's average annual gross receipts (measured over the three taxable years preceding the taxable year in which such contract is entered into) do not exceed a specified limit. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 460(e)(1)(B)(ii) provided that that this limit was $10 million. Section 13102 of the legislation amended Code § 460(e)(1)(B)(ii) to provide that the test used for purposes of the second part of the small construction contract exception is the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million). This change applies to contracts entered into after December 31, 2017, in taxable years ending after that date. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 460(e)(2)(B), as made with the consent of the IRS and must be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change.

- *Guidance on changing methods of accounting for long-term construction contracts and home construction contracts*. In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as "small business taxpayers") may obtain automatic consent to (1) change their method of accounting for exempt long-term construction contracts described in § 460(e)(1)(B) from the percentage-of-completion method of accounting described in Reg. § 1.460-4(b) to an exempt contract method of accounting described in Reg. § 1.460-4(c), or (2) stop capitalizing costs under § 263A for home construction contracts defined in § 460(e)(1)(A).

B. Inventories

1. Simplified inventory accounting for small businesses. Under § 471(a) and Reg. § 1.471-1, taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor must account for inventories. Generally, under Reg. § 1.446-1(c)(2), when the use of inventories is necessary to clearly reflect income, a taxpayer must use the accrual method for purchases and sales. The 2017 Tax Cuts and Jobs Act, § 13102, redesignated § 471(c) as § 471(d) and added new

§ 471(c). New § 471(c) provides that taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million) are not required to account for inventories under § 471. Instead, such taxpayers can use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories (either in an "applicable financial statement" as defined in § 451(b)(3) or in the taxpayer's books and records). This rule applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 471(c)(4), as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- *Guidance on accounting method changes for inventory*. In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as "small business taxpayers") may obtain automatic consent to change their method of accounting to treat inventory as non-incidental materials and supplies under Reg. § 1.162-3 pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

C. Installment Method

D. Year of Inclusion or Deduction

1. An expanded exception to the uniform capitalization rules for small businesses. The 2017 Tax Cuts and Jobs Act, § 13102, redesignated Code § 263A(i) as § 263A(j) and added new § 263A(i). New § 263A(i) excludes from the uniform capitalization rules of § 263A any taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million). In the case of a taxpayer other than a corporation or a partnership, the gross receipts test is applied as if each trade or business of the taxpayer were a corporation or partnership. This exclusion is broader than one that existed before this change. Prior to this amendment, taxpayers that produced property and those that acquired property for resale generally were subject to § 263A, but an exception existed for taxpayers acquiring property for resale with average annual gross receipts that did not exceed $10 million. Under new § 263A(i), all taxpayers (other than tax shelters), including those that produce property, with average annual gross receipts that do not exceed $25 million, are not subject to the uniform capitalization rules. This provision applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 263A(i)(3), as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- *Guidance on accounting method changes for exception from requirement to capitalize costs under § 263A*. In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as "small business taxpayers") may obtain automatic consent to change their method of accounting from capitalizing costs under § 263A to a method of accounting that no longer capitalizes costs under § 263A (including costs for self-constructed assets), pursuant to § 263A(i) as enacted by the 2017 Tax Cuts and Jobs Act.

2. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The 2017 Tax Cuts and Jobs Act, § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, "the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in" either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that

UT LAW CLE THE UNIVERSITY OF TEXAS TEXASLAW

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the UT Law CLE eLibrary (utcle.org/elibrary)

Title search: Recent Developments in Federal Income Taxation

Also available as part of the eCourse
2018 Taxation eConference

First appeared as part of the conference materials for the
66th Annual Taxation Conference session
"Recent Developments in Federal Income Taxation"