February 2020

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Accrual to Cash Initiative

Overview

The use of the cash method of accounting for tax purposes has become available to more taxpayers due to the Tax Cuts and Jobs Act of 2017 (TCJA). A taxpayer's use of the cash basis method of accounting was previously limited - new opportunities now exist.

Under the cash basis method of accounting, taxpayers recognize income as taxable when cash is received, and a deduction is allowed when an expense is paid. Because of the many benefits the cash basis method of accounting offers, taxpayers often find it desirable. Such benefits include:

- Immediate cash flow opportunities
- Decreased tax burden for current year
- Simpler to implement and maintain
- Better matching of available cash and income for tax payments

Old Law

Prior to the TCJA, C corporations and partnerships with C corporation partners were not permitted to use the cash basis method of accounting to compute their taxable income unless their gross receipts were less than $5 million for all of its prior tax years and they were not required to account for inventory. There were two exceptions to the gross receipts test that existed prior to the TCJA. Under the first exception, a taxpayer (other than a tax shelter) that was required to account for inventory could still use the cash method of accounting if their gross receipts were less than $1 million. The second exception allowed a taxpayer with average annual gross receipts of $10 million or less to utilize the cash basis method of accounting as long as their trade or business did not fall within one of the prohibited business activities, including mining, manufacturing, wholesale trade, retail trade, and information industries.

New Law

For tax years beginning after December 31, 2017, the TCJA expanded the availability of the use of the cash basis method of accounting for tax purposes. Under the new law, any taxpayer (other than a tax shelter) with average annual gross receipts of $25 million or less in the prior three years, may use the cash basis method of accounting, regardless of inventory accounting. The law also removed the limitations placed on taxpayers in previously disallowed industries, such as manufacturing and wholesale trade. Additionally, the TCJA removed the requirement to capitalize additional uniform capitalization (UNICAP) costs to inventory.

Who is now eligible to use the Cash Basis Method of Accounting?

- Any business entity that is not a C corporation or a partnership with a C corporation partner and does not carry inventory
- C corporations and partnerships with C corporation partners which carry inventory and have average annual gross receipts not exceeding $25 million for the prior three years
- C corporations or partnerships with a C corporation partner which engage in the trade or business of farming or select personal service corporations where substantially all activities are in the fields of health, law, engineering, architecture, actuarial science, performing arts, or consulting
- Taxpayers who have not changed their method of accounting during the previous five years

What Constitutes Gross Receipts?

A C corporation or a partnership with a C corporation meets the gross receipts test for the year if its average annual gross receipts for the past three tax years does not exceed $25 million. The average annual amount of gross receipts is adjusted periodically for inflation ($26 million for tax year beginning 2019).

For purposes of calculating average annual gross receipts, the following income should be included:

- Total sales
- Amounts received for services
- Income from investments and outside sources
- Interest, dividends, rent, royalties, etc.

Gross receipts should be reduced by returns and allowances and receipts from sales of capital assets or property used in the business.

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Taxpayers who may benefit from an Accrual to Cash Basis Accounting Method Change

- C corporations and partnerships with a C corporation partner with $25 million or less in gross receipts
- Taxpayers whose accounts receivables exceed their payables
- Producers and manufacturers not previously allowed to use the cash method of accounting

Taxpayers that qualify for a change from accrual to cash method of accounting may apply to use the cash method under the automatic consent procedures by filing Form 3115, Application for Change in Accounting Method, with the Internal Revenue Service.

Other Considerations

Tax Shelters are not eligible for the cash method of accounting. The Syndicate Rules define tax shelters as any entity other than a C corporation where more than 35% of the losses are allocated to partners or investors who are not actively participating in management. An individual is considered to be active in management if the individual actively participated in management of an entity at all times during the period or had participated in the entity's management for at least five years. Additionally, holdings in the entity by an active individual's spouse, children, or grandchildren are considered active holdings.

When computing a taxpayer's loss, the loss is determined based on the excess of deductions over income using the taxpayer's method of accounting; gains and losses from the sale of a capital asset are not included in the calculation. In the event that an entity using the cash basis method of accounting meets the definition of a tax shelter in a particular year, they will be required to switch to the accrual basis method of accounting. Use of the cash basis method of accounting in future years would require the request of another method of accounting change.

Related Party Rules – If related entities are treated as a single employer under the controlled business rules or affiliated service group rules, then C corporations or partnerships with C corporation partners would be required to aggregate the gross receipts from related entities for purposes of the gross receipts test. In general, the aggregation rules apply to entities that are members of a controlled group with more than 50% common control or that are considered an affiliated service group.

UNICAP - Taxpayers with $25 million or less in gross receipts are no longer required to capitalize uniform capitalization costs to inventory under section 263(a).

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