



Department
of the
Treasury

Internal
Revenue
Service

Publication 538

(Rev. April 2001)

Cat. No. 15068G

Accounting Periods and Methods



For tax years ending on or after December 31, 2001, a qualifying small business taxpayer can choose to use the cash method of accounting and not account for inventories. A qualifying small business taxpayer is any taxpayer with average annual gross receipts of more than \$1,000,000 but less than or equal to \$10,000,000 that is not prohibited from using the cash method of accounting under section 448 of the Internal Revenue Code. Certain other requirements must be met. For more information, see Notice 2001-76 in Internal Revenue Bulletin 2001-52.



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Introduction

Each taxpayer (business or individual) must figure taxable income on an annual accounting period called a tax year. The calendar year is the most common tax year. Other tax years are a fiscal year and a short tax year.

Each taxpayer must also use a consistent accounting method, which is a set of rules for determining how and when to report income and expenses. The most commonly used accounting methods are the cash method and an accrual method. Under the cash method, you generally report income in the tax year you receive it and deduct expenses in the tax year you pay them. Under an accrual method, you generally report income in the tax year you earn it, regardless of when payment is received, and deduct expenses in the tax year you incur them, regardless of when payment is made.

This publication explains some of the rules for accounting periods and accounting methods. In many cases, however, you may have to refer to the cited sources for a fuller explanation of the topic. Section references are to the Internal Revenue Code and regulation references are to the Income Tax Regulations.

This publication is not intended as a guide to general business and tax accounting rules.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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clude your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- 537** Installment Sales
- 541** Partnerships
- 542** Corporations

Form (and Instructions)

- 1128** Application To Adopt, Change, or Retain a Tax Year
- 3115** Application for Change in Accounting Method

See *How To Get Tax Help* near the end of this publication for information about getting these publications and forms.

User Fees

The IRS charges a user fee for certain requests to change an accounting period or method, certain tax rulings, and determination letters. The fee is reduced in certain situations and for certain requests, such as a request for substantially identical rulings for related entities. No fee is charged for changes permitted to be made by a published automatic change revenue procedure.

See Revenue Procedure 2001-1, 2001-1 IRB, or its successor, for more information.

Accounting Periods

You must figure taxable income on the basis of a tax year. A "tax year" is an annual accounting period for keeping records and reporting income and expenses. The tax years you can use are:

- 1) A calendar year.
- 2) A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individual and partnership returns is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors, partners, and S corporation shareholders. The due date for filing returns for corporations and S corporations is the 15th day of the 3rd month after the end of the tax year. If the 15th day of the month falls on a Saturday, Sunday, or legal holiday, the due date is the next business day.

This section discusses:

- 1) A calendar year.
- 2) A fiscal year (including a period of 52 or 53 weeks).
- 3) A short tax year.
- 4) An improper tax year.
- 5) A change in tax year.

- 6) Restrictions that apply to the accounting period of a partnership, S corporation, or personal service corporation.
- 7) Special situations that apply to corporations.

Calendar Year

A calendar year is 12 consecutive months beginning January 1 and ending December 31.

If you adopt the calendar year, you must maintain your books and records and report your income and expenses from January 1 through December 31 of each year.

If you file your first tax return using the calendar tax year and you later begin business as a sole proprietor, become a partner in a partnership, or become a shareholder in an S corporation, you must continue to use the calendar year unless you get IRS approval to change it. See *Change in Tax Year*, later.

Generally, anyone can adopt the calendar year. However, if any of the following apply, you must adopt the calendar year.

- 1) You do not keep adequate records.
- 2) You have no annual accounting period.
- 3) Your present tax year does not qualify as a fiscal year.

Fiscal Year

A fiscal year is 12 consecutive months ending on the last day of any month except December. A 52-53 week tax year is a fiscal year that varies from 52 to 53 weeks but may not end on the last day of a month.

If you adopt a fiscal year, you must maintain your books and records and report your income and expenses using the same tax year.

52-53 Week Tax Year

You can elect to use a 52-53 week tax year if you keep your books and records and report your income and expenses on that basis. If you make this election, your tax year will be 52 or 53 weeks long and always end on the same day of the week. You can choose to have your tax year end on the same day of the week that:

- 1) Last occurs in a particular month, or
- 2) Occurs nearest to the last day of a particular calendar month.

For example, if you elect a tax year that always ends on the last Monday in March, your 1999 tax year will end on March 27, 2000. If you elect a tax year ending on the Thursday nearest to the end of April, your 1999 tax year will end on April 27, 2000.

Election. To make the election, attach a statement with the following information to your tax return for the 52-53 week tax year.

- 1) The month in which the new 52-53 week tax year ends.
- 2) The day of the week on which the tax year always ends.

- 3) The date the tax year ends. It can be either of the following dates on which the chosen day:

- a) Last occurs in the month in (1), above, or
- b) Occurs nearest to the last day of the month in (1) above.

When you figure depreciation or amortization, a 52-53 week tax year is generally considered a year of 12 calendar months.

To determine an effective date (or apply provisions of any law) expressed in terms of tax years beginning, including, or ending on the first or last day of a specified calendar month, a 52-53 week tax year is considered to:

- 1) Begin on the first day of the calendar month beginning nearest to the first day of the 52-53 week tax year, and
- 2) End on the last day of the calendar month ending nearest to the last day of the 52-53 week tax year.

Example. Assume a tax provision applies to tax years beginning on or after July 1, 2001. For this purpose, a 52-53 week tax year beginning on June 24, 2001, is treated as beginning on July 1, 2001.

Change to or from 52-53 week tax year. Under certain circumstances, you can change to a 52-53 week tax year without IRS approval. However, in other cases, you must get approval before changing to or from a 52-53 week tax year.

Approval not required. You can change to a 52-53 week tax year without IRS approval as long as the day chosen for the end of the 52-53 week tax year occurs in the same calendar month in which your present tax year ends. You must attach the statement explained in *Election*, earlier, to the tax return for the year for which the election is made.

Example. You do not need IRS approval to change from a calendar tax year to a 52-53 week tax year ending on the Friday closest to December 31. You make the election by attaching the required statement to your tax return for the year of the change.

Approval required. You must get IRS approval to change your tax year to a 52-53 week tax year that ends in a calendar month different from the month in which your present tax year ends. For example, you must get IRS approval to change from a calendar year to a 52-53 week tax year ending on the Saturday nearest the end of November.

You must also get approval to change from a 52-53 week tax year to any other tax year.

See *Change in Tax Year*, later, for information on getting IRS approval.

Short Tax Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when you (as a taxable entity):

- 1) Are not in existence for an entire tax year, or

2) Change your accounting period.

Tax on a short period tax return is figured differently for each situation.

Not in Existence Entire Year

Even if you (a taxable entity) were not in existence for the entire year, a tax return is required for the time you were in existence. Requirements for filing the return and figuring the tax are generally the same as the requirements for a return for a full tax year (12 months) ending on the last day of the short tax year.

Example 1. Corporation X was organized on July 1, 2000. It elected the calendar year as its tax year and its first tax return was due March 16, 2001. This short period return will cover the period from July 1, 2000, through December 31, 2000.

Example 2. A calendar year corporation dissolved on July 23, 2001. Its final return is due by October 15, 2001, and it will cover the short period from January 1, 2001, to July 23, 2001.

Example 3. Partnership YZ was formed on September 4, 2000, and elected to use a fiscal year ending November 30. Partnership YZ must file its first tax return by March 15, 2001. It will cover the short period from September 4, 2000, to November 30, 2000.

Death of individual. When an individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year. The decedent's final return will be a short period tax return unless he or she dies on the last day of the regular tax year.

Example. Agnes Green was a single, calendar year taxpayer. She died on March 6, 2001. Her final tax return must be filed by April 15, 2002. It will cover the short period from January 1, 2001, to March 6, 2001.

Figuring Tax for Short Year

If the IRS approves a change in your tax year or you are required to change your tax year, you must figure the tax and file your return for the short tax period. The short tax period begins on the first day after the close of your old tax year and ends on the day before the first day of your new tax year.

You figure tax for a short year under the general rule, explained next. You may then be able to use a relief procedure, explained later, and claim a refund of part of the tax you paid.

General rule. Income tax for a short tax year is figured on an annual basis. However, self-employment tax is figured on the actual self-employment income for the short period.

Individuals. An individual must figure income tax for the short tax year as follows.

- 1) Determine your adjusted gross income for the short tax year and then subtract your actual itemized deductions for the short tax year. (You **must** itemize deductions when you file a short period tax return.)

- 2) Multiply the dollar amount of your exemptions by the number of months in the short tax year and divide the result by 12.
- 3) Subtract the amount in (2) from the amount in (1). This is your modified taxable income.
- 4) Multiply the modified taxable income in (3) by 12, then divide the result by the number of months in the short tax year. This is your annualized income.
- 5) Figure the total tax on your annualized income using the appropriate tax rate schedule.
- 6) Multiply the total tax by the number of months in the short tax year and divide the result by 12. This is your tax for the short tax year.

Example. Mike and Sara Smith have an adjusted gross income of \$48,000 for their short tax year. Their itemized deductions for January 1 through September 30 total \$12,400 and they can claim exemptions for themselves, and their two children. Each exemption is \$2,800. They figure the tax on their joint return for that period as follows.

- 1) $\$48,000 - \$12,400 = \$35,600$
- 2) $\$2,800 \times 4 \times 9/12 = \$8,400$
- 3) $\$35,600 - \$8,400 = \$27,200$ (modified taxable income)
- 4) $\$27,200 \times 12/9 = \$36,267$ (annualized income)
- 5) Tax on $\$36,267 = \$5,441$ (from 2000 tax rate schedule)
- 6) $\$5,441 \times 9/12 = \$4,081$ (tax for short tax year)

Corporations. A corporation figures tax for the short tax year under the general rule described earlier for individuals except there is no adjustment for personal exemptions.

Example. Because a calendar year corporation changed its tax year, it must file a short period tax return for the 6-month period ending June 30, 2000. For the short tax year, it had income of \$40,000 and no deductions. The corporation's annualized income is \$80,000 ($\$40,000 \times 12/6$). The tax on \$80,000 is \$15,450. The tax for the short tax year is \$7,725 ($\$15,450 \times 6/12$).

52-53 week tax year. If you change the month in which your 52-53 tax year ends, you must file a return for the short tax year if it covers more than 6 but fewer than 359 days.

If the short period created by the change is 359 days or more, treat it as a full tax year. If the short period created is 6 days or fewer, it is not a separate tax year. Include it as part of the following year.

For example, if you use a calendar year and the IRS approves your change to a 52-53 week tax year ending on the Monday closest to September 30, you must file a return for the short period from January 1 to September 30.

Figure the tax for the short tax year as shown previously, except that you prorate on a daily basis, rather than monthly. Use 365 days

(regardless of the number of days in the calendar year) instead of 12 months and the number of days in the short tax year instead of the number of months.

Relief procedure. Individuals and corporations can use a relief procedure to figure the tax for the short tax year. It may result in less tax. Under this procedure, the tax is figured by two separate methods. If the tax figured under both methods is less than the tax figured under the general rule, you can file a claim for a refund of part of the tax you paid. For more information, see section 443(b)(2).

Alternative minimum tax. To figure the alternative minimum tax (AMT) due for a short tax year:

- 1) Figure the annualized alternative minimum taxable income (AMTI) for the short tax period by doing the following.
 - a) Multiply the AMTI by 12.
 - b) Divide the result by the number of months in the short tax year.
- 2) Multiply the annualized AMTI by the appropriate rate of tax under section 55(b)(1). The result is the annualized AMT.
- 3) Multiply the annualized AMT by the number of months in the short tax year and divide the result by 12.

For information on the alternative minimum tax for individuals, see the instructions for Form 6251. For information on the alternative minimum tax for corporations, see Publication 542, or the instructions to Form 4626, *Alternative Minimum Tax Corporations*.

Tax withheld from wages. You can take a credit against your income tax liability for federal income tax withheld from your wages. Federal income tax is withheld on a calendar year basis. The amount withheld in any calendar year is allowed as a credit for the tax year beginning in the calendar year.

Improper Tax Year

A calendar year is a tax year of 12 months that ends on December 31 and a fiscal year is a tax year of 12 months that ends on the last day of any month other than December. A 52–53 week tax year is also a fiscal year, but may not end on the last day of a month. If you begin business operations on a day other than the first day of a calendar month and adopt a tax year of exactly 12 months from the date operations began, you will have adopted an improper tax year. You do not meet the requirements for a calendar or fiscal tax year.

To change to a proper tax year, you must do one of the following.

- 1) File an amended income tax return based on a calendar year, if you meet the requirements of Revenue Procedure 85–15 in Cumulative Bulletin 1985–1.

Attach a completed **Form 1128** to the amended tax return. Write "FILED UNDER REV. PROC. 85–15" at the top of Form 1128 and file the forms with the Internal Revenue Service Center where you filed your original return.

- 2) Request IRS approval to change to a tax year other than a calendar year.

Change in Tax Year

You must, with certain exceptions, get IRS approval to change your tax year. File a current **Form 1128** by the 15th day of the 2nd calendar month after the close of the short tax year to get IRS approval. (The short tax year begins on the first day after the end of your present tax year and ends on the day before the first day of your new tax year.) You must include the correct user fee, if any, with Form 1128. See *User fees* at the beginning of this publication.

Example. Steve Adams, a sole proprietor, files his return using a calendar year. For business purposes, he wants to change his tax year to a fiscal year ending June 30. Steve will have a short tax year for the period from January 1 to June 30. He must file Form 1128 by August 15, the 15th day of the 2nd calendar month after the close of the short tax year.

A Form 1128 received within 90 days after the due date may qualify for an extension and be considered timely filed. For more information, see the form instructions and Revenue Procedure 2001-1, in Internal Revenue Bulletin No. 2001-1 (or any successor).

Your application must contain all requested information. Do not change your tax year until the IRS has approved your request.

If your application is approved, you must file an income tax return for the short period. There are special rules for figuring tax when you file a short period return because you changed your tax year. See *Figuring Tax for Short Year*, earlier.

Husband and wife. A husband and wife who have different tax years cannot file a joint return. However, there is an exception to this rule if their tax years begin on the same date and end on different dates because of the death of either or both. If a husband and wife want to use the same tax year so they can file a joint return, the method of changing a tax year depends on whether they are newly married.

Newlyweds. A newly married husband and wife with different tax years who wish to file a joint return can change the tax year of one spouse without first getting IRS approval. They can file a joint return for the first tax year ending after the date of marriage if both of the following conditions are met.

- 1) The due date for filing the required separate short period tax return of the spouse changing tax years falls on or after the date of the marriage. The due date for the short period tax return is the 15th day of the 4th month following the end of the short tax year.
- 2) The spouse changing tax years files a timely short period tax return. It must include a statement that the tax year is being changed under section 1.442-1(e) of the regulations.

If the due date for filing the required short period tax return passed before the date the couple marries, they cannot file a joint return until the end of the second tax year after the date

of marriage. They can file a joint return for the second tax year only if the spouse changing his or her tax year files a timely short period tax return.

Example. John and Jane were married on July 30, 2000. John filed his return for the fiscal year ending June 30, 2000. Jane uses the calendar year, but wants to change to John's fiscal year so they can file a joint return. If Jane files a separate return by October 16, 2000, for the short period January 1, 2000, through June 30, 2000, she will have changed her accounting period to a fiscal year ending June 30. Then she and John can file a joint return for their tax year ending June 30, 2001.

Spouses other than newlyweds. A spouse who does not meet the earlier conditions must get IRS approval to change to the other spouse's tax year in order to file a joint return. Even though there is no substantial business purpose for requesting the change, approval may be granted in certain cases.

Partnerships, S Corporations, and Personal Service Corporations

Generally, partnerships, S corporations, and personal service corporations must use a "required tax year." The entity does not have to use the required tax year if it establishes a business purpose for a different tax year or makes an election under section 444. These issues are discussed later.

Partnership

A partnership must conform its tax year to its partners' tax years unless the partnership can establish a business purpose for a different period or it makes a section 444 election. The rules for the required tax year for partnerships are as follows.

- 1) If one or more partners having the same tax year own a majority interest (more than 50%) in partnership profits and capital, the partnership must use the tax year of those partners.
- 2) If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- 3) If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

If a partnership changes to a required tax year because of these rules, no formal application for a change in tax year is needed. Any partnership that changes to a required tax year must notify the IRS by writing at the top of the first page of its tax return for its first required tax year, "FILED UNDER SECTION 806 OF THE TAX REFORM ACT OF 1986."

Least aggregate deferral of income. The tax year that results in the least aggregate deferral of income is determined as follows.

- 1) Figure the number of months of deferral for each partner using one partner's tax year. Find the months of deferral by counting the months from the end of that tax year forward to the end of each other partner's tax year.
- 2) Multiply each partner's months of deferral figured in step (1) by that partner's share of interest in the partnership profits for the year used in step (1).
- 3) Add the amounts in step (2) to get the aggregate (total) deferral for the tax year used in step (1).
- 4) Repeat steps (1) through (3) for each partner's tax year that is different from the other partners' years.

The partner's tax year that results in the lowest aggregate (total) number is the tax year that must be used by the partnership. If more than one year qualifies as the tax year that has the least aggregate deferral of income, the partnership can choose any year that qualifies. However, if one of the tax years that qualifies is the partnership's existing tax year, the partnership must retain that tax year.

Example. A and B each have a 50% interest in partnership P, which uses a fiscal year ending June 30. A uses the calendar year and B uses a fiscal year ending November 30. P must change its tax year to a fiscal year ending November 30 because this results in the least aggregate deferral of income to the partners, as shown in the following table.

| Year End | Year | Profits Interest | Months of Deferral | Interest × Deferral |
|--------------------------|-------|------------------|--------------------|---------------------|
| 12/31: | End | | | |
| A | 12/31 | 0.5 | -0- | -0- |
| B | 11/30 | 0.5 | 11 | 5.5 |
| Total Deferral | | | | 5.5 |

| Year End | Year | Profits Interest | Months of Deferral | Interest × Deferral |
|--------------------------|-------|------------------|--------------------|---------------------|
| 11/30: | End | | | |
| A | 12/31 | 0.5 | 1 | 0.5 |
| B | 11/30 | 0.5 | -0- | -0- |
| Total Deferral | | | | 0.5 |

When determination is made. The determination of the tax year with the least aggregate deferral of income must generally be made at the beginning of the partnership's current tax year. However, the IRS can require the partnership to use another day or period that will more accurately reflect the ownership of the partnership. This could occur, for example, if a partnership interest was transferred for the purpose of qualifying for a particular tax year.

Short period return. When a partnership changes its tax year, a short period return must be filed. The short period return covers the months between the end of the partnership's prior tax year and the beginning of its new tax year.

If a partnership changes to the tax year resulting in the least aggregate deferral of income, it must attach a statement to the short period

return showing the computations used to determine that tax year. The short period return must indicate at the top of page 1, "FILED UNDER SECTION 1.706-1T."

More information. For more information on partnerships, see Publication 541.

S Corporation

If it meets the requirements, a small business corporation can elect to be an S corporation. All S corporations, regardless of when they became an S corporation, must use a "permitted tax year." A permitted tax year is the calendar year or any other tax year for which the corporation establishes a business purpose. For information on S corporations, see the instructions for Form 1120-S.

Personal Service Corporation

A personal service corporation must use a calendar tax year unless it can establish a business purpose for a different period or it makes a section 444 election, discussed later. A corporation is a personal service corporation if all the following conditions are met.

- 1) The corporation is a C corporation.
- 2) The corporation's principal activity during the testing period, defined later, is the performance of personal services.
- 3) Employee-owners of the corporation perform a substantial part of the services during the testing period.
- 4) Employee-owners own more than 10% of the corporation's stock on the last day of the testing period.

Principal activity. The principal activity of a corporation is considered to be the performance of personal services if, during the testing period, the corporation's compensation costs for personal service activities are more than 50% of its total compensation costs.

Testing period. Generally, the testing period for a tax year is the prior tax year.

Example. Corporation A has been in existence since 1980. It has always used a January 31 fiscal year for its accounting period. To determine whether A is a personal service corporation for its tax year beginning February 1, 2001, the testing period is A's tax year ending January 31, 2001.

New corporations. The testing period for the first tax year of a new corporation starts with the first day of the tax year and ends on the earlier of the following dates.

- 1) The last day of its tax year.
- 2) The last day of the calendar year in which the tax year begins.

Example. B Corporation's first tax year begins June 1, 2001. B wants to use a September 30 fiscal year for its accounting period. B's testing period for its first tax year is from June 1, 2001, through September 30, 2001. If B wants to

use a March 31 fiscal year, the testing period is from June 1, 2001, through December 31, 2001.

Performance of personal services. Any activity that involves the performance of services in the fields of health, veterinary services, law, engineering, architecture, accounting, actuarial science, performing arts, or certain consulting services is considered the performance of personal services.

Employee-owner. An employee-owner of a corporation is a person who:

- 1) Is an employee of the corporation on any day of the testing period, and
- 2) Owns any outstanding stock of the corporation on any day of the testing period.

Independent contractor. A person who owns any outstanding stock of the corporation and who performs personal services for or on behalf of the corporation is treated as an employee of the corporation. This rule applies even if the legal form of the person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

More information. For more information on the tax year of a personal service corporation, see section 1.441-4T of the regulations.

Section 444 Election

A partnership, S corporation, or personal service corporation can elect under section 444 to use a tax year other than its required tax year. Certain restrictions apply to the election. In addition, a partnership or S corporation may have to make a payment for the deferral period. See *Required payment for partnership or S corporation*, later. The section 444 election does not apply to any partnership, S corporation, or personal service corporation that establishes a business purpose for a different period, explained later.

A partnership, S corporation, or personal service corporation can make a section 444 election if it meets all the following requirements.

- 1) It is not a member of a tiered structure (defined in section 1.444-2T of the regulations).
- 2) It has not previously had a section 444 election in effect.
- 3) It elects a year that meets the deferral period requirement.

Deferral period. The determination of the deferral period depends on whether the partnership, S corporation, or personal service corporation is retaining its tax year or adopting or changing its tax year with a section 444 election.

Retaining tax year. Generally, a partnership, S corporation, or personal service corporation can make a section 444 election to retain its tax year only if the deferral period of the new tax year is 3 months or less. This deferral period is the number of months between the beginning of the retained year and the close of the first required tax year.

Adopting or changing tax year. If the partnership, S corporation, or personal service corporation is changing to a tax year other than its

required year, the deferral period is the number of months from the end of the new tax year to the end of the required tax year. The IRS will allow a section 444 election only if the deferral period of the new tax year is less than the shorter of:

- 1) Three months, or
- 2) The deferral period of the tax year being changed. This is the tax year immediately preceding the year for which the partnership, S corporation, or personal service corporation wishes to make the section 444 election.

If the partnership, S corporation, or personal service corporation's tax year is the same as its required tax year, the deferral period is zero.

Example 1. BD Partnership uses a calendar year, which is also its required tax year. BD cannot make a section 444 election because the deferral period is zero.

Example 2. E, a newly formed partnership, began operations on December 1, 2000. E is owned by calendar year partners. E wants to make a section 444 election to adopt a September 30 tax year. E's deferral period for the tax year beginning December 1, 2000, is 3 months, the number of months between September 30 and December 31.

Making the election. You make a section 444 election by filing **Form 8716, Election To Have a Tax Year Other Than a Required Tax Year**, with the Internal Revenue Service Center where the entity will file its tax return. Form 8716 must be filed by the earlier of:

- 1) The due date (not including extensions) of the income tax return for the tax year resulting from the section 444 election, or
- 2) The 15th day of the 6th month of the tax year for which the election will be effective. For this purpose, count the month in which the tax year begins, even if it begins after the first day of that month.

Attach a copy of Form 8716 to Form 1065 or the appropriate Form 1120 for the first tax year for which the election is made.

Example 1. AB, a partnership, begins operations on September 11, 2001, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 11, 2001. AB must file Form 8716 by January 15, 2002, which is the due date of the partnership's tax return for the period from September 11, 2001, to September 30, 2001.

Example 2. The facts are the same as *Example 1* except that AB begins operations on October 21, 2001. AB must file Form 8716 by March 15, 2002, the 15th day of the 6th month of the tax year for which the election will first be effective.

Example 3. B is a corporation that first becomes a personal service corporation for its tax year beginning September 1, 2001. B qualifies to make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 2001. B must file Form 8716 by December 17, 2001, the due date of the income

tax return for the short period from September 1, 2001, to September 30, 2001.

Extension of time for filing. There is an automatic extension of 12 months to make this election. See the form instructions for more information.

Effect of election. A partnership or an S corporation that makes a section 444 election must make certain required payments and a personal service corporation must make certain distributions. These are discussed later.

Ending the election. The section 444 election remains in effect until it is terminated. If the election is terminated, another section 444 election cannot be made for any tax year.

The election ends when the partnership, S corporation, or personal service corporation does any of the following.

- 1) Changes its tax year to a required tax year.
- 2) Liquidates.
- 3) Willfully fails to comply with the required payments or distributions.
- 4) Becomes a member of a tiered structure.

The election will also end if either of the following events occur.

- 1) An S corporation's S election is terminated. However, if the S corporation immediately becomes a personal service corporation, the personal service corporation can continue the section 444 election of the S corporation.
- 2) A personal service corporation ceases to be a personal service corporation. If the personal service corporation elects to be an S corporation, the S corporation can continue the election of the personal service corporation.

Required payment for partnership or S corporation. A partnership or an S corporation must make a "required payment" for any tax year:

- 1) The section 444 election is in effect.
- 2) The required payment for that year (or any preceding tax year) is more than \$500.

This payment represents the value of the tax deferral the owners receive by using a tax year different from the required tax year.

Form 8752, Required Payment or Refund Under Section 7519, must be filed each year the section 444 election is in effect, even if no payment is due. If the required payment is more than \$500 (or the required payment for any prior year was more than \$500), the payment must be made when Form 8752 is filed. If the required payment is \$500 or less and no payment was required in a prior year, Form 8752 must be filed showing a zero amount.

Form 8752 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins. Any tax year a section 444 election is in effect, including the first year, is called an "applicable election year." For example, if a

partnership's applicable election year begins July 1, 2001, Form 8752 must be filed by May 15, 2002.

Required distribution for personal service corporation. A personal service corporation with a section 444 election in effect must distribute certain amounts to employee-owners by December 31 of each applicable year. If it fails to make these distributions, it may be required to defer certain deductions for amounts paid to owner-employees. The amount deferred is treated as paid or incurred in the following tax year.

For information on the minimum distribution, see the instructions for Part I of Schedule H (Form 1120), *Section 280H Limitations for a Personal Service Corporation (PSC)*.

Back-up election. A partnership, S corporation, or personal service corporation can file a back-up section 444 election if it requests (or plans to request) permission to use a business purpose tax year, discussed later. If the request is denied, the back-up section 444 election must be activated (if the partnership, S corporation, or personal service corporation otherwise qualifies).

Making election. The general rules for making a section 444 election, as discussed earlier, apply. When filing **Form 8716**, type or print "BACK-UP ELECTION" at the top of the form. However, if Form 8716 is filed on or after the date Form 1128 is filed, type or print "FORM 1128 BACK-UP ELECTION" at the top of Form 8716.

Activating election. A partnership or S corporation activates its back-up election by filing the return required, making the required payment with **Form 8752**, and printing at the top of the form, "ACTIVATING BACK-UP ELECTION." The due date for filing Form 8752 and making the payment is the later of the following dates.

- 1) May 15 of the calendar year following the calendar year in which the applicable election year begins.
- 2) 60 days after the partnership or S corporation has been notified by the IRS that the business year request has been denied.

A personal service corporation activates its back-up election by filing Form 8716 with its original or amended income tax return for the tax year in which the election is first effective and printing on the top of the income tax return, "ACTIVATING BACK-UP ELECTION."

Business Purpose Tax Year

A business purpose tax year is an accounting period that has a substantial business purpose for its existence. See *Natural Business Year*, later. In considering whether there is a business purpose for a tax year, significant weight is given to tax factors. A prime consideration is whether the change would create a substantial distortion of income. The following are examples of income distortion.

- 1) Deferring substantial income or shifting substantial deductions from one year to another to significantly reduce tax liability.

- 2) Causing a similar deferral or shifting for any other person, such as a partner or shareholder.
- 3) Creating a short period in which there is a substantial net operating loss.

The following nontax factors, based on the convenience of the taxpayer, are generally not sufficient to establish a business purpose for a particular tax year.

- 1) Using a particular year for regulatory or financial accounting purposes especially if the change is not based on the taxpayer's own facts and circumstances.
- 2) Using a particular hiring pattern, such as typically hiring staff during certain times of the year.
- 3) Using a particular year for administrative purposes, such as:
 - a) Admission or retirement of partners or shareholders.
 - b) Promotion of staff.
 - c) Compensation or retirement arrangements with staff, partners, or shareholders.
- 4) Using a price list, model year, or other item that changes on an annual basis.
- 5) Deferring income to partners or shareholders.

For examples of situations in which a business purpose is not shown as well as examples in which a substantial business purpose has been established, see Revenue Ruling 87-57, in Cumulative Bulletin 1987-2.

Natural business year. One nontax factor that may be sufficient to establish a business purpose for a tax year is an annual cycle of business activity, called a "natural business year." A natural business year exists when a business has a peak and a nonpeak period. The natural business year is considered to end at or soon after the end of the peak period. A business whose income is steady from month to month all year would not have a natural business year.

A natural business year is considered a substantial business purpose for an entity changing its accounting period. The IRS will ordinarily approve this change unless it results in a substantial distortion of income or other tax advantage.

Automatic approval. The IRS provides a procedure for a partnership, an S corporation, or a personal service corporation to retain or automatically change to a natural business year as determined by the 25% test, discussed next. It also allows an S corporation to adopt, retain, or change to a fiscal year that satisfies the "ownership tax year test," discussed later. For more information, see Revenue Procedure 87-32, in Cumulative Bulletin 1987-2.

25% test. The natural business year is determined by applying the 25% test to the method of accounting used for the tax return for each year involved. To figure the 25% test, take the following steps.

- 1) Total the gross sales and services receipts for the most recent 12-month period that includes the last month of the requested fiscal year. Figure this for the 12-month period that ends before the filing of the request. Also total the gross sales and services receipts for the last 2 months of that 12-month period.
- 2) Determine the percentage of the receipts for the 2-month period by dividing the total of the last 2-month period by the total for the entire 12-month period. Carry the percentage to two decimal places.
- 3) Figure the percentage following steps (1) and (2) for the two 12-month periods just preceding the 12-month period used in (1).

If the percentage determined for each of the three years equals or exceeds 25%, the requested fiscal year is the natural business year.

Special rules. If the partnership, S corporation, or personal service corporation qualifies for more than one natural business year, the fiscal year producing the highest average of the three percentages is the natural business year.

If the partnership, S corporation, or personal service corporation does not have at least 47 months of gross receipts (which may include a predecessor organization's gross receipts), it cannot use this automatic procedure to obtain permission to use a fiscal year.

If the requested tax year is a 52-53 week tax year, the calendar month ending nearest the last day of the 52-53 week tax year is treated as the last month of the requested tax year for purposes of computing the 25% test.

Ownership tax year test. An S corporation or corporation electing to be an S corporation qualifies for automatic approval if it meets the ownership tax year test. The test is met if the corporation is adopting, retaining, or changing to a tax year and shareholders holding more than 50% of its issued and outstanding shares of stock on the first day of the requested tax year have, or are all changing to, the same tax year. Shareholders desiring to change to the same tax year should follow section 1.442-1(b)(1) of the regulations when requesting permission. If, on the first day of any tax year, the S corporation no longer meets the ownership tax year test, the corporation must change its tax year to a permitted year.

Filing information. To get automatic approval, a partnership, S corporation, or corporation electing to be an S corporation must file a tax return for the short period. The short period tax return must be filed by the due date, including extensions.

Form 1128 must be filed by the 15th day of the second calendar month following the close of the short period with the director of the Internal Revenue Service Center where the entity files its tax return. The envelope should be marked "Attention: ENTITY CONTROL." Type or print "FILED UNDER REV. PROC. 87-32" at the top of Form 1128.

In some cases, a late-filed Form 1128 may be accepted. However, applications the IRS receives more than 90 days after the due date will not be approved except in very unusual and compelling circumstances.

A corporation that elects to be an S corporation and requests to adopt, retain, or change its tax year must file **Form 2553, Election by a Small Business Corporation**. The form must be filed when the election request is made. (In certain cases, an extension of time can be granted for filing Form 2553.) The user fee is not due with the form. The IRS will notify you when the fee is due. See *User Fees*, earlier.

For more information on these tax year requirements, see Revenue Procedure 87-32 and Revenue Ruling 87-57 in Cumulative Bulletin 1987-2.

Corporations

A new corporation establishes its tax year when it files its first tax return. A newly reactivated corporation that has been inactive for a number of years is treated as a new taxpayer for the purpose of adopting a tax year. An S corporation or a personal service corporation must use the required tax year rules, discussed earlier, to establish a tax year.

Change in Tax Year

A corporation can change its tax year under section 1.442-1(c) of the regulations without getting IRS approval if all the following conditions are met.

- 1) It must not have changed its tax year within the 10 calendar years ending with the calendar year in which the short tax year resulting from the change begins.
- 2) Its short tax year must not be a tax year in which it has a net operating loss.
- 3) Its taxable income for the short tax year, if figured on an annual basis (annualized), is 80% or more of its taxable income for the tax year before the short tax year.
- 4) If a corporation is one of the following for **either** the short tax year or the tax year before the short tax year, it must have the same status for **both** the short tax year and the prior tax year.
 - a) Personal holding company.
 - b) Exempt organization.
 - c) Foreign corporation not engaged in a trade or business within the United States.
- 5) It must not apply to become an S corporation for the tax year that would immediately follow the short tax year required to effect the change.

Statement.

The corporation must file a statement with the IRS office where it files its tax return. The statement must be filed by the due date (including extensions) for the short tax year required by the change. It must indicate the corporation is changing its annual accounting period under section 1.442-1(c) of the regulations and show that all the preceding conditions have been met. If, on examination, the corporation does not meet all the conditions because of later adjustments in establishing tax liability, the statement will still be considered a timely application to

change the corporation's annual accounting period to the tax year indicated in the statement.

Automatic approval. Certain C corporations can automatically change their tax year. The corporation must, however, meet all the following criteria.

- 1) It cannot meet the five conditions listed earlier under *Change in Tax Year*.
- 2) It has not changed its annual accounting period within 6 calendar years (or in any of the calendar years of existence, if less than 6 years) ending with the calendar year that includes the beginning of the short period required to effect the tax year change. For a list of changes **not** considered a change in accounting period, see Revenue Procedure 2000-11 in Internal Revenue Bulletin 2000-3.
- 3) It is not any of the following:
 - a) A member of a partnership. See *Caution* later.
 - b) A beneficiary of a trust or an estate. See *Caution* later.
 - c) An S corporation (and does not attempt to make an S corporation election for the tax year immediately following the short period unless changing to a permitted tax year).
 - d) A personal service corporation.
 - e) An interest-charge domestic international sales corporation (DISC) or foreign sales corporation (FSC) or a shareholder in either. See *Caution* later.
 - f) A controlled foreign corporation or foreign personal holding company, or a minority shareholder in either. See *Caution* later.
 - g) A tax-exempt organization, except those exempt under section 521, 526, 527, or 528.
 - h) Certain passive foreign investment companies (PFICs) and their shareholders making an election under section 1295.
 - i) A cooperative association with a loss in the short period required to effect the tax year change unless more than 90% of the patrons of the association are the same in the year before, of and after the change.
 - j) A corporation with a section 936 election in effect.



For exceptions to 3 a, b, e, and f, see Revenue Procedure 2000-11.

Corporations that qualify and want to change their tax year using this automatic procedure must also comply with the following conditions.

- 1) The short period required to effect the tax year change must begin with the day following the close of the previous tax year and must end with the day preceding the first day of the new tax year.

- 2) The corporation must file a tax return for the short period by the due date, including extensions.
- 3) The books of the corporation must be closed as of the last day of the new tax year. Returns for later years must be made on the basis of a full 12 months (or 52-53 weeks) ending on the last day of the new tax year. The corporation must figure its income and keep its books and records, including financial reports and statements for credit purposes, on the basis of the new tax year.
- 4) Taxable income of the corporation for the short period must be figured on an annual basis (except for a real estate investment trust or a regulated investment company) and the tax must be figured as shown under *Figuring Tax for Short Year*, earlier.
- 5) If the corporation has a net operating loss (NOL) in the short period required to effect the change, the NOL generally cannot be carried back. However, a short period NOL can be carried back or forward if it:
 - a) Is \$50,000 or less.
 - b) Results from a short period of 9 or more months and is less than the NOL for a full 12-month period beginning with the first day of the short period.
- 6) If there is any unused credit for the short period, the corporation must carry the unused credit(s) forward. Unused credit(s) cannot be carried back.

See Revenue Procedure 2000-11 for more information.

Form 1128. To make this change, a corporation must file Form 1128 with the director of the Internal Revenue Service Center where it files its income tax return. It should mark the envelope "Attention: ENTITY CONTROL." The form must be filed by the due date (including extensions) of the short period return required for the change. It should type or print "FILED UNDER REV. PROC. 2000-11" at the top of Form 1128. If the request is denied, the service center will return Form 1128 with an explanation of the denial.

The request will be denied if Form 1128 is not filed on time or if the corporation fails to meet the requirements listed earlier. If a corporation changes its tax year without first meeting all the conditions, the tax year is considered changed without IRS approval.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item.

You choose an accounting method when you file your first tax return. If you later want to change your accounting method, you must get IRS approval. See *Change in Accounting Method*, later.

No single accounting method is required of all taxpayers. You must use a system that clearly shows your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same accounting method from year to year. An accounting method clearly shows income only if all items of gross income and expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, does.

Methods you can use. Subject to the preceding rules, you can compute your taxable income under any of the following accounting methods.

- 1) Cash method.
- 2) Accrual method.
- 3) Special methods of accounting for certain items of income and expenses.
- 4) Combination (hybrid) method using elements of two or more of the above.

The cash and accrual methods of accounting are explained later.

Special methods. This publication does not discuss special methods of accounting for certain items of income or expenses. For information on reporting income using one of the long-term contract methods, see section 460 and its regulations. Publication 535, *Business Expenses*, discusses methods for deducting amortization and depletion. The following publications also discuss special methods of reporting income or expenses.

- 1) Publication 225, *Farmer's Tax Guide*.
- 2) Publication 537, *Installment Sales*.
- 3) Publication 946, *How To Depreciate Property*.

Combination (hybrid) method. Generally, you can use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply.

- 1) If an inventory is necessary to account for your income, you must use an accrual method for purchases and sales. See, however, *Cash Method of Accounting for Qualifying Taxpayers*, later. You can use the cash method for all other items of income and expenses. See *Inventories*, later.
- 2) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
- 3) If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.
- 4) Any combination that includes the cash method is treated as the cash method.

Business and personal items. You can account for business and personal items using different accounting methods. For example, you can figure your business income under an accrual method, even if you use the cash method to figure personal items.

Two or more businesses. If you operate two or more separate and distinct businesses, you can use a different accounting method for each. No business is separate and distinct, however, unless a complete and separate set of books and records is maintained for the business.

If you use different accounting methods to create or shift profits or losses between businesses (for example, through inventory adjustments, sales, purchases, or expenses) so that income is not clearly reflected, the businesses will not be considered separate and distinct.

Cash Method

Most individuals and many small businesses use the cash method of accounting. Generally, however, if you produce, purchase, or sell merchandise, you must keep an inventory and use an accrual method for sales and purchases of merchandise. See *Cash Method of Accounting for Qualifying Taxpayers*, later, for an exception to this rule.

Income

Under the cash method, you include in your gross income all items of income you actually or constructively receive during the tax year. If you receive property and services, you must include their fair market value in income.

Constructive receipt. Income is constructively received when an amount is credited to your account or made available to you without restriction. You need not have possession of it. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations.

Example 1. Interest is credited to your bank account in December 2001, but you do not withdraw it or enter it into your passbook until 2002. You must include the amount in gross income for 2001, not 2002.

Example 2. You have interest coupons that mature and become payable in 2001, but you do not cash them until 2002. You must include the interest in gross income for 2001, the year of constructive receipt. You must include the interest in your 2001 income, even if you later exchange the coupons for other property, instead of cashing them.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

Expenses

Under the cash method, you generally deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance or you may be required to capitalize certain costs, as explained later under *Uniform Capitalization Rules*.

Expense paid in advance. An expense you pay in advance can be deducted only in the year to which it applies.

Example. You are a calendar year taxpayer and you pay \$1,000 in 2001 for a business insurance policy that is effective for one year, beginning July 1st. You can deduct \$500 in 2001 and \$500 in 2002.

Excluded Entities

The following entities cannot use the cash method, including any combination of methods that includes the cash method.

- 1) A corporation (other than an S corporation) with average annual gross receipts exceeding \$5 million.
- 2) A partnership with a corporation (other than an S corporation) as a partner, and with the partnership having average annual gross receipts exceeding \$5 million.
- 3) A tax shelter.

Exceptions

The following entities can use the cash method of accounting.

- 1) A family farming corporation with gross receipts of \$25 million or less for each prior tax year beginning after 1985.
- 2) A qualified personal service corporation.

See Publication 225 for more information on family farming corporations.

Gross receipts test. Any corporation or partnership, other than a tax shelter, that meets the gross receipts test for all tax years after 1985 can use the cash method. A corporation or a partnership meets the test if its average annual gross receipts are \$5 million or less for the 3 tax years ending with the prior tax year (or the period of existence, if shorter). Generally, a partnership applies the test at the partnership level. Gross receipts for a short tax year are annualized.

Aggregation rules. Organizations that are members of an affiliated service group or a controlled group of corporations treated as a single employer for tax purposes are required to aggregate their gross receipts to determine whether the gross receipts test is met.

Qualified personal service corporation. A personal service corporation that meets the following function and ownership tests can use the cash method.

Function test. A corporation meets the function test if at least 95% of its activities are in

the performance of services in the fields of health, veterinary services, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.

Ownership test. A corporation meets the ownership test if at least 95% of its stock is owned, directly or indirectly, at all times during the year by one of the following.

- 1) Employees performing services for the corporation in a field qualifying under the function test.
- 2) Retired employees who had performed services in those fields.
- 3) The estate of an employee described in (1) or (2).
- 4) Any other person who acquired the stock by reason of the death of an employee referred to in (1) or (2), but only for the 2-year period beginning on the date of death.

Indirect ownership is generally taken into account if the stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Stock owned by one of these entities is considered owned by the entity's owners in proportion to their ownership interest in that entity. Other forms of indirect stock ownership, such as stock owned by family members, are generally not considered when determining if the ownership test is met.

For purposes of the ownership test, a person is not considered an employee of a corporation unless that person performs more than minimal services for the corporation.

Change to accrual method. A corporation that fails to meet the function test for any tax year or fails to meet the ownership test at any time during any tax year must change to an accrual method of accounting, effective for the year in which the corporation fails to meet either test. A corporation that fails to meet the function test or the ownership test is not treated as a qualified personal service corporation for any part of that tax year.

Cash Method of Accounting for Qualifying Taxpayers

Generally, if you produce, purchase, or sell merchandise in your business, you must keep an inventory and use the accrual method for purchases and sales of merchandise. For tax years ending on or after December 17, 1999, qualifying taxpayers can use the cash method of accounting, even if they produce, purchase, or sell merchandise. Qualifying taxpayers can also choose to not keep an inventory, even if they do not change to the cash method.

Qualifying taxpayers. You are a qualifying taxpayer only if you meet the gross receipts test for each tax year ending after December 16, 1998. To qualify, your average annual gross receipts must be \$1,000,000 or less for the 3 tax years ending with the prior tax year. For example, you must test 1998 and 1999 to see if you qualify to use the cash method and not keep an inventory for 2000. You qualify if your average annual gross receipts for 1996, 1997, and 1998 are \$1,000,000 or less (1998 test) and your

average annual gross receipts for 1997, 1998, and 1999 are \$1,000,000 or less (1999 test). A tax shelter cannot be a qualifying taxpayer.

If you did not own your business for all of the 3-tax-year period, include the period of any predecessor. If your business has not been in existence for 3 tax years, base your average on the period it has existed including any short tax years, annualizing the short tax year's gross receipts.

Not keeping an inventory. If you choose to not keep an inventory, you will deduct the cost of the items you would otherwise include in inventory in the year you sell the items, or the year you pay for them, whichever is later. If you are a producer, you can use any reasonable method to estimate the raw material in your work in process and finished goods on hand at the end of the year to determine the raw material used to produce finished goods that were sold during the year.

Changing methods. If you qualify and want to change to the cash method, you must file Form 3115, *Application for Change in Accounting Method*. You must follow the provisions in Revenue Procedure 99-49 in Cumulative Bulletin 1999-2, as modified by Revenue Procedure 2001-10, for an automatic change in accounting method. Those provisions also apply if you no longer want to keep inventories. You may file one Form 3115 if you choose to make both changes.

More information. For more information, see Revenue Procedure 2001-10 in Internal Revenue Bulletin 2001-2.

Accrual Method

Under an accrual method of accounting, you generally report income in the year earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

Income

You generally include an amount as gross income for the tax year in which all events that fix your right to receive the income have occurred and you can determine the amount with reasonable accuracy.

Example. You are a calendar year, accrual basis taxpayer. You sold a computer on December 28, 2000. You billed the customer in the first week of January 2001, but did not receive payment until February 2001. You include the amount received in February for the computer in your 2000 income.

Estimated income. If you include a reasonably estimated amount in gross income and later determine the exact amount is different, take the difference into account in the tax year you make that determination.

Change in payment schedule. If you perform services for a basic rate specified in a contract, you must accrue the income at the basic rate, even if you agree to receive payments at a reduced rate. Continue this procedure until you

complete the services, then account for the difference.

Accounts receivable for services. You may not have to accrue your accounts receivable that, based on your experience, you will not collect. The *nonaccrual-experience method* is explained in section 1.448-2T of the regulations.

Advance Payment for Services

Generally, you report an advance payment for services to be performed in a later tax year as income in the year you receive the payment. However, if you receive an advance payment for services you agree to perform by the end of the next tax year, you can elect to postpone including the advance payment in income until the next tax year. However, you cannot postpone including any payment beyond that tax year.

Service agreement. You can postpone reporting income from an advance payment you receive for a service agreement on property you sell, lease, build, install, or construct. This includes an agreement providing for incidental replacement of parts or materials. However, this applies only if you offer the property **without** a service agreement in the normal course of business.

Postponement not allowed You generally cannot postpone including an advance payment in income for services if either of the following applies.

- 1) You are to perform any part of the service after the end of the tax year immediately following the year you receive the advance payment.
- 2) You are to perform any part of the service at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payment.

Examples. In each of the following examples, assume you use the calendar year and an accrual method of accounting.

Example 1. You manufacture, sell, and service computers. You received payment in 2001 for a one-year contingent service contract on a computer you sold. You can postpone including in income the part of the payment you did not earn in 2001 if, in the normal course of your business, you offer computers for sale without a contingent service contract.

Example 2. You are in the television repair business. You received payments in 2001 for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets manufactured and sold by unrelated parties. You include the payments in gross income as you earn them.

In *Examples 3 and 4*, if you do not perform part of the services by the end of the following tax year (2002), you must still include advance payments for the unperformed services in gross income for 2002.

Example 3. You own a dance studio. On November 2, 2001, you receive payment for a

one-year contract for 48 one-hour lessons beginning on that date. You give eight lessons in 2001. Under this method of including advance payments, you must include one-sixth (8/48) of the payment in income for 2001, and five-sixths (40/48) of the payment in 2002, even if you cannot give all the lessons by the end of 2002.

Example 4. Assume the same facts as *Example 3*, except the payment is for a two-year contract for 96 lessons. You must include the entire payment in income in 2001 since part of the services may be performed **after** the following year.

Guarantee or warranty. You generally cannot postpone reporting income you receive for a guarantee or warranty contract.

Prepaid rent or interest. You cannot postpone reporting income from prepaid rent or interest. Prepaid rent does not include payment for the use of a room or other space when significant service is also provided for the occupant. You provide significant service when you supply space in a hotel, boarding house, tourist home, motor court, motel, or apartment house that furnishes hotel service.

Books and records. Any advance payment you include in gross receipts on your tax return for the year you receive payment must not be less than the payment you include in gross receipts for your books and records and all your reports. This includes reports (including consolidated financial statements) to shareholders, partners, other proprietors or beneficiaries, and for credit purposes.

IRS approval. You must get IRS approval, as discussed later under *Change in Accounting Method*, to change to this method of accounting.

Advance Payment For Sales

Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods held primarily for sale to customers in the ordinary course of your trade or business. However, the rules do not apply to a payment (or part of a payment) for services that are not an integral part of the main activities covered under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts due and payable are considered received.

How to report payments. You generally include an advance payment in income in the year in which you receive it. However, you can use the alternative method, discussed next.

Alternative method of reporting. Under the alternative method, you generally include an advance payment in income in the **earlier** tax year in which:

- 1) You include advance payments in gross receipts under the method of accounting you use for tax purposes, or
- 2) You include any part of advance payments in income for financial reports under the method of accounting used for those reports. Financial reports include reports to shareholders, partners, beneficiaries, and other proprietors for credit purposes and consolidated financial statements.

Example 1. You are a retailer. You use an accrual method of accounting and you account for the sale of goods when you ship the goods. You use this method for both tax and financial reporting purposes. You can include advance payments in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods. However, see *Exception for inventory goods*, later.

Example 2. You are a calendar year taxpayer. You manufacture household furniture and use an accrual method of accounting. Under this method, you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In 2001, you received an advance payment of \$8,000 for an order of furniture to be manufactured for a total price of \$20,000. You shipped the furniture to the customer in December 2001, but it was not delivered and accepted until January 2002. For tax purposes, you include the \$8,000 advance payment in gross income for 2001 and you include the remaining \$12,000 of the contract price in gross income for 2002.

Information schedule. If you use the alternative method of reporting advance payments, you must attach a statement with the following information to your tax return each year.

- 1) Total advance payments received in the current tax year.
- 2) Total advance payments received in earlier tax years and not included in income before the current tax year.
- 3) Total payments received in earlier tax years included in income for the current tax year.

Exception for inventory goods. If you have an agreement to sell goods properly included in inventory, you can postpone including the advance payment in income until the end of the second tax year following the year you receive an advance payment if, on the last day of the tax year you meet the following requirements.

- 1) You account for the advance payment under the alternative method.
- 2) You have received a substantial advance payment on the agreement (discussed later).
- 3) You have enough substantially similar goods on hand, or available through your normal source of supply, to satisfy the agreement.

These rules also apply to an agreement, such as a gift certificate, that can be satisfied with goods that cannot be identified in the tax year you receive an advance payment.

If you meet these conditions, all advance payments you receive by the end of the second tax year, including payments received the prior years but not reported, must be included in income by the second tax year **following** the tax year of receipt of substantial advance payments. You must also deduct in that second year all actual or estimated costs for the goods required to satisfy the agreement. If you estimate the cost, you must take any difference between the

estimate and the actual cost into account when the goods are delivered.

You must report any advance payments you receive after the second year in the year received. No further deferral is allowed.

Substantial advance payments. Under an agreement for a future sale, you have substantial advance payments if, by the end of the tax year, the total advance payments received during that year and preceding tax years are equal to or more than the total costs reasonably estimated to be includible in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In 1998, you entered into a contract for the sale of goods properly includible in your inventory. The total contract price is \$50,000 and you estimate that your total inventoriable costs for the goods will be \$25,000. You receive the following advance payments under the contract.

| | |
|-----------------------------|-----------------|
| 1998 | \$17,500 |
| 1999 | 10,000 |
| 2000 | 7,500 |
| 2001 | 5,000 |
| 2002 | 5,000 |
| 2003 | 5,000 |
| Total contract price | \$50,000 |

Your customer asked you to deliver the goods in 2004. In your 1999 closing inventory, you had on hand enough of the type of goods specified in the contract to satisfy the contract. Since the advance payments you had received by the end of 1999 were more than the costs you estimated, the payments are substantial advance payments.

Include all payments you receive by the end of 2001, the second tax year following the tax year in which you received substantial advance payments, in income for 2001. You must include \$40,000 in sales for 2001 and include in inventory the cost of the goods (or similar goods) on hand. If no such goods are on hand, then estimate the cost necessary to satisfy the contract.

No further deferral is allowed. You must include in gross income the advance payment you receive each remaining year of the contract. Take into account the difference between any estimated cost of goods sold and the actual cost when you deliver the goods in 2004.

IRS approval. You must file Form 3115 to get IRS approval to change your method of accounting for advance payments for sales.

Expenses

Under an accrual method of accounting, you generally deduct or capitalize a business expense when both the following apply.

- 1) The all-events has been met. The test is met when:
 - a) All events have occurred that fix the fact of liability, and
 - b) The liability can be determined with reasonable accuracy.
- 2) Economic performance has occurred.

Economic Performance

You generally cannot deduct or capitalize a business expense until economic performance occurs. If your expense is for property or services provided to you, or for your use of property, economic performance occurs as the property or services are provided or the property is used. If your expense is for property or services you provide to others, economic performance occurs as you provide the property or services.

Example. You are a calendar year taxpayer. You buy office supplies in December 2001. You receive the supplies and the bill in December, but you pay the bill in January 2002. You can deduct the expense in 2001 because all events have occurred to fix the fact of liability, the liability can be determined, and economic performance occurred in 2001.

Your office supplies may qualify as a recurring expense, discussed later. If so, you can deduct them in 2001, even if the supplies are not delivered until 2002 (when economic performance occurs).

Workers' compensation and tort liability. If you are required to make payments under workers' compensation laws or in satisfaction of any tort liability, economic performance occurs as you make the payments. If you are required to make payments to a special designated settlement fund established by court order for a tort liability, economic performance occurs as you make the payments.

Taxes. Economic performance generally occurs as estimated income tax, property taxes, employment taxes, etc. are paid. However, you can elect to treat taxes as a recurring item, discussed later. You can also elect to ratably accrue real estate taxes. See chapter 6 of Publication 535 for information about real estate taxes.

Interest. Economic performance occurs with the passage of time (as the borrower uses, and the lender forgoes use of, the lender's money) rather than as payments are made.

Compensation for services. Generally, economic performance occurs as an employee renders service to the employer. However, deductions for compensation or other benefits paid to an employee in a year subsequent to economic performance are subject to the rules governing deferred compensation, deferred benefits, and funded welfare benefit plans. For information on employee benefit programs, see Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.

Vacation pay. You can take a current deduction for vacation pay earned by your employees if you pay it during the year or, if the amount is vested, within 2½ months after the end of the year. If you pay it later than this, you must deduct it in the year actually paid.

Exception for recurring items. An exception to the economic performance rule allows certain recurring items to be treated as incurred during the tax year even though economic performance has not occurred. The exception applies if all the following requirements are met.

- 1) The all-events test, discussed earlier, is met.
- 2) Economic performance occurs by the earlier of the following dates.
 - a) 8½ months after the close of the year.
 - b) The date you file a timely return (including extensions) for the year.
- 3) The item is recurring in nature and you consistently treat similar items as incurred in the tax year in which the all-events test is met.
- 4) Either:
 - a) The item is not material, or
 - b) Accruing the item in the year in which the all-events test is met results in a better match against income than accruing the item in the year of economic performance.

This exception does not apply to workers' compensation or tort liabilities.

Amended return. You may be able to file an amended return and treat a liability as incurred under the recurring item exception. You can do so if economic performance for the liability occurs after you file your tax return for the year, but within 8½ months after the close of the tax year.

Recurrence and consistency. To determine whether an item is recurring and consistently reported, consider the frequency with which the item and similar items are incurred (or expected to be incurred) and how you report these items for tax purposes. A new expense or an expense not incurred every year can be treated as recurring if it is reasonable to expect that it will be incurred regularly in the future.

Materiality. Factors to consider in determining the materiality of a recurring item include the size of the item (both in absolute terms and in relation to your income and other expenses) and the treatment of the item on your financial statements.

An item considered material for financial statement purposes is also considered material for tax purposes. However, in certain situations an immaterial item for financial accounting purposes is treated as material for purposes of economic performance.

Matching expenses with income. To determine whether the accrual of an expense in a particular year results in a better match with the income to which it relates, generally accepted accounting principles are an important factor. Costs directly associated with the revenue of a period are properly allocable to that period.

For example, a sales commission agreement can require certain payments to be made in a year subsequent to the year sales income is reported. In this situation, economic performance for part of the commission expense may not occur until the following year. Nevertheless, deducting the commission expense in the year the sales income is reported will result in a better match of the commission expense with the sales income. Also, if sales income is recognized in the year of sale, but the goods are not shipped

until the following year, the shipping costs are more properly matched to income in the year of sale than the year the goods are shipped.

Expenses such as insurance or rent are generally allocable to a period of time. If you are a calendar year taxpayer and enter into a 12-month insurance contract on July 1, of year 1, allocate half of your expense to year 1 and half to year 2. Expenses that cannot be practically associated with income of a particular period, such as advertising costs, should be assigned to the period the costs are incurred. The matching requirement is satisfied if the period to which the expenses are assigned is the same for tax and financial reporting purposes.

Related Persons

Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible **until** you make the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied, the rule will continue to apply even if your relationship with the person ends before the expense or interest is includible in the gross income of that person.

Related persons. For purposes of this rule, the following persons are related.

- 1) Members of a family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
- 2) Two corporations that are members of the same controlled group as defined in section 267(f).
- 3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 4) A tax-exempt educational or charitable organization and a person (if an individual, including the members of the individual's family) who directly or indirectly controls such an organization.
- 5) An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
- 6) A fiduciary of a trust and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- 7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- 8) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 10) A corporation and a partnership if the same persons own more than 50% in

value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.

- 11) A personal service corporation and any employee-owner, regardless of the amount of stock owned by the employee-owner.

Ownership of stock. To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

- 1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) An individual is treated as owning the stock owned directly or indirectly by or for the individual's family (as defined in item (1) under *Related persons*).
- 3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.
- 4) To apply rule (1), (2), or (3), stock constructively owned by a person under rule (1) is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) is not treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Contested Liability

If you use an accrual method of accounting and contest an asserted liability, you can deduct the liability either in the year you pay it (or transfer money or other property in satisfaction of it) or in the year you finally settle the contest. However, to take the deduction in the year of payment or transfer, you must meet certain conditions.

Conditions to be met. You must satisfy each of the following conditions to take the deduction in the year of payment or transfer.

Liability must be contested. You do not have to start a suit in a court of law to contest an asserted liability. However, you must deny its validity or accuracy by a positive act. A written protest included with payment of an asserted liability is enough to start a contest. Lodging a protest in accordance with local law is also enough to contest an asserted liability for taxes. You do not have to deny the validity or accuracy of an asserted liability in writing if you can show by all the facts and circumstances that you have asserted and contested the liability.

Contest must exist. The contest for the asserted liability must exist after the time of the transfer. If you make payment after the contest

is settled, you must accrue the liability in the year in which the contest is settled.

Example. You are a calendar year taxpayer using an accrual method of accounting. You had a \$500 liability asserted against you in 1998 for repair work completed that year. You contested the asserted liability and settled in 2000 for the full \$500. You pay the \$500 in January 2001. Since you did not make the payment until after the contest was settled, the liability accrues in 2000 and you can deduct it only in 2000.

Transfer to creditor. You must transfer to the creditor or other person enough money or other property to cover the payment of the asserted liability. The money or other property transferred must be beyond your control. If you transfer it to an escrow agent, you have met this requirement if you give up all authority over the money or other property. However, buying a bond to guarantee payment of the asserted liability, making an entry on your books of account, or transferring funds to an account within your control will **not** meet this requirement.

Liability deductible. The liability must have been deductible in the year of payment, or in an earlier year when it would have accrued, if there had been no contest.

Economic performance rule satisfied. You generally cannot deduct contested liabilities until economic performance occurs. For workers' compensation or a tort liability, economic performance occurs as payments are made to the person. The payment or transfer of money or other property into escrow to contest an asserted liability is not a payment to the claimant that discharges the liability. This payment does not satisfy the economic performance test, discussed earlier.

Recovered amounts. An adjustment is usually necessary when you recover any part of a contested liability. This occurs when you deduct the liability in the year of payment and recover any part of it in a later tax year when the contest is settled. Include in gross income in the year of final settlement the part of the recovered amount that, when deducted, decreased your tax for any tax year.

Foreign taxes and taxes of U.S. possessions. The rule allowing the deduction of contested liabilities in the tax year of payment does not apply to the **deduction** for income, war profits, and excess profits taxes imposed by any foreign government or U.S. possession. This means that an accrual method taxpayer deducts these liabilities in the tax year in which the contested foreign tax or U.S. possession tax is finally determined.

Contested foreign taxes accrued for the **foreign tax credit** are not covered under this provision but relate back to and are credited in the tax year in which they would have been accrued had they not been contested.

Inventories

An inventory is necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If you must account for an inventory in your busi-

ness, you must use an accrual method of accounting for your purchases and sales. However, see *Cash Method of Accounting for Qualifying Taxpayers*, earlier. See also *Accrual Method*, earlier.

To figure taxable income, you must value your inventory at the beginning and end of each tax year. To determine the value, you need a method for **identifying** the items in your inventory and a method for **valuing** these items. See *Identifying Cost* and *Valuing Inventory*, later.

The rules for valuing inventory cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting principles for similar businesses and must clearly reflect income. Your inventory practices must be consistent from year to year.



The rules discussed here apply only if they do not conflict with the uniform capitalization rules of section 263A and the mark-to-market rules of section 475.

Items Included in Inventory

Your inventory should include all of the following.

- 1) Merchandise or stock in trade.
- 2) Raw materials.
- 3) Work in process.
- 4) Finished products.
- 5) Supplies that physically become a part of the item intended for sale.

Merchandise. Include the following merchandise in inventory.

- 1) Purchased merchandise if title has passed to you, even if the merchandise is in transit or you do not have physical possession for another reason.
- 2) Goods under contract for sale that you have not yet segregated and applied to the contract.
- 3) Goods out on consignment.
- 4) Goods held for sale in display rooms, merchandise mart rooms, or booths located away from your place of business.

C.O.D. mail sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Include the merchandise in your closing inventory until the buyer pays for it.

Containers. Containers such as kegs, bottles, and cases, regardless of whether they are on hand or returnable, should be included in inventory if title has not passed to the buyer of the contents. If title has passed to the buyer, exclude the containers from inventory. Under certain circumstances, some containers can be depreciated. See Publication 946.

Merchandise not included. Do not include the following merchandise in inventory.

- 1) Goods you have sold, but only if title has passed to the buyer.
- 2) Goods consigned to you.

- 3) Goods ordered for future delivery if you do not yet have title.

Assets. Do not include the following in inventory.

- 1) Land, buildings, and equipment used in your business.
- 2) Notes, accounts receivable, and similar assets.
- 3) Real estate held for sale by a real estate dealer in the ordinary course of business.
- 4) Supplies that do not physically become part of the item intended for sale.



Special rules apply to the cost of inventory or property imported from a related person. See the regulations under section 1059A.

Identifying Cost

You can use any of the following methods to identify the cost of items in inventory.

Specific Identification Method

Use the specific identification method when you can identify and match the actual cost to the items in inventory.

Use the FIFO or LIFO method, explained next, if:

- 1) You cannot specifically identify items with their costs.
- 2) The same type of goods are intermingled in your inventory and they cannot be identified with specific invoices.

FIFO Method

The FIFO (first-in first-out) method assumes the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of. The items in inventory at the end of the tax year are matched with the costs of similar items that you most recently purchased or produced.

LIFO Method

The LIFO (last-in first-out) method assumes the items of inventory you purchased or produced last are the first items you sold, consumed, or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

LIFO rules. The rules for using the LIFO method are very complex. Two are discussed briefly here. For more information on these and other LIFO rules, see sections 472 through 474 and the corresponding regulations.

Dollar-value method. Under the dollar-value method of pricing LIFO inventories, goods and products must be grouped into one or more pools (classes of items), depending on the kinds of goods or products in the inventories. See section 1.472-8 of the regulations.

Simplified dollar-value method. Under this method, you establish multiple inventory pools in general categories from appropriate government price indexes. You then use changes in the price index to estimate the annual change in price for inventory items in the pools.

An eligible small business (average annual gross receipts of \$5 million or less for the 3 preceding tax years) can elect the simplified dollar-value LIFO method.

For more information, see section 474. Taxpayers who cannot use the method under section 474 should see section 1.472-8(e)(3) of the regulations for a similar simplified dollar-value method.

Adopting LIFO method. File **Form 970, Application To Use LIFO Inventory Method**, or a statement with all the information required on Form 970 to adopt the LIFO method. You must file the form (or the statement) with your timely filed tax return for the year in which you first use LIFO.

Differences Between FIFO and LIFO

Each method produces different income results, depending on the trend of price levels at the time. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, the opposite will hold.

Valuing Inventory

The value of your inventory is a major factor in figuring your taxable income. The method you use to value the inventory is very important.

The following methods, described below, are those generally available for valuing inventory.

- Cost
- Lower of cost or market
- Retail

Goods that cannot be sold. These are goods you cannot sell at normal prices or they are unusable in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You should value these goods at their bona fide selling price minus direct cost of disposition, no matter which method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, you must value them on a reasonable basis, considering their usability and condition. Do not value them for less than scrap value. This method does not apply to goods accounted for under the LIFO method.

Cost Method

To properly value your inventory at cost, you must include all direct and indirect costs associated with it. The following rules apply.

- 1) For merchandise on hand at the beginning of the tax year, cost means the ending inventory price of the goods.
- 2) For merchandise purchased during the year, cost means the invoice price minus appropriate discounts plus transportation or other charges incurred in acquiring the goods. It can also include other costs that have to be capitalized under the uniform capitalization rules.
- 3) For merchandise produced during the year, cost means all direct and indirect costs that have to be capitalized under the uniform capitalization rules.

Discounts. A **trade discount** is a discount allowed regardless of when the payment is made. Generally, it is for volume or quantity purchases. You must reduce the cost of inventory by a trade (or quantity) discount.

A **cash discount** is a reduction in the invoice or purchase price for paying within a prescribed time period. You can choose either to deduct cash discounts or include them in income, but you must treat them consistently from year to year.

Lower of Cost or Market Method

Under the lower of cost or market method, compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value.

This method applies to the following.

- 1) Goods purchased and on hand.
- 2) The basic elements of cost (direct materials, direct labor, and certain indirect costs) of goods being manufactured and finished goods on hand.

This method does not apply to the following. They must be inventoried at cost.

- 1) Goods on hand or being manufactured for delivery at a fixed price on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer).
- 2) Goods accounted for under the LIFO method.

Example. Under the lower of cost or market method, the following items would be valued at \$600 in closing inventory.

| Item | Cost | Market | Lower |
|------------------------|--------------|--------------|--------------|
| R | \$300 | \$500 | \$300 |
| S | 200 | 100 | 100 |
| T | 450 | 200 | 200 |
| Total | \$950 | \$800 | \$600 |

You must value each item in the inventory separately. You cannot value the entire inventory at cost (\$950) and at market (\$800) and then use the lower of the two figures.

Market value. Under ordinary circumstances for normal goods, market value means the usual bid price on the date of inventory. This price is based on the volume of merchandise you usually buy. For example, if you buy items in small lots at \$10 an item and a competitor buys identical items in larger lots at \$8.50 an item, your

usual market price will be higher than your competitor's.

Lower than market. When you offer merchandise for sale at a price lower than market in the normal course of business, you can value the inventory at the lower price, minus the direct cost of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices that vary materially from the actual prices will not be accepted as reflecting the market.

No market exists. If no market exists, or if quotations are nominal because of an inactive market, you must use the best available evidence of fair market price on the date or dates nearest your inventory date. This evidence could include the following items.

- 1) Specific purchases or sales you or others made in reasonable volume and in good faith.
- 2) Compensation amounts paid for cancellation of contracts for purchase commitments.

Retail Method

Under the retail method, the total retail selling price of goods on hand at the end of the tax year in each department or of each class of goods is reduced to approximate cost by using an average markup expressed as a percentage of the total retail selling prices.

To figure the average markup, apply the following steps in order.

- 1) Add the total of the retail selling prices of the goods in the opening inventory and the retail selling prices of the goods you bought during the year (adjusted for all markups and markdowns).
- 2) Subtract from the total in (1) the cost of goods included in the opening inventory plus the cost of goods you bought during the year.
- 3) Divide the balance in (2) by the total selling price in (1).

Then figure the approximate cost in two steps.

- 1) Multiply the total retail selling price by the average markup percentage. The result is the markup in closing inventory.
- 2) Subtract the markup in (1) from the total retail selling price. The result is the approximate cost.

Closing inventory. The following example shows how to figure your closing inventory using the retail method.

Example. Your records show the following information on the last day of your tax year.

| Item | Cost | Retail Value |
|-----------------------------|----------|--------------|
| Opening inventory | \$52,000 | \$60,000 |
| Purchases | 53,000 | 78,500 |
| Sales | | 98,000 |
| Markups | | 2,000 |
| Markdowns | | 500 |

Using the retail method, figure your closing inventory as follows.

| Item | Cost | Retail Value |
|---|-----------|-----------------|
| Opening inventory | \$52,000 | \$60,000 |
| Plus: Purchases | 53,000 | 78,500 |
| Net markups | | 1,500 |
| (\$2,000 – \$500 markdowns) . . . | | |
| Total | \$105,000 | \$140,000 |
| Minus: Sales | | 98,000 |
| Closing inventory at retail | | \$42,000 |
| Minus: Markup* (.25 × \$42,000) | | 10,500 |
| Closing inventory at cost | | <u>\$31,500</u> |

* See **Markup percentage**, next, for an explanation of how the markup percentage (25%) was figured for this example.

Markup percentage. The markup (\$35,000) is the difference between cost (\$105,000) and the retail value (\$140,000). Divide the markup by the total retail value to get the markup percentage (25%). You cannot use arbitrary standard percentages of purchase markup to figure markup. You must figure it as accurately as possible from department records for the period covered by your tax return.

Markdowns. When figuring the retail selling price of goods on hand at the end of the year, markdowns are recognized only if the goods were offered to the public at the reduced price. Markdowns not based on an actual reduction of retail sales price, such as those based on depreciation and obsolescence, are not allowed.

Retail method with LIFO. If you use LIFO with the retail method, you must adjust your retail selling prices for markdowns as well as markups.

Price index. If you are using the retail method and LIFO, adjust the inventory value, determined using the retail method, at the end of the year to reflect price changes since the close of the preceding year. Generally, to make this adjustment, you must develop your own retail price index based on an analysis of your own data under a method acceptable to the IRS. However, a department store using LIFO that offers a full line of merchandise for sale can use an inventory price index provided by the Bureau of Labor Statistics. Other sellers can use this index if they can demonstrate the index is accurate, reliable, and suitable for their use. For more information, see Revenue Ruling 75–181, in Cumulative Bulletin 1975–1.

Retail method without LIFO. If you do not use LIFO and have been figuring your inventory under the retail method except that, to approximate the lower of cost or market, you have followed the consistent practice of adjusting the retail selling prices of goods for markups (but not markdowns), you can continue that practice. The adjustments must be bona fide, consistent, and uniform and you must also exclude markups made to cancel or correct markdowns. The markups you include must be reduced by markdowns made to cancel or correct the markups.

If you do not use LIFO and you previously figured inventories without eliminating markdowns in making adjustments to retail selling prices, you can continue this practice only if you first get IRS approval. You can adopt and use this practice on the first tax return you file for the business, subject to IRS approval on examination of your tax return.

Figuring income tax. Resellers who use the retail method of pricing inventories can figure their tax on that basis.

To use this method, you must do all the following.

- 1) State that you are using the retail method on your tax return.
- 2) Keep accurate records.
- 3) Use this method each year unless the IRS allows you to change to another method.

You must keep records for each separate department or class of goods carrying different percentages of gross profit. Purchase records should show the firm name, date of invoice, invoice cost, and retail selling price. You should also keep records of the respective departmental or class accumulation of all purchases, mark-downs, sales, stock, etc.

Perpetual or Book Inventory

You can figure the cost of goods on hand by either a perpetual or book inventory if inventory is kept by following sound accounting practices. Inventory accounts must be charged with the actual cost of goods purchased or produced and credited with the value of goods used, transferred, or sold. Credits must be figured on the basis of the actual cost of goods acquired during the year and their inventory value at the beginning of the tax year.

Physical inventory. You must take a physical inventory at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Loss of Inventory

You claim a casualty or theft loss of inventory, including items you hold for sale to customers, through the increase in the cost of goods sold by properly reporting your opening and closing inventories. You cannot claim the loss again as a casualty or theft loss. Any insurance or other reimbursement you receive for the loss is taxable.

You can choose to take the loss separately as a casualty or theft loss. If you take the loss separately, adjust opening inventory or purchases to eliminate the loss items and avoid counting the loss twice.

If you take the loss separately, reduce the loss by the reimbursement you receive or expect to receive. If you do not receive the reimbursement by the end of the year, you cannot claim a loss for any amounts you reasonably expect to recover.

Creditors or suppliers. If your creditors forgive part of what you owe them because of your inventory loss, this amount is treated as income and is taxable.

Disaster loss. If your inventory loss is due to a disaster in an area determined by the President of the United States to be eligible for federal assistance, you can choose to deduct the loss on your return for the immediately preceding year. However, you must also decrease your opening inventory for the year of the loss so the loss will not show up again in inventory.

Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of property you produce or acquire for resale, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.



Special uniform capitalization rules apply to a farming business. See chapter 7 in Publication 225.

Activities subject to the rules. You are subject to the uniform capitalization rules if you do any of the following, unless the property is produced for your use other than in a trade or business or an activity carried on for profit.

- 1) Produce real or tangible personal property.
- 2) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are \$10 million or less.

Producing property. You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under a contract is treated as produced by you to the extent you make payments or otherwise incur costs in connection with the property.

Tangible personal property. Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property containing words, ideas, concepts, images, or sounds. However, free-lance authors, photographers, and artists are exempt from the uniform capitalization rules if they qualify.

Exceptions. The uniform capitalization rules do not apply to:

- 1) Resellers of personal property with average annual gross receipts of \$10 million or less.
- 2) Property produced to use as personal or nonbusiness property or for uses not connected with a trade or business or an activity conducted for profit.
- 3) Research and experimental expenditures deductible under section 174.
- 4) Intangible drilling and development costs of oil and gas or geothermal wells or any amortization deduction allowable under section 59(e) for intangible drilling, development, or mining exploration expenditures.
- 5) Property produced under a long-term contract, except for certain home construction contracts described in section 460(e)(1).
- 6) Timber and certain ornamental trees raised, harvested, or grown, and the underlying land.
- 7) Qualified creative expenses incurred as a free-lance (self-employed) writer, photographer, or artist that are otherwise deductible on your tax return.

- 8) Costs allocable to natural gas acquired for resale to the extent these costs would otherwise be allocable to "cushion gas" stored underground.
- 9) Property produced if substantial construction occurred before March 1, 1986.
- 10) Property provided to customers in connection with providing services. It must be de minimus in amount and not be inventory in the hands of the service provider.
- 11) Loan origination.
- 12) The costs of certain producers who use a simplified production method and whose total indirect costs are \$200,000 or less. See section 1.263A-2(b)(3)(iv) of the regulations for more information.

Qualified creative expenses. Qualified creative expenses are expenses paid or incurred by a free-lance (self-employed) writer, photographer, or artist whose personal efforts create (or can reasonably be expected to create) certain properties. These expenses do not include expenses related to printing, photographic plates, motion picture films, video tapes, or similar items.

These individuals are defined as follows.

- 1) A writer is an individual who creates a literary manuscript, a musical composition (including any accompanying words), or a dance score.
- 2) A photographer is an individual who creates a photograph or photographic negative or transparency.
- 3) An artist is an individual who creates a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print item. The originality and uniqueness of the item created and the predominance of aesthetic value over utilitarian value of the item created are taken into account.

Personal service corporation. The exemption for writers, photographers, and artists also applies to an expense of a personal service corporation that directly relates to the activities of the qualified employee-owner. A "qualified employee-owner" is a writer, photographer, or artist who owns, with certain members of his or her family, substantially all the stock of the corporation.

Inventories. If you must adopt the uniform capitalization rules, revalue the items or costs included in beginning inventory for the year of change as if the capitalization rules had been in effect for all prior periods. When revaluing inventory costs, the capitalization rules apply to all inventory costs accumulated in prior periods. An adjustment is required under section 481(a). It is the difference between the original value of the inventory and the revalued inventory.

If you must capitalize costs for production and resale activities, you are required to make this change. If you make the change for the first tax year you are subject to the uniform capitalization rules, it is an automatic change of accounting method that does not need IRS approval. Otherwise, IRS approval is required to make the change.

More information. For information about the uniform capitalization rules, see the section 263A regulations.

Change in Accounting Method

You can generally choose any permitted accounting method when you file your first tax return. You do not need IRS approval to choose the initial method. You must, however, use the method consistently from year to year and it must clearly show your income. See *Accounting Methods*, earlier.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. A material item is one that affects the proper time for inclusion of income or allowance of a deduction. Although an accounting method can exist without treating an item consistently, an accounting method is not established for that item, in most cases, unless the item is treated consistently.

IRS Approval

Once you have set up your accounting method and filed your first return, you must get IRS approval to change the method. If your current method clearly shows your income, the IRS will weigh the need for consistency in reporting against the need for change.

If you do not request IRS approval to change an accounting method, the absence of IRS approval will not be accepted as a defense to any penalty.

Approval required. The following changes are examples of types of changes that require IRS approval.

- 1) A change from the cash method to an accrual method or vice versa.
- 2) A change in the method or basis used to value inventory.
- 3) A change in the method of figuring depreciation (except certain permitted changes to the straight-line method for property placed in service before 1981, as explained in Publication 534, *Depreciating Property Placed in Service Before 1987*).

Approval not required. The following are not changes in accounting methods and do not require IRS approval.

- 1) Correction of a math or posting error.
- 2) Correction of an error in figuring tax liability (such as an error in figuring a credit).
- 3) An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it.
- 4) An adjustment in the useful life of a depreciable asset.

Filing Form 3115

In general, you must file a current Form 3115 to request a change in either an overall accounting method or the accounting treatment of any item. Attach any required user fee. No user fee is required for an automatic change (discussed later).

You must file Form 3115 during the tax year for which the change is requested. You should file as early in the year as possible to give the IRS enough time to respond to the form before the original due date of the return for the year of change. If you do not file a Form 3115 during the year of change, an extension to file the form will be granted only in unusual and compelling circumstances.

The IRS normally acknowledges receipt of a completed Form 3115 within 30 days after the applicant's filing date. See the form instructions if you do not receive an acknowledgment. The IRS does not acknowledge receipt of Form 3115 for automatic change procedures.

Conference. If you think the IRS may give an unfavorable response to your request to change your accounting method, you can request a conference when you file Form 3115. The National Office will arrange one before the IRS formally replies to your Form 3115. If you do not specifically request a conference, the IRS presumes you do not want one.

More than one business. You can use different methods of accounting for separate and distinct businesses. However, if you request a change in accounting method for one of the businesses, the IRS will consider whether the change creates or shifts profits or losses between the businesses and whether the proposed method clearly reflects your income. You must identify each business by name and method of accounting.

Incomplete Form 3115. If your application is not properly completed according to the instructions for a current Form 3115, you will be notified and given 21 days from the date of the notification letter to furnish the necessary information. If you do not submit the required information within the reply period, the IRS will not process your Form 3115. However, the IRS can grant up to an additional 15 days to furnish the information. Your written request for the 15-day extension must be submitted within the 21-day period.

Taxpayers under examination. If the IRS has contacted you to schedule an examination of any of your returns, you can request approval to change your accounting method under section 6 of Revenue Procedure 97-27 (or any successor) if that method of accounting is not an issue under consideration. You can request to make the change only under the following circumstances.

- 1) During the first 90 days of any tax year if you have been under examination for at least 12 months.
- 2) During the 120-day period following the date an examination ends, regardless of whether a subsequent examination has begun.
- 3) With the permission of the IRS director for your area.

Revenue Procedure 97-27 is in Cumulative Bulletin 1997-2.

Automatic Change Procedures

These are procedures under which certain taxpayers can presume to have IRS approval to change their method of accounting. The approval is granted for the tax year for which the taxpayer requests a change (year of change), if the taxpayer complies with the provisions of the automatic change procedures. No user fee is required for an application filed under an automatic change procedure. Generally, you must use Form 3115 to request an automatic change. See the form instructions and Revenue Procedure 99-49, as modified, (or any successor), for more information. Revenue Procedure 99-49 is in Cumulative Bulletin 1999-2.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.


The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

 **Personal computer.** With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed*) to find answers to questions you may have.

- **Forms & Pubs** to download forms and publications or search for forms and publications by topic or keyword.
- **Fill-in Forms** (located under *Forms & Pubs*) to enter information while the form is displayed and then print the completed form.
- **Tax Info For You** to view Internal Revenue Bulletins published in the last few years.
- **Tax Regs in English** to search regulations and the Internal Revenue Code (under *United States Code (USC)*).
- **Digital Dispatch** and **IRS Local News Net** (both located under *Tax Info For Business*) to receive our electronic newsletters on hot tax issues and news.
- **Small Business and Self-Employed Community** to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](ftp://irs.gov).



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.



Phone. Many services are available by phone.

- **Ordering forms, instructions, and publications.** Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- **Asking tax questions.** Call the IRS with your tax questions at **1-800-829-1040**.
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.

- **TeleTax topics.** Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistant and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistants objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



Walk-in. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Also, some libraries and IRS offices have:

- An extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.
- The Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at www.irs.gov/cdorders. The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *The Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676** or visiting the IRS web site at www.irs.gov/prod/bus_info/sm_bus/smbus-cd.html.

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