



December 21, 2020

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Re: Notice of Proposed Rulemaking Regarding Small Business Taxpayer Exceptions under Sections 263A, 448, 460 and 471 – [REG – 132766-18]

Dear Ms. Glazman and Ms. Gleysteen:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to address the need for guidance related to the small business taxpayer accounting method exceptions under sections 263A, 448, 460, and 471.¹ The AICPA previously submitted [comments²](#) on July 15, 2019 and [comments³](#) on July 23, 2018, with respect to the impact of Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)) on accounting method changes for small business taxpayers. The AICPA also previously submitted [comments⁴](#) on February 13, 2019, on the definition of a syndicate under section 1256(e)(3)(C)(v), urging Treasury and the IRS to use their authority under section 1256(e)(3)(C)(v) to provide relief from the definition of syndicate to small business entities that meet certain conditions. Subsequently, on August 5, 2020, Treasury and the IRS issued notice of proposed rulemaking [REG – 132766-18] that update various tax accounting regulations to adopt the simplified tax accounting rules for small businesses enacted by the TCJA. This letter is in response to the proposed regulations.

Specifically, the AICPA recommends that Treasury and the IRS provide guidance on the following issues:

¹ Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

² <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190715-aicpa-comment-letter-small-taxpayer-methods.pdf> (July 15, 2019).

³ <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180723-aicpa-small-tp-accounting-methods.pdf> (July 23, 2018).

⁴ <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190213-aicpa-small-business-relief-from-definition-of-tax-shelter-letter.pdf> (February 13, 2019).

- I. Application of the gross receipts test
 - a. Definition of predecessor
 - b. Aggregation rules
- II. Procedural guidance with respect to changes in method of accounting
- III. Modify the definition of “tax shelter” for purposes of section 448 to exclude syndicates
- IV. Section 481(a) adjustments should not affect syndicate determination if syndicate rules apply to small business taxpayers
- V. Simplify accounting for inventory for small business taxpayers that apply exemptions under sections 263A and 471
 - a. Non-incidental materials and supplies
 - b. Non-incidental materials and supplies treatment for inventory under Rev. Proc. 2001-10 or Rev. Proc. 2002-28
 - c. Book-inventory conformity: Books and records of inventory
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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Connie Cunningham, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (310) 557-8544, or CCCunningham@bdo.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,



Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Mr. John Moriarty, Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Service
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury

AMERICAN INSTITUTE OF CPAs

Notice of Proposed Rulemaking Regarding Small Business Taxpayer Exceptions under Sections 263A, 448, 460 and 471 – [REG – 132766-18]

December 21, 2020

BACKGROUND

The proposed regulations (REG-132766-18) issued August 5, 2020, update various tax accounting regulations to adopt the simplified tax accounting rules for small businesses enacted by the TCJA.

The TCJA contains numerous simplifying provisions allowing small business taxpayers to streamline their tax accounting methods for years beginning after December 31, 2017. The TCJA defines a small business taxpayer as a taxpayer with average annual gross receipts in the prior three-year period of \$25 million or less. The threshold of \$25 million is a welcome change for many taxpayers, as previous simplifying provisions with respect to certain accounting methods were generally applicable to taxpayers with average annual gross receipts of \$1 million, \$5 million, or \$10 million or less.

For purposes of determining whether a taxpayer qualifies as a small business taxpayer, the TCJA references the existing gross receipts test under section 448(c)(2) and increases the dollar threshold from \$5 million to \$25 million. Thus, the \$25 million gross receipts test is determined by averaging a taxpayer's gross receipts for the three prior taxable years. For example, if a taxpayer is assessing whether it may qualify for the simplifying provisions under the TCJA for its 2018 tax year, it would compute its average gross receipts using amounts from its 2015, 2016 and 2017 tax years (assuming no short taxable years and the taxpayer was in existence for the entire three-year period). If the average of the taxpayer's gross receipts from its 2015, 2016 and 2017 tax years does not exceed \$25 million, the taxpayer may apply the small business accounting method provisions under the TCJA for 2018. A qualifying small business taxpayer must then compute its prior three-year average gross receipts for each taxable year after 2018 to ensure that it may continue to utilize the simplifying provisions. If the taxpayer fails the \$25 million gross receipts test for a given taxable year, it may not apply any of the simplifying provisions for that taxable year.

For tax years beginning in 2019 and 2020, these simplified tax accounting rules apply for taxpayers with inflation-adjusted average annual gross receipts of \$26 million or less (known as the gross receipts test). Taxpayers classified as tax shelters are prohibited from using the simplified rules even if they meet the gross receipts test.

SPECIFIC COMMENTS

I. Application of the gross receipts test

a. Definition of predecessor

Overview

Proposed Reg. § 1.448-2(c) specifies that section 448 does not apply to any C corporation or partnership with a C corporation partner for any taxable year if such corporation or partnership (or any predecessor thereof) meets the gross receipts test. Temporary Reg. § 1.448-1T(f)(3) describes an example demonstrating the application of this rule in a context of requiring a newly formed corporation to take into account the gross receipts of the predecessor trade or business that was contributed in a transaction to which section 351 applies.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations that clarify the definition of the term “predecessor” in applying the gross receipts test. Specifically, the AICPA recommends using the definition of “predecessor” under the final bonus depreciation regulations for purposes of applying the section 448 gross receipts test.

Analysis

The proposed regulations do not define the term “predecessor,” nor provide examples explaining how the rule should be applied outside of incorporation of a trade or business in a section 351 transaction. For instance, it is unclear whether a newly-formed corporation as a result of a taxable asset acquisition must consider the predecessor entity’s (i.e., the entity that sold the assets and liabilities) gross receipts for purposes of applying the section 448 gross receipts test. Therefore, defining the term “predecessor” would reduce ambiguity. The final regulations should adopt the definition of predecessor used in the final bonus depreciation regulations in order to provide taxpayers with additional clarity. Under Treas. Reg. § 1.168(k)-2(a)(2)(iv), a predecessor includes: (i) a transferor of an asset to a transferee in a transaction to which section 381(a) applies; (ii) a transferor of an asset to a transferee in a transaction in which the transferee’s basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor; (iii) a partnership that is considered as continuing under section 708(b)(2); (iv) the decedent in the case of an asset acquired by an estate; or (v) a transferor of an asset to a trust.

b. Aggregation rules

Overview

Pursuant to the aggregation rules provided under Treas. Reg. § 1.448-1T(f)(2)(ii), all persons treated as a single employer under section 52(a) or (b), or section 414(m) or (o), shall be treated as one person for the gross receipts test. Section 52(a) further references the controlled group rules under section 1563(a). Under section 1563(b)(2)(C), a foreign corporation subject to section 881

is generally excluded from the definition of a "component member" of a controlled group of corporations.

Recommendation

The AICPA recommends that Treasury and the IRS clarify the application of the aggregation rules to exclude foreign corporations subject to tax under section 881 from the aggregation rules.

Analysis

The proposed section 448 regulations do not explicitly state whether the exclusion of foreign corporations under section 1563(b)(2)(C) are to apply in the context of the section 448 aggregation rules.⁵ Therefore, a foreign corporation does not appear to be excluded from a controlled group of corporations for purposes of applying the gross receipts test. Many small United States (U.S.) corporations that generate less than \$26 million in average annual gross receipts, owned by a foreign parent, may not realize that they must consider their foreign parent's gross receipts in the application of the test. Accordingly, for purposes of applying the gross receipts test under section 448, taxpayers should take into account the component member rules of section 1563(b), such that gross receipts of foreign corporations subject to tax under section 881 would be excluded from the aggregation rules which would reduce controversy and provide additional administrative simplicity.

II. Procedural guidance with respect to changes in method of accounting

Overview

Automatic accounting method changes are needed for former small business taxpayers to adopt other permissible methods of accounting with waiver of the 5-year eligibility rules under Rev. Proc. 2015-13.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations clarifying the application of the gross receipts test by stating that in general, taxpayers satisfying the gross receipts test under section 448(c) may use the overall cash method.

The AICPA also recommends that, for a small taxpayer meeting the gross receipts test under section 448(c), the IRS waive the 5-year eligibility rules to file an accounting method change to either adopt or change a small taxpayer accounting method, including designated automatic accounting method change numbers (DCNs) 233, 234, 235 and 236. In addition, the IRS should provide similar eligibility waivers for former small business taxpayers to adopt permissible methods of accounting including the accrual method, section 471, and section 263A.

⁵ As of note there are other provisions that do explicitly address the inclusion/exclusion of foreign corporations. For example, controlled groups for research and development, or the section 414 regulations.

Finally, the AICPA recommends clarifying section 15.18(1) of Rev. Proc. 2019-43 to allow eligible small business taxpayers to change to the cash method even if inventory is an income-producing factor.

Analysis

The eligibility rule waiver should apply for any change due to ineligibility as a small business taxpayer. At a minimum, such waiver should apply for the first two years following a change from a taxpayer eligible for the small business taxpayer methods to an ineligible taxpayer. In the context of smaller businesses, the change eligibility for these methods is often not identified by small business taxpayers in the first year and permitting such taxpayers to change on an automatic basis will limit the number of non-automatic method changes required by small businesses.

The eligibility rule waiver will provide small taxpayers the flexibility to file an automatic accounting method change when required to do so either for former syndicates or small taxpayers that become ineligible to apply the small business taxpayer methods due to gross receipts. Such automatic method change with a limited waiver of the 5-year eligibility rules already exists for cash to accrual (DCN 122). Similar changes with the waiver of eligibility limitations are recommended for sections 471 and 263A. To avoid abuse by taxpayers voluntarily and successively changing methods within the 5-year period, the waiver should only apply to situations for which a change in accounting method is required.

Many taxpayers have already adopted the small taxpayer methods. The guidance provided in the proposed regulations and future guidance may conflict with the positions initially taken by these taxpayers in applying these rules. Therefore, it is essential to provide a waiver of the 5-year eligibility rule to change the small business taxpayer methods to adopt the final regulations. In addition, since small business taxpayers often are less sophisticated in tax matters, such waiver should apply to bring their small business taxpayer methods into compliance with final regulations going forward, not just during a transition period. The waiver will limit the cases when a small business taxpayer is burdened by a significant user fee and compliance costs, as discussed above. The waiver is also necessary, for example, in the case of a small taxpayer relying on the Applicable Financial Statement (AFS) or non-AFS method that undergoes a change in book inventory accounting.

Small taxpayers should also be given the ability to readopt a small taxpayer method if they were previously required to change from their desired method of accounting due to change in eligibility.

Example:

Taxpayer qualifies as a small business in 2018 and changes to the cash method and small taxpayer methods under sections 471 and 263A. In 2020, due to unexpected losses related to the pandemic or an unusually large number of gross receipts, the taxpayer no longer qualifies and must revert to the accrual method; however, if the taxpayer subsequently meets the gross receipt test, it would not be eligible to change back to the cash method and other small business taxpayer methods with an automatic accounting method change until 2025, which is burdensome. The

taxpayer is essentially prohibited for 5 years from changing back to the small business taxpayer methods using an automatic accounting method change, even though the taxpayer is otherwise eligible to use the cash method under the TCJA. Small taxpayers may prefer to return to the cash method once they qualify rather than waiting a mandatory 5-year period.

In order to mitigate IRS concern of taxpayer abuse, taxpayers would likely be open to alternative terms and conditions. For example, it may be reasonable in such fact patterns to require netting of favorable and previous unfavorable section 481(a) adjustments or to require acceleration of any unamortized section 481(a) adjustments from prior changes to the year of change.

Minimizing the number of non-automatic changes would reduce the administrative burden for both small business taxpayers and the IRS. For example, the \$10,800 user fee imposed for a non-automatic change is often a cost prohibitive hurdle for small taxpayers. The user fee is often more costly than paying professional fees for general tax return preparation. Also, the taxpayer will incur additional tax preparation fees to prepare and represent the taxpayer to request the non-automatic method change. In addition, since the determination of whether the taxpayer will have a loss or income is not known until the accounting has been completed, this creates more difficulty related to filing and year-end tax planning. Likewise, many additional resources are required for the IRS to continue to review numerous non-automatic changes. Automatic changes would allow for administrative convenience and simplicity.

Section 15.18(1) of Rev. Proc. 2019-43 should also be updated to state that all taxpayers, with the exception of tax shelters, may change to the cash method of accounting if they satisfy the gross receipts test, even if the sale of inventory is an income-producing factor as eligibility of such taxpayers is presently unclear and updating the revenue procedure will provide additional guidance so that taxpayers are aware they are allowed more flexibility to change their methods of accounting.

III. Modify the definition of “tax shelter” for purposes of section 448 to exclude syndicates

Overview

Section 448(a)(3) provides that “in the case of a tax shelter, taxable income shall not be computed under the cash receipts and disbursements method of accounting.”

Section 461(i)(3) defines a tax shelter as “(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii)).”

Section 1256(e)(3)(B) defines a syndicate as “any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs.” An interest in an entity is not treated as held by a limited partner or a limited entrepreneur for any period if during such period such interest is held by an individual who actively participates at all times during such

period in the management of such entity.⁶ Subsequent clauses provide additional exceptions to the limited partner and limited entrepreneur status, including (v), authority for the Secretary to determine (by regulations or otherwise) that an interest should be treated as held by an individual who actively participates in the management of an entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations which provide an exemption for all taxpayers meeting the gross receipts test of section 448(c) from syndicate status solely for purposes of determining eligibility for the small business taxpayer accounting methods. Exercising authority under section 1256(e)(3)(C)(v), Treasury and the IRS should deem entity owners of a small business as a holding by an individual who actively participates in the management of the entity. The guidance should deem these small business entity owners as active participants in management and should deem tiered structures that meet the gross receipts test as active participants in management, considering aggregation and attribution of gross receipts.

The AICPA also recommends providing *de minimis* rules to prevent minor losses from requiring an accounting method change. Treasury could consider *de minimis* rules that would prevent the *per se* application of the syndicate rule for purposes of section 448 for taxpayers otherwise eligible for the small business taxpayer provisions. For example, the *de minimis* rules could include:

- An exception from the syndicate rule if the aggregate of ordinary income, gain, deduction and loss for every owner is a positive number;
- An exception from the syndication rule if the average aggregate of ordinary income, gain, deduction and loss for the last five years is a positive number;
- Rules to prevent minor amounts of loss from requiring an accounting method change;
- Exclude losses or deductions entirely or substantially limited by taxable income (e.g., long-term capital losses, section 179 deduction, foreign tax deduction) from determining if there is a loss for purpose of the syndicate rule;
- A presumption, similar to that in section 183, such that an entity with profits in three out of the prior five years would not be considered a syndicate; and
- A presumption that any entity would not be a syndicate if there has not been a change in ownership of more than 35%, other than to existing owners or related parties within the last taxable year.

Analysis

Congress granted Treasury the authority, in section 1256(e)(3)(C)(v), to address situations where tax-avoidance is not an issue as follows: “If the Secretary determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.”

⁶ Section 1256(e)(3)(C)(i).

For example, if during a taxable year, an S corporation has a loss and more than 35% of that loss is allocated to shareholders who are limited entrepreneurs, the S corporation will meet the definition of a syndicate under section 1256. If the S corporation is classified as a syndicate under section 1256, the S corporation will meet the definition of a tax shelter under section 461, and section 448. As a tax shelter, the S corporation will not be allowed to use the cash method and must change from the cash method the following year.⁷

Another example, under a literal reading of the statute, relates to an entity with a negative amount in ANY box of a Schedule K-1, which could trigger the initial application of this rule. A section 179 deduction of \$100 could be one of the “losses of such entity during the taxable year.” Assume an entity has \$1 million in ordinary income and a \$1,000 capital loss. There is no specific guidance outlining that taxpayers are allowed to net all items on an entity Schedule K in determining whether there is a loss for purposes of section 1256. Guidance would assist with determining if a “deduction” is the same as a “loss” within the meaning of this section. In addition, guidance would allow taxpayers to determine if the “loss” is deductible for purposes of this rule.

A net loss of a minor amount (e.g., \$1.00), in any one year in which more than 35% of the interests are held by a party(ies) not active in management will result in the loss of the cash method the following year. Moreover, if the pass-through entity is profitable, but has any loss that passes through to its owners, the partnership or S corporation appears to be within the definition of a tax shelter. There are no reasonable cause or extenuating circumstance exceptions.

The grant of authority to write regulations (or other guidance) interpreting section 1256(e) is an acknowledgment by Congress that additional guidance is needed in this area. In the almost 40 years that this statute has been law, Treasury has never exercised that authority. Treasury and the IRS should use the authority provided in section 1256(e)(3)(c)(v) to reduce the number of accounting method changes by businesses struggling to survive financially, and which have no other indicia of tax shelter status. This is especially applicable to businesses whose gross receipts are below the \$26 million threshold, which Congress sought to exclude from the mandatory accrual method as well as the business interest limitation of section 163(j). Treasury could provide the maximum relief while protecting the interests of the government. Congress intended for small businesses to benefit from simplifying methods, in essence acknowledging small businesses are too small to abuse the cash method.

All presumptions created by a legislative regulation could be subject to an anti-abuse rule if the government felt such protection was needed. Moreover, we do not suggest that the proposed safe harbors should apply to any entity that meets one of the other definitions of tax shelter, such as the entities described in section 6662(d)(2)(C).

In 1981, Congress enacted section 1256 in order to require annual reporting of regulated commodity futures contracts to be marked to market at the end of the tax year. Gain or loss resulting from the mark to market are capital gains or losses. There are also rules regarding mixed straddles, in which a person holds a position in a regulated commodity future and an offsetting position in other property.

⁷ Treas. Reg. § 1.448-1T(b)(5).

The Senate report contains the following language:

“In order to prevent possible manipulation of the hedging exemption by tax shelters structured as limited partnerships, the exemption for hedging transactions does not apply to transactions entered into by syndicates.”

The report to the House bill states:

“Syndicates are not entitled to the hedging exemption. A syndicate is defined as a flow-through entity (1) more than 35 percent of whose losses go to limited partners or limited entrepreneurs; or (2) whose interests must at any time be registered under State or Federal law.”

This definition appears in the text of section 1256(e)(3)(B). There is no language that refers to a tax avoidance motivation or intent, in either the law or the legislative history behind this definition. There was no intent to extrapolate this rule to serve any purpose other than restricting the hedging exemption for commodity futures traders. However, Congress repurposed this definition in 1984. The economic performance rule for deducting accrued expenses contained (and still contains) the recurring item exception. Congress believed that this exception should not apply to tax shelters. In addition to the common-sense definition of a tax shelter as an entity that has promoted tax savings to potential investors, the 1984 act included the section 1256 definition of syndicate. The legislative history gives no explanation for the inclusion of syndicates within the definition of tax shelters.

In 1986, Congress enacted section 448 in order to mandate the use of the accrual method of accounting. Exceptions were provided but none applied to tax shelters. This rule adopted the section 461(i) definition of tax shelters. There is no legislative history regarding the inclusion of syndicates, as defined in section 1256. Thus, for nearly 35 years, the syndicate rule, originally intended to govern hedging by commodity traders, has been extrapolated to include virtually every pass-through entity with a significant percentage of passive investors. Exercise of the regulatory authority in section 1256 is most appropriate in curbing the expansion of the syndicate rule, which has expanded to encompass far more situations than the legislative history might reasonably infer.

Moreover, Treasury and the IRS have not provided a definition of the term “active management.” Taxpayers are uncertain as to whether active management includes authority to actively manage, or the exercising of that authority. Taxpayers are uncertain as to the degree of active management required. The expansion of the simplifying accounting provisions to taxpayers meeting the gross receipts test of section 448(c) heightens the need for guidance regarding active management. Unless guidance is provided as to the definition of the term “active management,” the simplification of accounting methods for small businesses is not available to many entities, especially those formed as limited liability companies.

To further the goal of simplification, Treasury and the IRS should exercise regulatory authority to deem individuals as actively participating in management for section 1256(e)(3) purposes. Small business taxpayers tend to have few owners and the owners are likely involved in the operations and management of the business. Small business taxpayers are not large enough to warrant

exclusion from the simplification provisions. Section 461(i)(3)(C) provides that any tax shelter defined in section 6662(d)(2)(C)(ii) is available to prevent abuse of the small business provisions. We suggest providing clarification regarding the level of management required, as well as additional clarification for tiered structures. Additional detail is needed regarding active management at both the entity as well as the individual level.

Clarification is also needed regarding whether an entity is viewed as active in management as the owner of a small business. An upper-tier entity may own more than 35 percent of an interest in a lower-tier LLC. However, it is unclear if the lower-tier entity is automatically categorized as a syndicate because it does not have active participation by an individual owner of at least 65 percent.

The syndicate rules are heightened as the population of entities meeting the gross receipts test has expanded. There are currently additional sources related to outside investments and additional (and complex) ownership structures and thresholds when compared to those that existed decades ago.

Currently, taxpayers may have significant losses due to COVID-19. For example, the 100% bonus depreciation rules an economic incentive provided by Congress, may create a loss for an entity that utilizes them. The CARES Act further encourages investments in equipment and continuing employment of workers. The current syndicate rules discourage the investments encouraged by Congress therefore, we urge Treasury and the IRS to exercise their regulatory authority to provide final regulations that include our recommendations.

IV. Section 481(a) adjustments should not affect syndicate determination if syndicate rules apply to small business taxpayers

Overview

Section 1256(e)(3)(B) defines a syndicate as “any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs.”

Treasury Reg. § 1.448-1T(b)(3) provides that the determination of whether a business has a loss for a taxable year should be made “...under the enterprise’s method of accounting used for federal income tax purposes (determined without regard to this section).”

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations clarifying that section 481(a) adjustments recognized due to the adoption of a small business taxpayer method of accounting does not affect the determination of losses allocated to limited partners and limited entrepreneurs in determining whether the pass-through entity is a syndicate. Further, in years subsequent to the adoption of small taxpayer methods, the determination of losses allocated to limited partners and limited entrepreneurs should be based on the taxpayer’s present method of accounting.

Analysis

A taxpayer can only be defined as a syndicate in a year that it has a loss. Proposed Reg. § 1.448-2(b)(2)(iii)(3)(A) provides that the determination of whether a business has a loss for a taxpayer year should be made “...under the entities' method of accounting used for Federal income tax purposes (determined without regard to this section).” Treasury Reg. § 1.448-1T(b)(3) also contains almost identical language and has for many years. In response to a comment that a loss generated from a negative section 481(a) adjustment should not cause a taxpayer to potentially be classified as a tax shelter, the preamble to the proposed regulations indicated that this concept was not adopted because “[n]o exception was provided in the TCJA to limit the application of the definition of tax shelter in section 448(d)(3) for taxpayers making an overall method change.”⁸

While the TCJA did not permit the exclusion of a section 481(a) adjustment from taxable income for purposes of determining whether a taxpayer is a tax shelter, the regulations under section 448 have always provided that taxable income should be measured on the taxpayer’s “method of accounting...**(determined without regard to this section)**.” (emphasis added)⁹ While the regulations do not state that it is the ‘present’ method of accounting, interpreting the rule in any other manner would result in circularity. Measuring losses based on the taxpayer’s present method of accounting is a reasonable interpretation of the existing and proposed regulatory language. Otherwise, the negative section 481(a) adjustment from the desired change to the cash method may generate the loss due to syndicate status. That is, prior to the proposed change, the entity has taxable income on the accrual method. The change to the cash method creates a negative section 481(a) adjustment, which results in the taxpayer reporting a loss for the year due only to the required section 481(a) adjustment from that change. The same effect may arise from other changes required or permitted by section 448 or any other provision dependent on section 448 (e.g., sections 263A(i), 471(c), and 460(e)). The AICPA urges the government to adopt this approach to avoid precluding otherwise profitable taxpayers from adopting these provisions that are intended to simplify compliance for small business taxpayers.

This interpretation is similar to the approach taken for section 163(j) in Prop. Regs. §§ 1.448-2(b)(2)(vi) and 1.1256(e)-2(b), which provides that taxable income is measured before the application of section 163(j) for purposes of determining whether the taxpayer has a loss. For purposes of section 163(j), a taxpayer first determines whether it is a syndicate and only then applies section 163(j) after it makes that determination. The taxpayer need not retest its status as a syndicate again after it applies section 163(j). The same process should be true for the small taxpayer methods of accounting that are also dependent on the determination of whether the entity is a syndicate. The determination should be made based on the present method of accounting and should not be retested again after applying section 481(a) adjustments from the desired change.

The section 448 regulations presently provide some adjustments in determining a taxpayer’s status as a syndicate, which provides some precedent in making additional adjustments to taxable income for this determination. Pursuant to Treas. Reg. § 1.448-1T(b)(3) taxable income is measured without regard to gains or losses from the sale of capital assets and assets used in a trade or business that are subject to an allowance for depreciation. Adjusting taxable income to remove the effect

⁸ 85 FR 47511.

⁹ Treas. Reg. §1.448-1T(b)(3).

of any section 481(a) adjustments as well as the result of the proposed change in method of accounting resulting from the accounting method change would also be reasonable adjustments to make under the authority already exercised to make the capital gain or loss and depreciable property taxable income adjustments.

As a result, the existing regulatory language as well as the proposed regulatory language support a view that a section 481(a) adjustment and the current year result of a proposed change in method of accounting with respect to a small taxpayer method of accounting would be disregarded in measuring taxable income for purposes of making a determination of whether a taxpayer is a syndicate. The IRS and Treasury should clarify that this language requires a taxpayer to apply the method of accounting used to compute taxable income without regard to a section 481(a) adjustment originating from the change in the overall method of accounting.

There is also a lack of clarity on testing whether there is a tax loss in subsequent tax year while the taxpayer is applying the cash method or other small taxpayer methods. When applying the “determined without regard to this section,” it is not clear whether the taxpayer should apply the method of accounting it is presently using or if it should instead continue to compute accrual method taxable income. While that may be feasible for the accrual method, the result could be unclear in applying the concept to inventory. Treasury and the IRS should clarify that that the parenthetical language does not require the taxpayer to apply a method of accounting other than the one it is presently using in determining whether the pass-through entity has incurred losses allocable to limited partners and limited entrepreneurs.

V. Simplify accounting for inventory for small business taxpayers that apply exemptions under sections 263A and 471

Background

Section 263A(i) provides a small taxpayer exemption from applying the capitalization requirements of section 263A. Section 471(c) provides that the requirement to maintain inventories in section 471(a) does not apply to a taxpayer that meets the gross receipts test under section 448. The taxpayer’s method of accounting for inventory will not be treated as failing to clearly reflect income if the taxpayer either treats the inventory as non-incidentals materials and supplies or if the taxpayer’s method conforms to the method used in the taxpayer’s AFS or the taxpayer’s books and records, as applicable. The proposed regulations provide guidance for the small taxpayer exemptions under both section 263A(i) and section 471(c). However, the guidance is administratively complex and does not properly account for non-incidentals materials and supplies and inventory costs.

a. Non-incidentals materials and supplies

Overview

The proposed regulations currently require taxpayers to continue to apply certain costing concepts from section 263A or section 471 (e.g. capitalizing direct labor costs). In addition, the proposed regulations appear to require capitalization of certain direct materials into the produced inventory

at the time they are used or consumed, which is inconsistent with the small business taxpayer exceptions provided for in sections 471 and 263A.

Proposed Reg. § 1.471-1(b)(4) states:

“inventory treated as non-incidentals materials and supplies (“section 471(c) materials and supplies”) is recovered through costs of goods sold only in the taxable year in which such inventory is actually used or consumed in the taxpayer's business, or in the taxable year in which the taxpayer pays for or incurs the costs of the items, whichever is later. Section 471 materials and supplies are used or consumed in the taxable year in which the taxpayer provides the items to its customer. Inventory treated as non-incidentals materials and supplies under this paragraph (b)(4) is not eligible for the *de minimis* safe harbor election under Treas. Reg. §1.263(a)-1(f)(2).”

Proposed Reg. § 1.471-1(b)(4)(ii) states:

“...The inventory costs includible in the section 471(c) materials and supplies method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code.”

The discussion of non-incidentals materials and supplies and inventory costs in the proposed regulations is complex and is not consistent with the statute and intent of Congress.

Recommendation

The AICPA recommends that Treasury and the IRS provide rules in the final regulations related to non-incidentals materials and supplies that are simpler and consistent with the statute and intent of Congress. Taxpayers electing to treat inventory as materials and supplies should be required to capitalize only direct material costs. In determining material costs, the AICPA recommends that the *de minimis* rule apply to inventory accounted for as non-incidentals materials and supplies in the same manner as the rule applies to other materials and supplies. Finally, direct materials used in the production of inventory should be treated as used or consumed at the time they are used or consumed in the production process.

Analysis

Generally, we agree with the comments provided by [Ivins Phillips Barker dated August 30, 2020](#) related to inventoriable goods and non-incidentals materials and supplies.¹⁰ For example, eligible taxpayers allowed to use the *de minimis* rule under Treas. Reg. § 1.263(a)-1(f) or the proposed regulations should permit a similar election if such election is deemed not to apply to inventory

¹⁰ <https://www.taxnotes.com/tax-notes-today-federal/accounting-periods-and-methods/firm-seeks-guidance-4-areas-small-business-accounting-regs/2020/09/01/2cx1j?highlight=Comments%20with%20Respect%20to%20REG-132766-18> (August 30, 2020).

accounted under section 471(c). Similar to the rationale for the *de minimis* rule in traditional materials and supplies, the *de minimis* rule will provide simplification and reduce controversy over inherently *de minimis* amounts of costs that have not been tracked for book purposes and which would require extraordinary efforts by small taxpayers to recreate a proper accounting of these inventory costs.

Additionally, Treasury and the IRS should allow eligible taxpayers to follow the direct material amounts capitalized in their books and records, without requirement to continue to apply certain costing concepts from section 263A or section 471, (e.g., capitalizing direct labor costs). The additional burden created by the proposed regulations is inconsistent with the intent of Congress to provide simplification for eligible small business taxpayers.

Finally, direct materials used in the production of inventory should be treated as used or consumed at the time they are used or consumed in the production process. Treasury Reg. § 1.162-3 provides that non-incidentals materials and supplies are deductible at the time they are first used or consumed in the taxpayer's operations. The proposed regulations appear to require capitalization of these materials into the produced inventory at the time they are used or consumed, which is inconsistent with the small business taxpayer exceptions provided for in sections 471 and 263A.

b. Non-incidentals materials and supplies treatment for inventory under Rev. Proc. 2001-10 or Rev. Proc 2002-28

Overview

Taxpayers may account for inventory as non-incidentals materials and supplies under Rev. Proc. 2001-10 or Rev. Proc. 2002-28.

Recommendations

The AICPA recommends that Treasury and the IRS clarify in the final regulations that taxpayers presently accounting for inventory as non-incidentals materials and supplies under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 are permitted to use section 22.19 of Rev. Proc. 2019-43 to change from treating the amounts as non-incidentals supplies to either conform to their AFS treatment or, if there is no AFS, to their books and records prepared in accordance with their accounting procedures.

However, should Treasury and the IRS issue future guidance clarifying or changing the "used and consumed" definition for non-incidentals materials and supplies in a manner that deviates from the interpretation set forth in Rev. Proc. 2002-28, the AICPA recommends that Treasury and the IRS clarify that section 22.19 of Rev. Proc. 2019-43 can be used by such taxpayers to conform to the new definition.

Analysis

If a taxpayer wants to remain on their present method of accounting for inventory as non-incidentals materials and supplies, Treasury and the IRS should clarify that they may continue to follow their

present method without filing an accounting method change to the extent their present method complies with section 471(c)(1)(B)(i) and the regulations thereunder.

Alternatively, if a taxpayer elects to change from treating the amounts as non-incidental material and supplies (or change to conform to a new definition of “used and consumed” if addressed in future guidance), clarification from the Treasury and the IRS that such taxpayer can use the automatic method change procedures provided for in Rev. Proc. 2019-43 would be beneficial.

c. Book inventory conformity: Books and records of inventory

Overview

Section 471(c) provides that a taxpayer’s method of accounting for inventory for such taxable year shall not be treated as failing to clearly reflect income if the method conforms to the taxpayer’s method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer’s accounting procedures. Proposed Reg. § 1.471-1(b)(5) provides that a taxpayer that meets the gross receipts test and that has an AFS for such taxable year may use “the AFS section 471(c) method,” in which an inventory cost is a cost that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. Proposed Reg. § 1.471-1(b)(6) provides a similar rule for the non-AFS section 471(c) method.

Recommendations

The AICPA recommends that Treasury and the IRS clarify the use the AFS section 471(c) method or the non-AFS section 471(c) method, as applicable (the “book method”), in cases where the taxpayer does not maintain inventories for book purposes or does not include certain costs in inventory.

Additionally, the AICPA recommends that Treasury and the IRS provide guidance to limit the treatment of inventory records as books and records for non-AFS purposes to cases where the taxpayer has made a determination of ending inventory cost, rather than informal counts of inventory items.

Analysis

The AFS and non-AFS method allow small business taxpayers to account for inventory costs in accordance with the method used in their AFS or books and records, as applicable. Proposed Reg. § 1.471-1(b)(5)(i) provides that an inventory cost is a cost that a taxpayer capitalized to property produced or acquired for resale in its AFS. Under this definition, if a cost is not capitalized under the taxpayer’s AFS or books and records, it is unclear how those costs should be handled by a taxpayer applying the AFS or non-AFS section 471(c) method. The inventory method used for books and records or AFS may vary significantly from one taxpayer to the next. For example, a cash method taxpayer may not capitalize any costs to inventory while other small taxpayers may capitalize only certain types of direct or indirect inventory costs. The preamble to the proposed regulations provides:

“A taxpayer’s method of accounting for inventory may not clearly reflect income if a taxpayer meets the Section 448(c) gross receipts test but does not take an inventory, and also does not either treat its inventory as non-incidental materials and supplies or in conformity with its AFS, or its books and records if it does not have an AFS. In such instances, the general rules under section 446 for analyzing whether a method of accounting clearly reflects income are applicable. (85 FR 47514)”

A taxpayer who does not capitalize some or all of its inventory costs may be uncertain whether it can rely upon an AFS or non-AFS section 471(c) method for those inventory costs that are never capitalized to inventory. Such taxpayer may interpret the proposed regulations as scoping out such uncapitalized costs from the AFS or non-AFS section 471(c) method and leaving that taxpayer uncertain what treatment of these costs is necessary to comply with section 446 for clear reflection of income. The statute exempts small businesses from applying section 471(a), which is the tax provision that would otherwise require maintaining inventories. The legislative history states that the provision exempts small “taxpayers from the requirement to keep inventories.” The regulations should confirm that a taxpayer applying the AFS or non-AFS section 471(c) method can rely on this method for inventory costs, regardless of whether such costs have been capitalized for financial statement purposes.

The proposed regulations provide some guidance that broadens non-AFS books and records beyond the year-end financial statements. The preamble indicates that books and records must reflect the taxpayer’s business activities for non-Federal income tax purposes. A taxpayer performing a physical count used in determining inventory in the taxpayer’s books and records must use the count for the purposes of the non-AFS section 471 method. Proposed Reg. 1.471-1(b)(6) example 2 provides an example of a taxpayer that takes a physical count of inventory at year end as part of its regular business practices and provides representations to its creditor of the amount of inventory on hand. Such taxpayer is required to use that physical inventory to determine its ending inventory, even though its electronic bookkeeping software treats all inventory costs as deductible at year end. While requiring the use of inventory in such cases may be reasonable, most fact patterns are far less clear. In the example, the taxpayer appears to make financial representations of the cost or value of the inventory, but in many cases translating a physical inventory into a cost basis inventory balance would require significant effort that is not part of the taxpayer’s regular business practices. These physical inventories may be done sporadically, incompletely, and such records may never be known to those responsible for the taxpayer’s accounting records.

d. Book conformity: Book-tax differences

Overview

Proposed Reg. § 1.471-1(b)(5) provides that a taxpayer meeting the gross receipts test and that has an AFS for the taxable year may use “the AFS section 471(c) method,” in which an inventory cost is a cost that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. Proposed Reg. § 1.471-1(b)(6) provides a similar rule for the non-AFS section 471(c) method. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable, in whole or in part, under a provision of the IRC (e.g., section 162(c), (e), (f), (g), or

274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) method recovers its inventory costs in accordance with the inventory method used in its AFS.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations allowing eligible taxpayers to follow the AFS method or their books and records method, as applicable, without having to apply costing concepts from section 263A or section 471, such as accounting for book-tax differences or reserves.

The AICPA also recommends permitting taxpayers to adjust taxable income for the full amount of book-tax differences incurred during the year, such as meals and entertainment or tax depreciation, without regard to whether a portion of the expense is included in ending inventory.

The AICPA further recommends that Treasury and the IRS provide additional examples of the application of book-tax differences to inventory in the final regulations.

Analysis

Proposed Reg. §§ 1.471-1(b)(5) and 1.471-1(b)(6) require that a small business using one of the two methods must make adjustments to its inventory costs for book-tax differences, similar to the types of adjustments that must be made under section 263A. The preamble to the proposed regulations states:

“The proposed regulations provide that a taxpayer is not permitted to recover a cost that it otherwise would be neither permitted to recover nor deduct for Federal income tax purposes solely by reason of it being an inventory cost in the taxpayer's AFS inventory method. In addition, these proposed regulations provide that a taxpayer may not capitalize a cost to inventory any earlier than the taxable year in which the amount is paid or incurred under the taxpayer's overall method of accounting for Federal income tax purposes (for example, if applicable, section 461(h) is met) or not permitted to be capitalized by another Code provision (for example, section 263(a)). (85 FR 47516)”

However, making such adjustments to the actual book ending inventory is more complex than the adjustments required for such book-tax differences under the simplified methods in section 263A. Since these taxpayers no longer apply section 263A, they cannot rely on the simplified methods of determining the amount of a book-tax difference allocable into ending inventory and would be required to perform a detailed analysis of their inventory accounting to determine the portion allocable to ending inventory based on their burden rate or standard costing methodology. Performing such analysis on section 471 costs is burdensome on very large taxpayers implementing the final section 263A regulations. The requirement to perform the analysis by small business taxpayers would represent a significant and unnecessary burden. This requirement appears to impose the continued application of part of section 263A despite the statute exempting

eligible small businesses from applying those rules. This level of complexity was not intended by Congress since the provision was enacted to provide simplification to eligible small businesses.

Based on the preamble to the proposed regulations, it appears that Treasury and the IRS are concerned small businesses will fail to adjust taxable income for book-tax differences that are embedded in costs that were capitalized to inventory under the book method. The preamble indicates that the requirement to address book-tax differences is necessary because section 471 is a timing provision. However, if certain book-tax differences are capitalized for book purposes in one year, they will be deducted in a subsequent year when the inventory is sold or otherwise disposed, meaning it is a timing difference. Proposed Reg. §1.471-1(b)(8) provides that a change in the taxpayer's inventory accounting method in its AFS or books and records results in a change in method of accounting for tax purposes. This provision preserves the timing nature of capitalization of costs for book purposes otherwise not deductible for tax purposes. Furthermore, Congress appears to have agreed that this valuation of inventory was permissible for tax purposes in light of section 471(c). The requirement to make adjustments to inventory for book-tax differences would render the statute meaningless.

To create a more administrable approach consistent with the intent of simplification, Treasury and the IRS should allow eligible small businesses electing the AFS or non-AFS section 471(c) method to strictly follow the book method for inventory. These businesses must also take into account the full amount of book-tax differences in the year the underlying cost is incurred, similar to any adjustments for other timing differences such as tax depreciation, without regard to whether the underlying cost was capitalized into inventory under the book method. The adjustment should be made to the otherwise deductible costs for the current year as if the costs had not been capitalized into inventory under the book method. Such simplification would be aligned with Congressional intent to provide simplification to eligible small businesses and is consistent with the language of the statute.

Finally, we request that the final regulations contain additional examples of the application of book-tax differences to inventory. The examples will assist small taxpayers that have inventory to properly apply the regulations and reduce controversy.