

New accounting method change procedures issued for small business taxpayers

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TAX ACCOUNTING

The IRS and Treasury released two revenue procedures (Rev. Procs. 2022-9 and 2022-14) on Dec. 16, 2021, and Jan. 31, 2022, respectively, on accounting method change procedures. Rev. Proc. 2022-9 modifies Rev. Proc. 2019-43, the exclusive revenue procedure for automatic consent accounting method changes, to enable small business taxpayers to obtain automatic consent to change to simplified methods of accounting to comply with the final regulations under Secs. 263A, 448, 460, and 471 issued on Jan. 5, 2021 (T.D. 9942).

Rev. Proc. 2022-9 modifies existing automatic method changes, adds several new automatic changes, and contains transition rules that provide more flexibility for taxpayers to change to or from the simplified methods. Procedures also are provided for taxpayers to revoke a syndicate election made under the proposed small business taxpayer regulations issued in August 2020. Rev. Proc. 2022-14 updates the list of automatic accounting method changes and significantly modifies Rev. Proc. 2019-43, including revising some items in Rev. Proc. 2022-9.

In December 2017, the law known as the Tax Cuts and Jobs Act, P.L. 115-97, introduced a number of simplifying tax provisions for eligible small business taxpayers. These small business taxpayer methods expand the use of the overall cash method of accounting and grant exemptions from the requirement to take an inventory under Sec. 471(a), from capitalizing costs under the uniform capitalization rules under Sec. 263A, from the required use of the percentage-of-completion method for certain exempt long-term construction contracts under Sec. 460, or from the requirement to capitalize costs under Sec. 263A for Sec. 460 home construction contracts. The final regulations apply for tax years beginning on or after Jan. 5, 2021; however, they may be applied for a tax year beginning after Dec. 31, 2017, and before Jan. 5, 2021 (early-adoption year), or alternatively, a taxpayer may rely on the proposed regulations for these tax years.

Small taxpayers distinguished

As stated in the final regulations, taxpayers that are voluntarily changing their methods of accounting are distinguishable from taxpayers that are required by the Code to change their methods of accounting because they either no longer qualify for the small business taxpayer exemptions or were previously required to change their methods of accounting but subsequently requalify for the small business taxpayer exemptions. A taxpayer is a small business taxpayer if it is not a tax shelter (as defined under Secs. 448(d) (3) and 461(i)(3)) that meets the Sec. 448(c) gross-receipts test, under which the average annual gross receipts for the three prior tax years are \$25 million or less, adjusted for inflation. The terms and conditions of automatic consent procedures

added or modified by Rev. Proc. 2022-9 are more flexible and favorable for taxpayers that are required by the Code to change their methods than for taxpayers that are optionally changing their methods of accounting.

For example, if within the prior five tax years, a taxpayer made a change from a small business taxpayer method to a non-small business taxpayer method in the first tax year that the taxpayer did not qualify as a small business taxpayer, the prior change is disregarded for determining whether the taxpayer has made a change for the same item in the past five years (the “five-year eligibility requirement” under the method change procedures of Rev. Proc. 2015-13). This will give small business taxpayers more opportunity and flexibility to change between non-small business taxpayer methods and small business taxpayer methods as their circumstances change and they are able to again utilize small business taxpayer methods after being disqualified within the past five years. New rules are provided for recognizing Sec. 481(a) adjustments remaining from prior accounting method changes for the same item, and the rules that permitted netting under Section 3.04 of Rev. Proc. 2018-40 are removed.

Highlights of automatic changes to small business taxpayer accounting methods

Under revised Section 15.17 of Rev. Proc. 2022-14, the scope of a change from an overall accrual accounting method to the overall cash method is expanded to include changes from either an overall cash or overall accrual method to a method of using an accrual method for purchases and sales of inventories and the cash method for computing all other items of income and expense. Under this change, exempt long-term construction contracts may change to the cash method, and such contracts that include the sale of inventory may change to use an accrual method for purchases and sales of such inventory and the cash method for computing all other items of income and expense from such contracts.

Section 22.18 of Rev. Proc. 2022-14 permits a change to a small business taxpayer inventory method under the final regulations, or for tax years beginning after Dec. 31, 2017, and before 471(c) and the proposed regulations. Streamlined procedures are available for a taxpayer making a change to comply with the Sec. 471(c) inventory methods in the final regulations in the taxpayer’s early-adoption year, or the taxpayer’s first tax year beginning on or after Jan. 5, 2021, if the final regulations are not early adopted and the Sec. 481(a) adjustment for the change is zero.

Under these procedures, neither a Form 3115, *Application for Change in Accounting Method*, nor a separate statement is required to be filed. Updates made by Rev. Proc. 2022-14 permit a taxpayer that makes a change to a method under the final regulations in the taxpayer’s early-adoption year or in the first final regulations year if the taxpayer does not early adopt and the Sec. 481(a) adjustment is zero to not apply the five-year eligibility requirement for subsequent accounting method changes. This will permit taxpayers that were substantially complying with the final regulations to make a subsequent automatic change to another method without waiting five years.

Section 23.01 of Rev. Proc. 2022-14 is modified to clarify that a small business taxpayer may use the automatic change from a last-in, first-out (LIFO) method to a small business taxpayer exception method. A taxpayer that made a change from a small business taxpayer exception inventory method to LIFO in the first tax year it did not qualify as a small business taxpayer may disregard that prior change for purposes of the five-year eligibility requirement. Additionally, the five-year

eligibility requirement does not apply to a taxpayer's early-adoption year or the first final regulations year if the taxpayer does not early adopt.

A new automatic accounting method change has been added to Rev. Proc. 2022-14 under Section 22.19 to permit a small business taxpayer to make changes within its Sec. 471(c) Jan. 5, 2021, to methods under Sec. inventory method. The changes available under this section apply to a small business taxpayer that, in general, is changing from a nonincidental materials and supplies (NIMS) method under Sec. 471(c) or the final regulations Sec. 471(c) NIMS method and going to permitted methods, or taxpayers changing from an applicable financial statement (AFS) or a non-AFS method under Sec. 471(c) or the final regulations' AFS or non-AFS methods and changing the manner in which it accounts for inventory in its AFS or books and records, as applicable, and is required to use such method of accounting for inventory in its AFS or its books and records, as applicable, for purposes of applying the Sec. 471(c) AFS or non-AFS inventory method. The five-year eligibility requirement applies to the changes under the Sec. 471(c) NIMS inventory method but does not apply to the changes under the AFS and non-AFS Sec. 471(c) inventory methods. Changes under the AFS and non-AFS Sec. 471(c) inventory methods do not receive audit protection.

Highlights of automatic method changes to non-small business taxpayer methods

Rev. Proc. 2022-9 provides a second new accounting method change related to inventory in Section 22.20 of Rev. Proc. 2022-14, applicable to a change from using a small business taxpayer inventory method under Sec. 471(c), or from the proposed or final regulations, to accounting for inventory using a non-small business taxpayer method. When an inventory is required to be taken, an accrual method must be used for purchases and sales; with the modifications to the overall cash method automatic method change for a small business taxpayer under Section 15.17 of Rev. Proc. 2022-14, it appears that a small business taxpayer using an overall cash method that wishes to voluntarily change to a non-small business taxpayer inventory method can now automatically change to use an accrual method for purchases and sales of inventory while retaining an overall cash method. The five-year eligibility requirement does not apply to this change if the change is made in the first tax year the taxpayer does not qualify as a small business taxpayer.

Several other automatic accounting method changes have been modified by Rev. Proc. 2022-9. The modified consent procedures for an overall cash to accrual method change under Section 15.01 of Rev. Proc. 2022-14 now also apply to taxpayers that are required to change in a mandatory Sec. 448 year (the first or subsequent tax year in which the taxpayer is subject to Sec. 448) and a taxpayer's mandatory Sec. 447 year for farming businesses required to use an accrual method under Sec. 447.

This accounting method change is modified to state that, for purposes of the change, a taxpayer using an accrual method for purchases and sales of inventories and the cash method for computing all other items of income and expense is deemed to be using a cash method of accounting and not a hybrid method, thereby permitting taxpayers using this method as a small business taxpayer to use this automatic change to go to a full accrual accounting method.

However, a method that has other items on an accrual method besides purchases and sales of inventory, as well as some items on a cash method, is defined as a hybrid method of accounting and is specifically scoped out of the automatic change, which continues to limit the ability of taxpayers using such a method to make an automatic method change to use an overall accrual

method. A taxpayer making a change from the cash method in its first or mandatory Sec. 448 year or a mandatory Sec. 447 year may disregard any prior change to the overall cash method for purposes of the five-year eligibility requirement.

Syndicate election

Finally, Rev. Proc. 2022-9 provides procedures for taxpayers to revoke the binding election made under Prop. Regs. Sec. 1.448-2(b)(2)(i)(B) to use allocations made in the immediately preceding tax year, instead of the current tax year's allocations, when determining if more than 35% of losses of an entity are allocated to limited partners or limited entrepreneurs for purposes of the syndicate definition, for tax years beginning on or after Jan. 5, 2021, or in an early application year. The final regulations have favorably modified this election by making it an annual election that is irrevocable for the year made.

The election applies for all provisions of the Code that specifically refer to Sec. 448(a)(3) to define a tax shelter, such as the small business exemptions, including the limitation of the business interest deduction. As explained below, a taxpayer that wishes to revoke the binding election for a year beginning before Jan. 5, 2021, must take action (by making the annual election under the final regulations, or if it does not make the annual election for the year it applies the final regulations, by attaching a statement to the return or by timely filing certain automatic accounting method changes specified in Section 5.02(3)(c) of Rev. Proc. 2022-9 for an early-adoption year). If not, the binding election is automatically revoked beginning with the taxpayer's first tax year beginning on or after Jan. 5, 2021, and for all subsequent tax years. An entity will have to determine annually whether it wishes to make the annual election to use the prior-year allocations and take the appropriate action under Regs. Sec. 1.448-2(b)(2)(iii)(B).

Effective date

Rev. Proc. 2022-9 is effective for Forms 3115 filed on or after Dec. 16, 2021. Several transition rules are provided for changes that can no longer be made under an automatic change and a duplicate copy of the Form 3115 has already been filed, or changes that were filed as nonautomatic that now qualify as an automatic change.

Editor Notes

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