RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

67th Annual UT Law 2019 Taxation Conference

December 4, 2019
8:30 a.m. – 10:30 a.m.
AT&T Conference Center
Austin, Texas

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My thanks to Bruce McGovern, South Texas College of Law Houston, and to Cassady V. (Cass) Brewer, Georgia State University College of Law, for sharing their outline presented at the State Bar of New Mexico Tax Symposium

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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 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 Service. Presumably, the Service 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 Service 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 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 Service 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 Service 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).

3. *A genuine issue of material fact existed as to whether a C corporation (that eventually changed to an S corporation) adopted the deposit, in lieu of the deferral, method of accounting.* Thrasys, Inc. v. Commissioner, 116 T.C.M. (CCH) 531, 2018 T.C.M. (RIA) ¶ 2018-199 (12/4/18). This case concerned whether the taxpayer, Thrasys, Inc., could, in its 2008 tax year, properly account for a $15 million payment received from its customer, Siemens, under the deferral method allowed by Rev. Proc. 2004-34. The Tax Court (Judge Lauber) dismissed the Service's motion for summary judgment and concluded that genuine issues of material fact existed as to whether the taxpayer had adopted the "deposit" method of accounting in 2008. The Service argued in its motion for summary judgment that the taxpayer could not switch from the "deposit" method of accounting—which the Service argued the taxpayer had adopted for this type of payment through its accounting treatment—to the deferral method because it never received the Service's consent to make that switch. Section 446(a) provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Under Reg. § 1.446-1(e)(1), "[a] taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return." Section 446(e) provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary." Moreover, according to the court, under § 446(a) and (e), "an accounting treatment constitutes a 'method of accounting' if the taxpayer 'regularly computes his income' using it." The court denied the Service's motion for summary judgment, **first**, because the taxpayer treated only one customer payment (the 2008 $15 million payment from Siemens) as a deposit for book or federal income tax purposes (and then shifted the $15 million to the deferred revenue category on its Form 1120S in 2009). Therefore, "[a] question of material fact exists as to whether [taxpayer's] 'deposit' treatment displayed the consistency required to constitute a method of accounting on the basis of which Thrasys 'regularly compute[d]' its income." And, **second**, the Tax Court noted that a change in the taxpayer's "method of accounting does not include 'a change in treatment resulting from a change in underlying facts'" under Reg. § 1.446-1(e)(2)(ii)(b). Thrasys (and its auditor) "may reasonably have believed that treating the $15 million payment as a deposit was a required 'change in treatment resulting from a change in underlying facts'" because "Thrasys treated the $15 million payment differently from

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First appeared as part of the conference materials for the
67th Annual Taxation Conference session
"Recent Developments in Federal Income Taxation"