

## Chapter 5

### Inventory - General Rules

The reading materials for this topic consists primarily of IRC and regulations and a set of slides prepared by Professor Nellen. A few case studies will also be discussed in class.

#### Questions to Accompany Reading for Chapter 5

1. Are video tapes of a video rental store considered inventory which would require the store to use the accrual method of accounting? Explain. Explain what tax accounting rules you would use for your video rental store client. [Rev. Rul. 75-544]

2. Assuming the IRS has dropped its position that rotatable spare parts for customer-owned machines are inventory, is there any relevance of the *Honeywell* and *Hewlett Packard* cases? Explain.

3. Per §1.471-2(a), what two tests must each inventory conform?

1.

2.

4. President Clinton's FY2000 Budget proposed to repeal the lower-of-cost-or-market method and subnormal goods rule for valuing inventory for companies with gross receipts over \$5 million. That didn't happen. In 2007, Congressman Rangel introduced HR 3970 which also proposed to repeal LCM along with several other reforms. President Obama's 2010 budget calls for repeal of LCM and the subnormal goods method. What possible arguments exist to support the repeal of these provisions? What possible arguments exist to support retaining these provisions? What type of §481(a) adjustment would be needed if this proposal were enacted?

5. The *Thor Power Tool* case is cited not just for its holding with respect to inventory writedowns, but also for its discussion of the differing goals of GAAP and tax accounting. Per the Supreme Court's discussion on this topic, what are the differing goals of GAAP and tax accounting? Provide two examples of this difference.

6. Your client silk-screens designs onto T-shirts. The shirts are only bought to fill each customer order. Does your client have inventory? Is your client a manufacturer/producer or a retailer or just a service provider? Explain. [See TAM 9223003]

7. How should a manufacturer treat cash discounts and trade discounts received on purchases?  
[Rev. Rul. 73-65, 1973-1 C.B. 216, Rev. Rul. 69-619, 1969-2 C.B. 111, Gertzman treatise §6.06[1]]

8. Provide two examples of companies that fall under Rev. Proc. 2002-28.

9. Based on your in Chapter 5 and your experience, list possible book-tax differences a manufacturer is likely to have with respect to inventory.

## Case Studies—Application of Inventory Accounting Provisions

For each of the following four fact patterns, assume you are the attorney or accountant in the IRS National Office assigned to issue the requested ruling. Be sure to state your conclusion and rationale, including the primary authority that supports your conclusion.

### 1. Does the Taxpayer Have Inventory?

Review each of the independent fact patterns below. For each, explain whether the taxpayer has inventory. Assume that each taxpayer has gross receipts in excess of \$1 million.

- a. ABC Company is a service provider that occasionally sells books to clients. The cost of the books compared to the taxpayer's gross receipts is 6%. Are the books de minimis inventory that ABC may account for as supplies? What is the percentage required for inventory to be considered de minimis?

- b. Allergy Clinic is an S corporation that provides medical services to patients suffering from allergies. As part of the services rendered, the doctors develop special allergy medications for each patient, which is given to patients weekly. Supplies or inventory? If inventory, is it de minimis? Could the hybrid method be used?

c. Ostrich Software is a sole proprietorship that develops and transfers educational software. OS only sells to customers via the Internet—both the software and payment (by credit card) are transferred via the phone lines. The software is not customized, but is off-the-shelf type software. OS expenses its software development costs under §174 and has no §263A costs. Is OS required to use the accrual method of accounting? Is it subject to §471 on the premise that it is selling "something"? If the software is considered inventory, is it de minimis? How should the *Wilkinson-Beane, supra*, formula be applied where the cost of the "inventory" was expensed under §174?

d. This example is taken verbatim from EITF 99-19, *Recording Revenue Gross as a Principal versus Net as an Agent*.<sup>1</sup> “Company A facilitates the sale of home furnishing products. Each product marketed has a unique supplier and that supplier is identified in product catalogs distributed to customers. Company A maintains no inventories of products in advance of customer orders. Company A takes title to the products ordered by customers at the point of shipment from suppliers. Title is passed to the customer upon delivery. The gross amount owed by a customer is charged to the customer’s credit card prior to shipment and Company A is the merchant of record. Company A is responsible for collecting the credit card charges and must remit amounts owed to suppliers regardless of whether that collection occurs. Suppliers set the product selling prices. Company A retains a fixed percentage of the sales price and remits the balance to the supplier. Written information provided to customers during marketing and included in the terms of sales contracts states:

Company A manages ordering, shipping, and billing processes to help you purchase home furnishing products. Company A does not buy, sell, manufacture, or design the products. When you use Company A, you are purchasing the products from the Suppliers. Company A has no control over the quality or safety of the products listed. Orders will not be binding on Company A or the Suppliers until the applicable Supplier accepts them. Company A will process your requests for order changes, cancellations, returns, and refunds with the applicable Supplier. All order changes, cancellations, returns, or refunds are governed by the Supplier’s policies, and you agree to pay additional shipment costs or restocking charges imposed by the Supplier. You agree to deal directly with the Supplier regarding warranty issues. Company A will not be liable for loss, damage, or penalty resulting from delivery delays or delivery failures due to any cause beyond reasonable control.”

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<sup>1</sup> EITF 99-19 addresses the accounting issue as to when a sale should be reported as gross (as if the business was the seller) or at net (as if the business only earned a commission for facilitating a sale). The SEC’s concern with the varied accounting treatment it was seeing among some Internet companies was that if a company reported at gross when it should have been net, it had artificially inflated its revenues, and likely its stock price. For a discussion of the tax issues in this area, see the Appendix to this outline. The situations described in EITF 99-19 also raise potential tax issues as to who is liable to collect sales tax on the sale.

EITF 99-19 provides a list of factors that are to help in determining whether a company should report revenues at gross or net. None of the indicators are to be considered presumptive or determinative. Per EITF 99-19 a company should report revenue at gross if it: (1) is the primary obligor of the arrangement, (2) has general inventory risk, (3) has latitude in setting prices, (4) changes the product or performs part of the service, (5) has discretion in selecting suppliers, (6) is involved in determining product or service specifications, (7) has physical loss inventory risk, and (8) has credit risk. A company should report revenue at net if: (1) the supplier is the primary obligor in the arrangement, (2) the amount earned by the company is fixed, and (3) the supplier has credit risk. EITF 99-19 includes 13 examples to help illustrate application of the indicators.

## 2. Is an Inventory Method Required?<sup>2</sup>

**Facts:** T, an S corporation, was incorporated on August 20, 1990, and conducted business in that year. T is licensed in Florida to sell automobiles to the public. T also repairs automobiles and sells automotive parts. T uses an overall accrual method of accounting.

T's automobile sales activity consists of selling used automobiles. T acquires these used automobiles from other dealers or at auctions.

After purchasing a used automobile, T brings the automobile to its lot where it makes any needed repairs and cleans the automobile. T acquires legal title to the automobile, although it may take one or two months thereafter for T to receive its certificate of title. T insures the automobile and immediately begins efforts to resell the automobile. Usually, T resells the automobile before it receives the certificate of title.

T states that the used automobiles are “entrusted” to it while it is attempting to locate purchasers. T contends that “entrusting” permits it to resell the automobiles, but that it should not be treated as the owner of the automobiles.

In some cases, T resells the used automobiles for cash. When this occurs, the purchaser receives title to the automobile. T primarily sells its used automobiles on credit, however, and T provides the financing. When T finances an automobile sale, the purchaser signs a note for the purchase price of the automobile, less any cash paid, and pledges the purchased automobile as collateral. T retains legal title to the automobile until the note is paid in full. The usual interest rate on the note is approximately x percent. T usually holds and collects on a note for about two or three months, then sells the note to an unrelated finance company at a price that is less than the aggregate payments required on the note. [1](#)

With regard to notes that T sells to finance companies, T transfers title of the automobiles securing the notes to the finance companies.

T claims that it sells automobiles for an amount approximately equal to its cost of acquiring the automobiles and that it realizes little or no profit from the selling of used automobiles. T also claims that it earns substantially all its net income from its consumer financing activities and the discounting of the consumer notes. T represents that its ability to function as a going concern is due to its financing activities.

T's 1991 and 1992 tax years are under examination. On its original federal income tax return for 1990 and 1991, T reported its installment notes as accounts receivable. T filed an amended return for 1991 after the due date of the 1991 return, and subsequently filed its federal income tax return for 1992, reporting the outstanding notes as ending inventory under the lower of cost or market method of accounting.

Further, T's federal income tax returns for 1991 and 1992 showed that it held an inventory of automobiles. This inventory consisted of unsold automobiles on T's lot at year end. Automobiles that T had sold to customers on credit were not included in T's ending inventory, even though T held legal title to these automobiles as collateral.

T takes the position that it is a dealer in securities; thus, section 1.471-5 permits T to inventory its notes using the lower of cost or market method of accounting. The notes are securities within the meaning of section 1236(c) of the Internal Revenue Code. In 1991, T reported the notes as accounts receivable on its books of account. In conjunction with filing its 1991 amended return, T revised the way in which it reported the notes on its books of account for 1991, inventorying the notes on the basis of cost or market,

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<sup>2</sup> TAM 9723004.

whichever is lower. In 1992, for book accounting purposes, T continued to inventory the notes using the lower of cost or market method.

Further, T claims that since it is a securities dealer and not an automobile dealer, it should not have inventoried its automobiles but may deduct the costs of its automobiles currently. Alternatively, T argues that it is not required to maintain an inventory of automobiles because it rarely receives title to the automobiles before it sells them to customers.

T has not filed a Form 3115, Application for Change in Accounting Method, seeking the Commissioner's permission to change to the lower of cost or market method of accounting for its installment notes. Further, T has not filed a Form 3115 seeking the Commissioner's permission to change its method of accounting for its inventory of used automobiles.

**Issue:** If T is a dealer in securities for purposes of section 1.471-5 of the Income Tax Regulations, must T maintain an inventory of unsold automobiles it holds at year end?

### 3. Review - Separate Trades or Businesses/Timing of Income<sup>3</sup>

**Facts:** The taxpayer is an S corporation engaged as a franchisee of several weight control centers that helps clients attain a goal weight through monitoring of behavior, counseling, and encouragement. The taxpayer also sells specially formulated food products, vitamin and minerals, sweatshirts, recipe cards and other miscellaneous items to its clients. The taxpayer was incorporated in 1989 and uses the cash receipts and disbursements method of accounting for Federal tax purposes. The taxpayer uses an accrual method of accounting for book purposes; however, the taxpayer does not account for inventories for either tax or book purposes. Sales of supplements and other merchandise represented 50 percent of total sales in 1990 and 41 percent in 1991 as reported on the cash-basis tax returns.

A client enters into a weight reduction contract with the taxpayer to lose a specified amount of weight within a targeted time period. The weight goal and the time period are determined on an individual basis by the client and the counselor, and this weight goal and time period determines the amount owed for the contract. If the client reaches the goal weight within the specified time period, the client is entitled to a free stabilization phase for one month and a free maintenance phase for up to one year from the date of the original contract. If the client meets the conditions of the contract but does not reach the goal weight within the specified time period, the client can continue the program until the goal weight is reached without additional cost.

Services begin immediately upon execution of the contract with a general health evaluation and various questionnaires to determine the client's habits and life-style. The client is also counseled on how the program works and evaluated as to what the client's goal weight should be. This initial visit is the longest and most detailed. After the initial visit, the client visits the taxpayer's location on a regular basis, either daily or weekly, and follows an outlined program. The program consists of monitoring progress, monitoring blood pressure, heart rate and body measurements, discussing any problems, reviewing goals, and purchasing supplements. These subsequent visits can be very short or last 10-15 minutes.

The food supplements and other items sold by the taxpayer are available as an option to the client. These products are not held for sale to the general public; the customer must be an active member of the weight reduction program, stabilization phase or the maintenance phase of the program. No sales of these products are given on account or included in the financing agreements. The products are displayed and sold at each center, and they are sold by the same personnel who sell the weight reduction contracts and counsel the members.

Approximately 40 to 50 percent of all contracts are paid in full when the contract is executed. Those contracts not paid in full are financed over an agreed upon schedule, usually due within four to six months. There are no finance charges or late fees assessed.

The contract is not assignable and not transferable. If a client fails to make the scheduled payments and does not visit a center for 90 days, the taxpayer sends a certified letter to the client to determine if the client has moved, filed bankruptcy, etc. After the status of the client is determined and the taxpayer attempts to collect for approximately six months, the account is turned over to a collection agent and is considered uncollectible. No legal action is taken by the taxpayer to collect overdue accounts, because the taxpayer hopes that the client will some day return to the program.

The taxpayer is required by the franchise agreement to keep books and records on the accrual method and to report to the franchisor on that basis. The franchise agreement requires that the taxpayer record the entire contract price as income on the date the contract is executed. Any unpaid balance is recorded as accounts receivable. If the taxpayer determines that accounts are uncollectible, the franchisor will credit

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<sup>3</sup> TAM 9408003.



**Rev. Proc. 2001-10**  
**2001-1 I.R.B. 272**

**1. Purpose**

This revenue procedure modifies and supersedes Rev. Proc. 2000- 22, 2000-20 I.R.B. 1008, and provides that the Commissioner of Internal Revenue will exercise his discretion to except a qualifying taxpayer with average annual gross receipts of \$1,000,000 or less from the requirements to use an accrual method of accounting under section 446 of the Internal Revenue Code and to account for inventories under section 471. This revenue procedure also provides the procedures by which a qualifying taxpayer (as defined in section 3 of this revenue procedure) may obtain automatic consent to change to the cash receipts and disbursements method of accounting (the cash method) and to a method of accounting for inventory as materials and supplies that are not incidental under section 1.162-3 of the Income Tax Regulations.

**2. Background and Changes**

- .01 Section 446(a) provides that taxable income must be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping the taxpayer's books.
- .02 Section 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, including the cash method and an accrual method, subject to certain restrictions. For example, section 446(b) provides that the selected method must clearly reflect income. In addition, section 1.446-1(c)(2)(i) requires that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever section 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under section 1.446-1(c)(2)(ii). Under section 1.446-1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.
- .03 The cash method generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. Section 1.446-1(c)(1)(i).
- .04 Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. Section 1.471-1 requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.
- .05 Section 1.162-3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.
- .06 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. However, resellers with gross receipts of \$10,000,000 or less and producers with \$200,000 or less of indirect costs are not required to capitalize costs under section 263A. See sections 263A(b)(2)(B) and 1.263A-2(b)(3)(iv).
- .07 Sections 446(e) and 1.446-1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with section 446(e).
- .08 Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year.
- .09 Rev. Proc. 2000-22 is modified in the following respects:

- (1) Section 3 is modified to make clear that this revenue procedure does not apply to taxpayers described in section 448(a)(3) (tax shelters).
- (2) Section 4.02 is added to clarify the proper time to take into account the cost of inventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) that are treated as materials and supplies that are not incidental under section 1.162-3;
- (3) The conformity requirement of section 5.07 has been removed. Taxpayers are reminded that they must comply with the requirements under section 446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See section 1.446-1(a)(4);
- (4) Section 6.02(1) is modified to provide that qualifying taxpayers using an accrual method of accounting that are not required under section 471 to account for inventories may use the automatic consent provisions of this revenue procedure to change to the cash method;
- (5) Section 6.02(2) is modified to provide that qualifying taxpayers (including taxpayers not currently accounting for inventories) may use the automatic consent provisions of this revenue procedure to change to the method of accounting for inventoriable items as materials and supplies that are not incidental under section 1.162-3;
- (6) Section 6.03 is added to provide guidance on the computation of the adjustment required under section 481(a) in connection with the automatic changes in method of accounting under this revenue procedure; and
- (7) Section 8 is modified in accordance with the removal of the conformity requirement of section 5.07.

### **3. Scope**

This revenue procedure applies to taxpayers (other than a taxpayer described in section 448(a)(3)) with “average annual gross receipts” of \$1,000,000 or less (as defined in section 5.01 of this revenue procedure)(“qualifying taxpayers”).

### **4. Small Taxpayer Exception**

- .01 Pursuant to the discretion under sections 446(b) and 471, and to simplify bookkeeping requirements for small taxpayers, the Commissioner, as a matter of administrative convenience, will except qualifying taxpayers from the requirements to use an accrual method under section 446 and to account for inventories under section 471. For purposes of this revenue procedure, notwithstanding section 1001 and the regulations thereunder, qualifying taxpayers that use the cash method include amounts in income attributable to open accounts receivable (i.e., receivables due in 120 days or less) as amounts are actually or constructively received. However, section 1001 may be applicable to other transactions. Qualifying taxpayers that do not want to account for inventories must treat inventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) in the same manner as materials and supplies that are not incidental under section 1.162-3. Section 263A does not apply to inventoriable items that are treated as materials and supplies that are not incidental.
- .02 Under section 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year in which the taxpayer sells the merchandise or finished goods. Thus, under the cash method, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later. Producers may use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw materials that were used to produce finished goods that are sold during the tax year, provided that method is used consistently.

.03 The Service and Treasury expect to provide further guidance on when items may be treated as incidental materials and supplies (the cost of which may be deducted currently under section 1.162-3) and when items are inventoriable items (the cost of which, under this revenue procedure, may be deducted no earlier than the year in which the items are consumed and used).

## 5. Definitions

.01 Average annual gross receipts defined. A taxpayer has average annual gross receipts of \$1,000,000 or less if, for each prior tax year ending on or after December 17, 1998, the taxpayer's average annual gross receipts for the 3-tax-year period ending with the applicable prior tax year does not exceed \$1,000,000.

.02 Gross receipts defined. Gross receipts is defined consistent with section 1.448-1T(f)(2)(iv) of the temporary regulations. Thus, gross receipts for a tax year equal all receipts derived from all of the taxpayer's trades or businesses that must be recognized under the method of accounting actually used by the taxpayer for that tax year for federal income tax purposes. For example, gross receipts include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents. However, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority.

.03 Aggregation of gross receipts. For purposes of computing gross receipts, all taxpayers treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 (or that would be treated as a single employer under these sections if the taxpayers had employees) will be treated as a single taxpayer. However, when transactions occur between taxpayers that are treated as a single taxpayer by the previous sentence, gross receipts arising from these transactions will not be treated as gross receipts for purposes of the average annual gross receipts limitation. See section 1.448-1T(f)(2)(ii).

.04 Taxpayer not in existence for 3 tax years. If a taxpayer has been in existence for less than the 3-tax-year period referred to in section 5.01 of this revenue procedure, the taxpayer must determine its average annual gross receipts for the number of years (including short tax years) that the taxpayer has been in existence.

.05 Treatment of short tax years. In the case of a short tax year, the taxpayer's gross receipts must be annualized by multiplying the gross receipts of the short tax year by 12 and then dividing the product by the number of months in the short tax year. See section 1.448-1T(f)(2)(iii).

.06 Treatment of predecessors. Any reference to taxpayer in this section 5 includes a reference to any predecessor of such taxpayer.

.07 Example. Taxpayer A, a calendar year taxpayer, manufactures and sells widgets. For federal income tax purposes, Taxpayer A uses an overall accrual method of accounting. Further, Taxpayer A complies with the requirements of section 1.471-1 to use inventory accounts and section 263A to capitalize direct and indirect costs.

Taxpayer A has gross receipts (as defined in section 5.02 of this revenue procedure) of \$200,000 in 1996, \$800,000 in 1997 and \$1,100,000 in 1998.

To determine whether it qualifies for the small taxpayer exception set forth in section 4 of this revenue procedure beginning with the 1999 tax year, Taxpayer A computes its average annual gross receipts for each prior tax year ending on or after December 17, 1998, that is, its 1998 tax year. Taxpayer A's average annual gross receipts for 1998 is \$700,000 ( $\$200,000 (1996) + \$800,000 (1997) + \$1,100,000 (1998) = \$2,100,000/3$ ).

Taxpayer A's average annual gross receipts for each prior tax year ending after December 17, 1998, does not exceed \$1,000,000. Therefore, Taxpayer A qualifies for the small taxpayer exception for its 1999 tax year. By following the procedures set forth in section 6.02 of this revenue procedure, Taxpayer A may change to the cash method and a method of treating inventoriable items in the same

manner as materials and supplies that are not incidental under section 1.162-3 for the tax year ending December 31, 1999.

Taxpayer A must determine its applicability for the small taxpayer exception set forth in section 4 of this revenue procedure each year. Thus, to qualify for the exception for its 2000 tax year, Taxpayer A's average annual gross receipts for 1999 (i.e., the average of A's gross receipts for 1999, 1998, and 1997) also must be \$1,000,000 or less. If, in any later year, Taxpayer A ceases to qualify for the small taxpayer exception set forth in section 4 of this revenue procedure, it must change to an inventory method and an accrual method with respect to the production and sale of widgets in accordance with section 6.04 of this revenue procedure.

## **6. Change in Accounting Method**

.01 In general. Any change in a taxpayer's method of accounting pursuant to this revenue procedure is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

.02 Automatic change for taxpayers within the scope of this revenue procedure.

(1) Automatic change to the cash method. A qualifying taxpayer that wants to change to the cash method must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 I.R.B. 725 (or its successor) with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate;

(b) A taxpayer making a change under section 6.02 of this revenue procedure for its first tax year ending on or after December 17, 1999, that, on or before January 16, 2001, files or filed its original federal income tax return for such year, is not required to comply with the filing requirement in section 6.02(2)(a) of Rev. Proc. 99-49, provided the taxpayer complies with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for the taxpayer's first tax year ending on or after December 17, 1999. This amended return must be filed no later than June 15, 2001. A copy of the Form 3115 must be filed with the national office (see section 6.02(5) of Rev. Proc. 99-49 for the address) no later than when the taxpayer's amended return is filed;

(c) For a change in method of accounting within the scope of this revenue procedure, the provisions of Rev. Proc. 99-49 are effective for tax years ending on or after December 17, 1999; and

(d) Taxpayers filing Form 3115 for a change in method of accounting under section 6.02 of this revenue procedure are reminded to complete all applicable parts of the form, including Part II, line 17 (regarding information on gross receipts in previous years) and Part III (regarding the section 481(a) adjustment). Such taxpayers must also complete Part I of Schedule A of Form 3115, but need not complete Part II. Taxpayers should write "Filed under Rev. Proc. 2001-10" at the top of the form.

(2) Automatic change to section 1.162-3. A qualifying taxpayer that does not want to account for inventories must make any necessary change from the taxpayer's current method of accounting for inventoriable items (including, if applicable, from the method of capitalizing costs under section 263A) to treat inventoriable items in the same manner as materials and supplies that are not incidental under section 1.162-3. For purposes of such a change, the rules of section 6.02(1)

of this revenue procedure apply. Taxpayers may file a single Form 3115 for both changes described in sections 6.02(1) and (2).

- .03 Section 481(a) adjustment. The net amount of the section 481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, a taxpayer that wants to treat inventory as materials and supplies that are not incidental under section 1.162-3 must take into account the difference resulting from this recharacterization in determining the section 481(a) adjustment.
- .04 Taxpayers not within the scope of this revenue procedure. A taxpayer that ceases to qualify for the small taxpayer exception described in section 4 of this revenue procedure and otherwise is required to use an accrual method (e.g., a taxpayer otherwise required to account for inventories) must change to an accrual method and, if applicable, an inventory method that complies with sections 263A and 471 using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 99-49, if applicable, or the advance consent provisions of Rev. Proc. 97-27, 1997-1 C.B. 680 (or its successor).

#### **7. Effect on Other Documents**

Rev. Proc. 2000-22 is modified and, as modified, is superseded. Rev. Proc. 99-49 is modified and amplified to include this automatic change in section 5 of the APPENDIX.

#### **8. Effective Date**

This revenue procedure is effective for tax years ending on or after December 17, 1999. However, the Service will not challenge a taxpayer's use of the cash method under section 446 (or a taxpayer's failure to account for inventories under section 471) in an earlier year if the taxpayer would satisfy the 3-tax-year-period gross receipts test of section 5.01 of this revenue procedure (applied by testing the 3-tax-year period ending prior to such earlier year).

**Rev. Proc. 2002-28**  
**2002-18 I.R.B. 815**

**1. Purpose**

In order to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service and small business taxpayers regarding the requirement to use an accrual method of accounting (accrual method) under § 446 of the Internal Revenue Code because of the requirement to account for inventories under § 471, this revenue procedure provides that the Commissioner of Internal Revenue will exercise his discretion to except a qualifying small business taxpayer (as defined in section 5.01 of this revenue procedure) from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471. This revenue procedure also provides the procedures by which a qualifying small business taxpayer may obtain automatic consent to change to the cash receipts and disbursements method of accounting (cash method) and/or to a method of accounting for inventoriable items as materials and supplies that are not incidental under § 1.162-3 of the Income Tax Regulations.

**2. Background**

.01 Section 446(a) provides that taxable income must be determined under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

.02 Section 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, including the cash method or an accrual method, subject to certain restrictions. For example, § 446(b) provides that the selected method must clearly reflect income. In addition, § 1.446-1(c)(2)(i) requires that a taxpayer use an accrual method with regard to purchases and sales of merchandise whenever § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under § 1.446-1(c)(2)(ii). Under § 1.446-1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.

.03 Section 447 generally requires the taxable income from farming of a C corporation engaged in the trade or business of farming, or a partnership engaged in the trade or business of farming with a C corporation partner, to be determined using an accrual method, unless the C corporation meets the \$1,000,000 (\$25,000,000 for family corporations) gross receipts test.

.04 Section 448 generally prohibits the use of the cash method by a C corporation (other than a farming business and a qualified personal service corporation) and a partnership with a C corporation partner (other than a farming business and a qualified personal service corporation), unless the C corporation or partnership with a C corporation partner meets a \$5,000,000 gross receipts test. Section 448 also prohibits tax shelters from using the cash method.

.05 The cash method generally requires an item of income to be included in income when actually or constructively received and permits a deduction for an expense when paid. Section 1.446-1(c)(1)(i). Other provisions of the Code or regulations applicable to cash method taxpayers may change these general rules, including, for example, § 263 (requiring the capitalization of expenses paid out for a new building or for permanent improvements or betterments made to increase the value of any property or estate, or for restoring property or making good the exhaustion of property for which an allowance is or has been made); § 263A (requiring capitalization of direct and allocable indirect costs of real or tangible personal property produced by a taxpayer or real or personal property that is acquired by a taxpayer for resale); § 460 (requiring the use of the percentage-of-completion method for certain long-term contracts); and § 475 (requiring dealers in securities to mark securities to market).

.06 Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. Section 1.471-1 generally requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

.07 Section 1.162-3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the taxable year. In the case of incidental materials and supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, taxpayers may include in their expenses and deduct from gross income the total cost of such incidental supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

.08 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. However, resellers with gross receipts of \$10,000,000 or less are not required to capitalize costs under § 263A, and certain producers with \$200,000 or less of indirect costs are not required to capitalize certain costs under § 263A. See §§263A(b)(2)(B) and 1.263A-2(b)(3)(iv).

.09 Sections 446(e) and 1.446-1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

.10 Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is determined under a method of accounting different from the method used to determine taxable income for the preceding taxable year.

### **3. Scope**

.01 *Applicability.* This revenue procedure applies to a qualifying small business taxpayer as defined in section 5.01.

.02 *Taxpayers Not within the Scope of this Revenue Procedure.* Notwithstanding section 3.01 of this revenue procedure, this revenue procedure does not apply to a farming business (within the meaning of § 263A(e)(4)) of a qualifying small business taxpayer. If a qualifying small business taxpayer is engaged in the trade or business of farming, this revenue procedure may apply to the taxpayer's non-farming trades or businesses, if any. A taxpayer engaged in the trade or business of farming generally is allowed to use the cash method for any farming business, unless the taxpayer is required to use an accrual method under § 447 or is prohibited from using the cash method under § 448.

### **4. Qualifying Small Business Taxpayer Exception**

.01 Pursuant to his discretion under §§ 446 and 471, and to simplify the record keeping requirements of a qualifying small business taxpayer, the Commissioner, as a matter of administrative convenience, will allow a qualifying small business taxpayer to use the cash method as described in this revenue procedure for a trade or business described in this section 4.01 (eligible trade or business).

- (1) A qualifying small business taxpayer may use the cash method as described in this revenue procedure for all of its trades or businesses if the taxpayer satisfies any one of the following three tests and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this revenue procedure.

- (a) The taxpayer reasonably determines that its principal business activity (as defined in section 5.04, below) is described in a North American Industry Classification System ("NAICS") code other than one of the ineligible codes listed below. The ineligible NAICS codes are as follows:
- (i) mining activities within the meaning of NAICS codes 211 and 212;
  - (ii) manufacturing within the meaning of NAICS codes 31 - 33;
  - (iii) wholesale trade within the meaning of NAICS code 42;
  - (iv) retail trade within the meaning of NAICS codes 44 and 45; and,
  - (v) information industries within the meaning of NAICS codes 5111 and 5122.

Information regarding the NAICS codes can be found at [www.census.gov](http://www.census.gov).

Visitors to the site should select "Subjects A to Z," followed by "N," and then should select "North American Industry Classification System." Taxpayers also may find a partial list of NAICS codes, described as "Principal Business Activity Codes," in the instructions to their tax return forms.

- (b) Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the provision of services, including the provision of property incident to those services.
- (c) Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. For purposes of this rule, tangible personal property is not fabricated or modified in accordance with customer design or specifications if the customer merely chooses among pre-selected options (such as size, color, or materials) offered by the taxpayer or if the taxpayer must make only minor modifications to its basic design to meet the customer's specifications. Moreover, a taxpayer that manufactures an item in quantities for a customer is not treated as fabricating or modifying tangible personal property in accordance with customer design or specifications.

(2) Under current law, a taxpayer with two or more trades or businesses that has a trade or business that is permitted to use the cash method may use such method for such trade or business. Therefore, notwithstanding that a taxpayer's principal business activity is not described above in section 4.01(1) and thus the taxpayer can not use the cash method for all of its trades or businesses, a taxpayer may use the cash method with respect to any separate and distinct trade or business if the principal business activity of the trade or business is not described in an ineligible NAICS code in section 4.01(1)(a)(i) through (v) or is described in either section 4.01(1)(b) or section 4.01(1)(c). No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business. See § 1.446-1(d)(2).

.02 A taxpayer who satisfies the qualifying small business taxpayer exception described in section 4.01 and chooses not to use an overall accrual method with inventories being accounted for under § 471 has the following three options for an eligible trade or business under this revenue procedure:

- (1) The taxpayer can use the overall cash method and account for inventories under § 471;
- (2) The taxpayer can use an overall accrual method and account for inventoriable items, as defined in section 5.09 below, in the same manner as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below); or
- (3) The taxpayer can use the overall cash method and account for inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below).

.03 Notwithstanding § 1001 and the regulations thereunder, qualifying small business taxpayers that use the cash method for an eligible trade or business under section 4.01 of this revenue procedure shall include amounts attributable to “open accounts receivable” (as defined in section 5.10) in income as such amounts are actually or constructively received. However, §1001 may be applicable to other transactions.

.04 Qualifying small business taxpayers that are permitted to use the cash method for an eligible trade or business under section 4.01 of this revenue procedure and that do not want to account for inventories under § 471 must treat all inventoriable items in such trade or business in the same manner as materials and supplies that are not incidental under § 1.162-3. For purposes of this revenue procedure, taxpayers are not required to apply § 263A to inventoriable items that are treated as materials and supplies that are not incidental. Items that would be accounted for as incidental materials and supplies for purposes of § 1.162-3 may still be accounted for in that manner. Whether an item is purchased for resale or use (and thus accounted for as a non-incidental material and supply) or is purchased to provide to customers incident to services (and thus may be accounted for as either an incidental or a non-incidental material and supply depending on the facts and circumstances) must be determined under general tax principles.

.05 Under § 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer provides the items to a customer. Thus, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the goods, whichever is later. A qualifying small business taxpayer may determine the amount of the allowable deduction for non-incidental materials and supplies by using either a specific identification method, a first in, first out (FIFO) method, or an average cost method, provided that method is used consistently. See § 1.471-2(d). A taxpayer may not use the last in, first out (LIFO) method described in § 472 and the regulations thereunder to determine the amount of the allowable deduction for non-incidental materials and supplies.

.06 The method of accounting used by a qualifying small business taxpayer for financial accounting (“book”) purposes will not affect the taxpayer's eligibility under this revenue procedure to use the cash method or the method of accounting for inventoriable items as non-incidental materials and supplies under § 1.162-3. However, taxpayers must still comply with the requirements under § 446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See § 1.446-1(a)(4).

## **5. Definitions**

.01 *Qualifying Small Business Taxpayer.* A qualifying small business taxpayer is any taxpayer with “average annual gross receipts” of \$10,000,000 or less that is not prohibited from using the cash method under § 448.

.02 *Average Annual Gross Receipts.* A taxpayer has average annual gross receipts of \$10,000,000 or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three taxable-year period ending with the applicable prior taxable year do not exceed \$10,000,000. If a taxpayer has not been in existence for three prior taxable years, the taxpayer must determine its average annual gross receipts for the number of years (including short taxable years) that the taxpayer has been in existence. See § 448(c)(3)(A).

.03 *Business Activity.* A taxpayer may use any reasonable method of applying the relevant facts and circumstances to determine what is a business activity. For example, for some taxpayers, the provision of services, the sale of goods, and the production of goods each will be treated as a different business activity. However, if a taxpayer sells or produces goods incident to the performance of services, the different activities may be treated as one business activity - the provision of services.

*.04 Principal Business Activity.* A principal business activity is determined by the sources of gross receipts. Under sections 4.01(1)(a), (b), and (c), a taxpayer must apply the tests in this section to all the taxpayer's trades or businesses in the aggregate. Under section 4.01(2), a taxpayer must apply the tests in such section separately to each trade or business for which the taxpayer keeps a complete and separable set of books and records. A taxpayer may use either of the following tests to determine the principal business activity of the taxpayer or of the taxpayer's trades or businesses.

(1) *Principal business activity prior year test.* Under the principal business activity prior year test, the principal business activity is the activity from which the largest percentage of gross receipts was derived during the prior taxable year (even if this amount is less than 50 percent of the aggregate gross receipts of the taxpayer or the trade or business). If a taxpayer or a trade or business is in its first taxable year, the principal business activity is the activity from which the largest percentage of gross receipts is derived for that taxable year.

(2) *Principal business activity three-year average test.* Under the principal business activity three-year average test, the principal business activity is the activity from which the largest percentage of average annual gross receipts was derived over the three taxable-year period ending with the prior taxable year. If a taxpayer or a trade or business has not been in existence for three prior taxable years, the taxpayer must determine average annual gross receipts for the number of years (including short taxable years) that the taxpayer or the trade or business has been in existence. See § 448(c)(3)(A).

*.05 Gross Receipts.* Gross receipts is defined consistent with § 1.448-1T(f)(2)(iv) of the Temporary Income Tax Regulations. Thus, gross receipts for a taxable year equal all receipts that must be recognized under the method of accounting actually used by the taxpayer for that taxable year for federal income tax purposes. For example, gross receipts include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents. However, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. See also § 448(c)(3)(C).

*.06 Aggregation of Gross Receipts.* For purposes of computing gross receipts under section 5.02, all taxpayers treated as a single employer under subsection (a) or (b) of § 52 or subsection (m) or (o) of § 414 (or that would be treated as a single employer under these sections if the taxpayers had employees) will be treated as a single taxpayer. However, when transactions occur between taxpayers that are treated as a single taxpayer by the previous sentence, gross receipts arising from these transactions will not be treated as gross receipts for purposes of the average annual gross receipts limitation. See §§ 448(c)(2) and 1.448-1T(f)(2)(ii).

*.07 Treatment of Short Taxable Years.* In the case of a short taxable year, a taxpayer's gross receipts must be annualized by multiplying the gross receipts for the short taxable year by 12 and then dividing the result by the number of months in the short taxable year. See §§ 448(c)(3)(B) and 1.448-1T(f)(2)(iii).

*.08 Treatment of Predecessors.* Any reference to a taxpayer in this section 5 includes a reference to any predecessor of that taxpayer. See § 448(c)(3)(D).

*.09 Inventoriable Item Defined.* An inventoriable item is any item either purchased for resale to customers or used as a raw material in producing finished goods.

*.10 Open Accounts Receivable Defined.* For purposes of this revenue procedure, open accounts receivable is defined as any receivable due in full in 120 days or less.

## **6. Examples**

For purposes of the following examples, assume that:

- (1) the taxpayers use the calendar year;

- (2) the taxpayers are not prohibited from using the cash method under § 448 (except *Example 4*); and
- (3) the taxpayers satisfy the average annual gross receipts test of section 5.02 of this revenue procedure (except *Examples 2 and 3*).

*Example 1 — Principal Business Activity Not an Ineligible NAICS Code.* Taxpayer is a graphic design firm. Taxpayer plans, designs, and manages the production of visual communications that convey specific messages or concepts. Taxpayer's activities include the design of printed materials, packaging, advertising, signage systems, and corporate identification (logos). Taxpayer reasonably determines that its principal business activity is described in NAICS code 541430 (graphic design services), which is not one of the ineligible NAICS codes listed in section 4.01(1)(a)(i) - (v) of this revenue procedure. Taxpayer may use the cash method for its graphic design business.

*Example 2 — Satisfaction of the Average Annual Gross Receipts Test.* Taxpayer is a plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer reasonably determines that its principal business activity is construction, which is described in NAICS code 23. Taxpayer's gross receipts at the end of the three preceding taxable years are:

|       | <u>Gross receipts</u> |
|-------|-----------------------|
| 1998: | \$ 6,000,000          |
| 1999: | 9,000,000             |
| 2000: | 12,000,000            |

Taxpayer's average annual gross receipts for the three taxable-year period ending in the 2000 taxable year are \$9,000,000 ( $(\$6,000,000 + \$9,000,000 + \$12,000,000) / 3 = \$9,000,000$ ). Taxpayer may use the cash method for all its trades or businesses pursuant to this revenue procedure for its 2001 taxable year because its average annual gross receipts for each prior taxable year ending on or after December 31, 2000, is \$10,000,000 or less and its principal business activity is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i) - (v).

*Example 3 — Failure of the Average Annual Gross Receipts Test.* Same as *Example 2*, except that Taxpayer's gross receipts in 2001 equal \$15,000,000. Taxpayer's average annual gross receipts for the three taxable-year period ending in the 2001 taxable year are \$12,000,000 ( $(\$9,000,000 + \$12,000,000 + \$15,000,000 / 3) = \$12,000,000$ ). Taxpayer is not a qualifying small business taxpayer for purposes of this revenue procedure for its 2002 taxable year or any subsequent year because its average annual gross receipts for each prior taxable year ending on or after December 31, 2000, is not \$10,000,000 or less.

*Example 4 — Inability to Use this Revenue Procedure When §448 Applies.* Same as *Example 2*, except that Taxpayer is a C corporation. Because Taxpayer's average annual gross receipts for the previous three years (\$9,000,000) exceed \$5,000,000, Taxpayer is prohibited from using the cash method under §448. Consequently, Taxpayer is not eligible to use the cash method under this revenue procedure. The same result would apply under §448 if, instead of being a C corporation, Taxpayer were a tax shelter (regardless of Taxpayer's average annual gross receipts) or Taxpayer were a partnership with a C corporation as a partner.

*Example 5 — Principal Business Activity Prior Year Test.* Taxpayer is a plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer also has a store that sells plumbing equipment to homeowners and other plumbers who visit the store. During its prior taxable year, Taxpayer derived 60 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 40 percent of its total receipts from the sale of plumbing equipment through its store. Under the principal business activity prior year test, Taxpayer reasonably determines that its principal business activity is plumbing installation, which is a construction activity described in NAICS code 23. Because Taxpayer's principal business activity - plumbing installation - is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i)-(v), Taxpayer may use the cash method for both business activities (plumbing installation and retail sales).

*Example 6 — Principal Business Activity Three-Year Average Test.* Same as *Example 5*, except that for the prior taxable year, Taxpayer derived 40 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 60 percent of its total receipts from the sale of plumbing equipment through its store. Under the principal business activity prior year test, Taxpayer's principal business activity is retail, which is described in an ineligible NAICS code. Thus, Taxpayer is not eligible to use the cash method for all of its trades or businesses under the principal business activity prior year test. However, Taxpayer may still be eligible to use the cash method for all of its trades or businesses under section 4.01(1) of this revenue procedure if Taxpayer reasonably determines that its principal business activity is plumbing installation under the principal business activity three-year average test. Taxpayer's gross receipts for the prior three taxable years are as follows:

|                          | <u>2000</u>        | <u>1999</u>        | <u>1998</u>        | <u>3 Year<br/>Average</u> |
|--------------------------|--------------------|--------------------|--------------------|---------------------------|
| Plumbing installation    | \$2,000,000        | \$6,000,000        | \$4,000,000        | \$4,000,000               |
| Retail sale of equipment | <u>\$3,000,000</u> | <u>\$2,000,000</u> | <u>\$4,000,000</u> | <u>\$3,000,000</u>        |
| Total                    | \$5,000,000        | \$8,000,000        | \$8,000,000        | \$7,000,000               |

The approximate percentage of Taxpayer's average annual gross receipts for the prior three taxable years is 57 percent ( $\$4,000,000/\$7,000,000$  total average gross receipts) for plumbing installation and 43 percent ( $\$3,000,000/\$7,000,000$ ) for the retail sale of plumbing equipment through its store. Thus, Taxpayer reasonably determines that its principal business activity is plumbing installation under the principal business activity three-year average test. Because Taxpayer's principal business activity - plumbing installation - is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i)-(v), Taxpayer may use the cash method for both business activities (plumbing and retail sales).

*Example 7 — Application of Section 4.01(2) Where Taxpayer Is Ineligible to Use the Cash Method Under Section 4.01(1).* Same as *Examples 5 and 6*, except that Taxpayer's principal business activity is retail sales under both the principal business activity prior year test and the principal business activity three-year average test. Taxpayer is not eligible to use the cash method for all of its trades or businesses under section 4.01(1) because Taxpayer's principal business activity (retail sales) is described in an ineligible NAICS code under section 4.01(1)(a)(iv) and is neither the provision of services under section 4.01(1)(b) nor the fabrication or modification of tangible personal property under section 4.01(1)(c). Taxpayer, however, maintains its retail sales and plumbing installation activities as separate and distinct businesses with a complete and separable set of books and records for each business. Under section 4.01(2) of the revenue procedure, Taxpayer may use the cash method for its separate plumbing installation business notwithstanding that its principal business activity (retail sales) is ineligible under section 4.01(1)(a) - (c).

*Example 8 — A Principal Business Activity Can Account for Less Than 50 Percent of Gross Receipts.* Taxpayer has four activities, Activities A through D. During the prior taxable year, Taxpayer derived 35 percent of its gross receipts from Activity A, 25 percent from Activity B, 20 percent from Activity C, and 20 percent from Activity D. Under the principal business activity prior year test, Activity A would be Taxpayer's principal business activity because it represents the largest percentage of gross receipts. Similarly, if the percentages of Taxpayer's average annual gross receipts for the prior three taxable years were 35 percent from Activity A, 25 percent from Activity B, 20 percent from Activity C, and 20 percent from Activity D, under the principal business activity three-year average test, Activity A would be Taxpayer's principal business activity because it represents the largest percentage of average annual gross receipts.

*Example 9 — Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b), or the Custom Manufacturing Exception in Section 4.01(1)(c).* Taxpayer sells refrigerators. As part of the sale price, Taxpayer delivers the refrigerator to the customer and confirms that the refrigerator is functioning properly at the customer's site. Taxpayer's principal business activity is described in the ineligible NAICS code 44. Moreover, Taxpayer's principal business activity is not the provision of services under section 4.01(1)(b). Taxpayer does not provide refrigerators incident to the performance of services. Rather, Taxpayer performs certain services (delivery and confirmation of

functionality) incident to the sale of refrigerators. In addition, Taxpayer does not fabricate or modify tangible personal property under section 4.01(1)(c). Taxpayer may not use the cash method under this revenue procedure.

*Example 10 — Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b), or the Custom Manufacturing Exception in Section 4.01(1)(c).* Taxpayer is a sofa manufacturer that only produces sofas upon receipt of a customer order. Customers are allowed to pick among 150 different fabrics offered by the Taxpayer or to provide their own fabric, which the Taxpayer will use to finish the customer's sofa. Taxpayer's principal business activity is described in the ineligible NAICS code 33. Taxpayer does not provide sofas incident to the performance of services for purposes of section 4.01(1)(b). Rather, Taxpayer performs certain services (upholstering) incident to the sale of sofas. Taxpayer also does not fabricate or modify tangible personal property for purposes of section 4.01(1)(c) because customers merely choose among pre-selected options offered by Taxpayer and Taxpayer only makes minor modifications to the basic design of its sofa. Taxpayer may not use the cash method under this revenue procedure.

*Example 11 — Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b) or the Custom Manufacturing Exception in Section 4.01(1)(c).* Taxpayer is a publisher who produces and sells high school and college yearbooks. Taxpayer's principal business activity is described in the ineligible NAICS code 5111 (newspaper, periodical, book, and database publishers). Taxpayer is not providing a service for purposes of section 4.01(1)(b) because Taxpayer's principal business activity is the production of yearbooks for customers. In addition, Taxpayer is not a custom manufacturer for purposes of section 4.01(1)(c) because Taxpayer, although it produces yearbooks to the detailed specifications of schools, is producing yearbooks in quantities. As such, Taxpayer may not use the cash method under this revenue procedure.

*Example 12 — Taxpayer Creating Prototype Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a) but Does Satisfy the Custom Manufacturing Exception in Section 4.01(1)(c).* Taxpayer makes tools based entirely on specific designs and specifications provided to it by customers. Taxpayer produces the customer's prototype and gives the prototype to the customer for production. Taxpayer's principal business activity is described in the ineligible NAICS code 33. However, Taxpayer's principal business activity is the fabrication of tangible personal property upon demand in accordance with customer design or specifications for purposes of section 4.01(1)(c). Taxpayer may use the cash method under this revenue procedure (subject to the potential application of § 460).

*Example 13 — Taxpayer Producing Quantities of Prototype Does Not Satisfy the Custom Manufacturing Exception in Section 4.01(1)(c).* Same as *Example 12*, except that instead of producing the customer's prototype and giving the prototype to the customer for further production, Taxpayer is also the producer of the customer's goods using the prototype. Taxpayer's principal business activity would not fall under the custom manufacturer exception of section 4.01(1)(c).

*Example 14 — Application of Accounts Receivable 120-Day Rule in Section 4.03.* Taxpayer is eligible to use the cash method under this revenue procedure. Taxpayer chooses to use the cash method and to account for inventorable items as non-incidentals materials and supplies under § 1.162-3. In December 2001, Taxpayer transfers property to a customer in exchange for an open accounts receivable (due in full in 120 days or less). In February 2002, the customer satisfies the accounts receivable when it pays cash to Taxpayer. As provided by section 4.03 of this revenue procedure, Taxpayer would not include any amount attributable to the accounts receivable in income in 2001. Rather, Taxpayer would include the full amount of the accounts receivable in income in 2002 when it actually receives the cash payment from the customer.

*Example 15 — Timing of Deduction for Inventorable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 - Construction.* Taxpayer is a roofing contractor that is eligible to use the cash method under this revenue procedure. Taxpayer chooses to use the cash method and to account for inventorable items as non-incidentals materials and supplies under § 1.162-3. Taxpayer enters into a

contract with a homeowner in December 2001 to replace the homeowner's roof. Taxpayer purchases roofing shingles from a local supplier and has them delivered to the homeowner's residence. Taxpayer pays the supplier \$5,000 for the shingles upon their delivery later that month. Taxpayer replaces the homeowner's roof in December 2001, and gives the homeowner a bill for \$15,000 at that time. Taxpayer receives a check from the homeowner in January 2002. The shingles are non-incidental materials and supplies. The cost of the shingles is deductible in the year Taxpayer uses and consumes the shingles or actually pays for the shingles, whichever is later. In this case, Taxpayer both pays for the shingles and uses the shingles (by providing the shingles to the customer in connection with the performance of roofing services) in 2001. Thus, Taxpayer deducts the \$5,000 cost of the shingles on its 2001 federal income tax return. Taxpayer includes the \$15,000 in income in 2002 when it receives the check from the homeowner.

*Example 16 — Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 - Construction.* Same as in *Example 15*, except that Taxpayer does not replace the roof until January 2002 and is not paid until March 2002. Because the shingles are not used until 2002, their cost can only be deducted on Taxpayer's 2002 federal income tax return notwithstanding that Taxpayer paid for the shingles in 2001. Thus, on its 2002 return, Taxpayer must report \$15,000 of income and \$5,000 of deductions.

*Example 17 — Timing of Deduction for Non-Inventoriable Items - Speculative Home Sales.* Taxpayer is eligible to use the cash method as described in this revenue procedure. Taxpayer is a speculative builder of houses that are built on land it owns. In 2001, Taxpayer builds a house using various items such as lumber, piping, and metal fixtures that it had paid for in 2000. In 2002, Taxpayer sells the house to a buyer. Because the house is real property held for sale by Taxpayer, the house and the material used to build the house are not inventoriable items under this revenue procedure. Thus, Taxpayer may not account for the items used to build the house as non-incidental materials and supplies under § 1.162-3. Rather, Taxpayer must capitalize the costs of the lumber, piping, metal fixtures and other goods used by Taxpayer to build the house under § 263. Upon the sale of the house in 2002, the costs capitalized by Taxpayer will be offset against the house sales price to determine Taxpayer's gain or loss from the sale.

*Example 18 — Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 - Construction.* Same as in *Example 17*, except that (1) Taxpayer builds houses on land its customers own, and (2) the houses are built in three months with payment due at completion. Because Taxpayer does not own the house, the lumber, piping, metal fixtures and other goods used by Taxpayer in the provision of construction services are inventoriable items, not real property held for sale. Taxpayer elects to treat the goods used to build the house as non-incidental materials and supplies under § 1.162-3. Taxpayer must deduct the cost of the lumber, piping, metal fixtures and other non-incidental materials and supplies that are used by it to build the house in 2001 (the year those items were used by Taxpayer to build the house) notwithstanding that Taxpayer had paid for the items in 2000. Taxpayer will report income it receives from its customer as the income is actually or constructively received.

*Example 19 — Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 - Reseller.* Taxpayer is a veterinarian that also sells pet supplies from its clinic. Taxpayer reasonably determines that its principal business activity is veterinary services, which is not described in one of the ineligible NAICS codes in section 4.01(1)(a)(i)-(v). Consequently, Taxpayer is eligible to use the cash method for all its business activities (veterinary services and retail sales). For both business activities, Taxpayer chooses to use the cash method and to account for inventoriable items (such as pet food) as non-incidental materials and supplies under § 1.162-3. In December of 2001, Taxpayer purchases and pays for pet food to be resold from its clinic. Taxpayer sells the pet food from its clinic (and receives cash payment from the customer) in 2002. Because the pet food is not provided to customers until 2002, its cost can not be deducted until 2002.

*Example 20 — Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 - Manufacturer.* Taxpayer is a landscape designer that also manufactures lawn ornaments. Taxpayer does not manufacture lawn ornaments pursuant to customer contracts. Taxpayer

reasonably determines that its principal business activity is landscape design, which is not described in an ineligible NAICS code under section 4.01(1)(a)(i)-(v). Consequently, Taxpayer is eligible to use the cash method for all its business activities (landscape design and lawn ornament manufacturing). For both business activities, Taxpayer chooses to use the cash method and to account for inventoriable items (such as raw materials) as non-incidental materials and supplies under § 1.162-3. In 2001, Taxpayer purchases and pays for raw materials to be used in its manufacturing business and uses the raw materials to produce lawn ornaments. During 2002, Taxpayer sells the lawn ornaments to customers. Because the lawn ornaments are not provided to customers until 2002, the cost of the raw materials used to produce the lawn ornaments can not be deducted until 2002.

*Example 21 — Application of Long Term Contract Rules - § 460 Applicable.* Taxpayer is a specialty tool and die manufacturer. Taxpayer receives a request from a large automobile manufacturer to design and produce a custom-made die that the customer will use in its manufacturing operation. The contract to manufacture the die is entered into in December 2001 but is not completed until May 2002. Because it satisfies the requirements of section 4.01(1)(c) of this revenue procedure, Taxpayer is eligible to use the overall cash method of accounting. Notwithstanding the Taxpayer's eligibility to use the overall cash method, however, because the contract to manufacture the custom-made die requires the production of a “unique item” and will not be completed in the year it is entered into, it is a “long term contract” for purposes of § 460, and the income and expense relating to that contract must be accounted for under the percentage-of-completion method of accounting described in § 460 and the underlying regulations.

*Example 22 — Application of Long Term Contract Rules - § 460 Not Applicable.* Taxpayer is a residential home builder that specializes in modest single family homes whose construction period averages six months. Taxpayer uses an overall accrual method of accounting, and although it is not required to do so, Taxpayer has elected to use the percentage-of-completion method of accounting, as described in § 1.460-4(b), in accounting for its home construction activities. Because its principal business activity is not described in an ineligible NAICS code described in section 4.01(1)(a), Taxpayer may elect the overall cash method described in this revenue procedure. Further, because its home construction activity is not required to be accounted for using the percentage-of-completion method described in § 460, Taxpayer is eligible (but not required) to change its method of accounting for that activity to the cash method.

*Example 23 — Taxpayer Satisfies the NAICS Code Provision in Section 4.01(1)(a).* Taxpayer is a licensed medical clinic that provides specialized chemotherapy treatment to cancer patients. The medication provided to patients accounts for 26 percent of Taxpayer's average annual gross receipts. Taxpayer does not sell the medications separately from its provision of services, selects the medications to be used in a particular session based on its own professional skill and judgment, and does not maintain medications for more than two weeks. Because the provision of medical services (NAICS code 62) represents Taxpayer's principal business activity, Taxpayer qualifies to use the cash method under section 4.01(1)(a) for all of its trades or businesses. Even if the cost of the chemotherapy medications represented Taxpayer's principal source of gross receipts, Taxpayer nonetheless would qualify to use the cash method under section 4.01(1)(a) of this revenue procedure, because its principal business activity would still be providing medical services, with goods being provided only incident to the provision of those services. See *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999), *acq.* AOD 2000-05, 2000-23 I.R.B. 1149.

*Example 24 — Change in Principal Business Activity.* Taxpayer owns a hardware store and a small appliance repair business. Following the issuance of this revenue procedure, Taxpayer reasonably determined that its principal business activity was its appliance repair business, which is not described in an ineligible NAICS code under section 4.01(1)(a)(i)-(v). Consequently, Taxpayer was eligible to use the cash method under this revenue procedure for both its business activities (appliance repair and retail sales). Over time, Taxpayer's hardware store began to generate a larger portion of Taxpayer's gross receipts than its repair business. In 2005, Taxpayer's retail business became its principal business activity. Because retail trade is described in ineligible NAICS code 44, starting in 2006, Taxpayer is no longer eligible to use the cash method for all its trades or businesses under section 4.01(1). Accordingly,

Taxpayer must change to an accrual method for its retail business. If Taxpayer maintains a complete and separable set of books and records in 2006 for its repair business, Taxpayer may continue to use the cash method for its repair business under section 4.01(2). If Taxpayer does not maintain a complete and separable set of books and records in 2006 for its repair business, Taxpayer also must change to an accrual method for its repair business — however, in any subsequent taxable year that Taxpayer maintains complete and separable books and records for its repair business, Taxpayer will be eligible under section 4.01(2) to change to the cash method for its repair business.

*Example 25 — Change in Principal Business Activity.* Same as *Example 24*, except that Taxpayer's repair business again becomes its principal business activity in 2009. Taxpayer is no longer eligible to use the cash method for its retail business under section 4.01(1). For section 4.01(1) to apply, Taxpayer must not have previously changed (or have been previously required to change) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this revenue procedure. Because Taxpayer was required to change to an accrual method for its retail business in 2006 as a result of becoming ineligible to use the cash method under this revenue procedure, Taxpayer is not eligible to rely on section 4.01(1) for 2006 or any subsequent taxable year.

*Example 26 — Change in Principal Business Activity.* Same as *Example 24*, except that following the issuance of this revenue procedure, Taxpayer's principal business activity was retail sales and Taxpayer used an accrual method for both businesses (retail and repair). Over time, Taxpayer's repair business began to generate a larger portion of Taxpayer's gross receipts than its retail business. In 2007, Taxpayer's repair business became its principal business activity. Starting in taxable year 2008, Taxpayer is eligible under section 4.01(1) to use the cash method for all its trades and businesses because Taxpayer did not change (and was not required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method for that trade or business under this revenue procedure, and Taxpayer's principal business activity is no longer described in an ineligible NAICS code under section 4.01(1)(a)(i)-(v).

## **7. Change In Accounting Method**

*.01 In General.* Any change in a taxpayer's method of accounting pursuant to this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

*.02 Automatic Change for Taxpayers within the Scope of this Revenue Procedure.*

(1) *Automatic change to the cash method.* A qualifying small business taxpayer that wants to use the cash method as described in this revenue procedure for an eligible trade or business must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (or its successor), as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696 and Announcement 2002-17, 2002-8 I.R.B. 561, with the following modifications:

- (a) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, see section 6.02(9) of Rev. Proc. 2002-9 for additional filing requirements.
- (b) Taxpayers filing Form 3115, Application for Change in Accounting Method, for a change in method of accounting under this revenue procedure must complete all applicable parts of the form but need not complete Part II of Schedule A of Form 3115. Specifically, Part II of Form 3115, line 17 (regarding information on gross receipts in previous years) and Part III of Form 3115 (regarding the § 481(a) adjustment) must be completed. Taxpayers should write “Filed under Rev. Proc. 2002-28” at the top of their Form 3115.
- (c) A taxpayer making a change under section 7.02 of this revenue procedure for its first taxable year ending on or after December 31, 2001, that, on or before May 6, 2002, files or filed its original federal income tax return for such year, is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies

with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2001. This amended return must be filed no later than September 16, 2002. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9 for the address) no later than when the taxpayer's amended return is filed.

(2) *Automatic change to § 1.162-3.* A qualifying small business taxpayer that does not want to account for inventories under § 471 must make any necessary change from the taxpayer's inventory method (and, if applicable, from the method of capitalizing costs under § 263A) to treat inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162-3. For purposes of such a change, the rules of section 7.02(1) of this revenue procedure apply.

(3) *Other automatic changes.* An automatic change in method under this revenue procedure would also include any other change in method of accounting that is eligible to be made under this revenue procedure in conjunction with either or both of the above changes in this section 7.02 (such as a change from a long-term contract method that is not required to be used by § 460). For purposes of such a change, the rules of section 7.02(1) of this revenue procedure apply.

(4) *Single Form 3115.* Any combination of changes under this revenue procedure may be included in the same Form 3115 to be filed by the taxpayer.

#### *.03 Section 481(a) Adjustment.*

(1) *Determining the net amount.* The net amount of the §481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, the §481(a) adjustment may include the difference resulting from changing from taking inventory accounts under §471 to treating the inventoriable items as materials and supplies that are not incidental under §1.162-3.

(2) *Multiple adjustments.* In the event that a taxpayer is taking into account a §481(a) adjustment from another accounting method change in addition to the §481(a) adjustment required by this revenue procedure, the §481(a) adjustments would be taken into account separately. For example, a taxpayer that changed from the cash method to an accrual method in 1999 and was required to take its § 481(a) adjustment into account over four years would continue to take into account that adjustment over the appropriate four years even though the taxpayer changes back to the cash method in 2001 and has an additional § 481(a) adjustment required by this revenue procedure.

(3) *Section 481(a) adjustment period.* As provided in section 2 of Rev. Proc. 2002-19, the period for negative § 481(a) adjustments is one year, and the period for positive §481(a) adjustments is four years.

#### *.04 Taxpayers Not within the Scope of this Revenue Procedure.*

(1) A taxpayer that ceases to qualify for the qualifying small business taxpayer exception described in section 4 of this revenue procedure for a trade or business and that otherwise is required to use an accrual method for that trade or business must change to an accrual method (and, if applicable an inventory method that complies with §§263A and 471) for that trade or business using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 2002-9, if applicable, as modified by Rev. Proc. 2002-19 or the advance consent provisions of Rev. Proc. 97-27, 1997-1 C.B. 679 (or its successor), as modified by Rev. Proc. 2002-19.

(2) No inference is intended regarding whether a taxpayer that does not satisfy the qualifying small business taxpayer exception in section 4 is otherwise permitted to use the cash method. Taxpayers who do not qualify to change to the cash method under this revenue procedure may

still request permission to change to the cash method under Rev. Proc. 97-27, as modified. See also Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

#### **8. Effect On Other Documents**

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in sections 5 and 9 of the APPENDIX. Notice 2002-14, 2002-8 I.R.B. 548, is modified and superseded.

#### **9. Effective Date**

This revenue procedure is effective for taxable years ending on or after December 31, 2001. However, the Service will not challenge a taxpayer's use of the cash method under § 446 or a taxpayer's failure to account for inventories under § 471 for a trade or business in an earlier year if the taxpayer, for that year, would have been a qualifying small business taxpayer as described in section 5.01 of this revenue procedure and would have been eligible to use the cash method in such year under section 4 of this revenue procedure if this revenue procedure had been applicable to that taxable year.

APPLICATION OF REV. PROC. 2002-28

