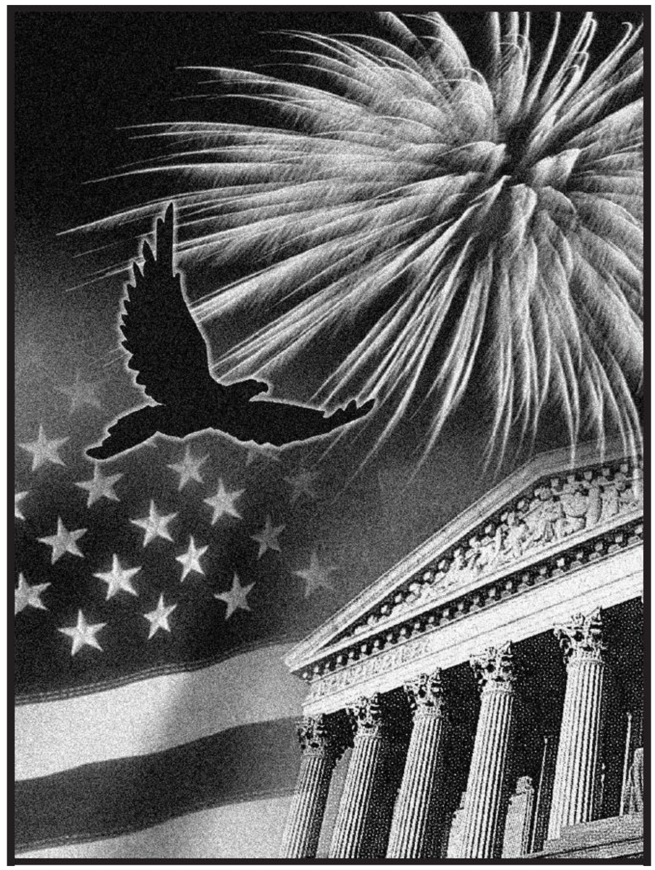
Publication 538

Accounting Periods and Methods

Volume 1 of 2



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Future Developments

For the latest information about developments related to Pub. 538, such as legislation enacted after it was published, go to *IRS.gov/Pub538*.

Introduction

Every taxpayer (individuals, business entities, etc.) must figure taxable income for an annual accounting period called a tax year. The calendar year is the most common tax year. Other tax years include a fiscal year and a short tax year.

Each taxpayer must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are the cash method and the accrual method.

Under the cash method, you generally report income in the tax year you receive it, and deduct expenses in the tax year in which you pay the expenses.

Under the accrual method, you generally report income in the tax year you earn it, regardless of when payment is received. You deduct expenses in the tax year you incur them, regardless of when payment is made.

TIP *This publication explains some of the rules for accounting periods and accounting methods. In some cases, you may have to refer to other sources for a more in-depth explanation of the topic.*

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Useful Items

You may want to see:

Publication

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

Form (and Instructions)

- ☐ **1128** Application To Adopt, Change, or Retain a Tax Year
- ☐ **2553** Election by a Small Business Corporation
- ☐ **3115** Application for Change in Accounting Method
- ☐ **8716** Election To Have a Tax Year Other Than a Required Tax Year

See *Ordering forms and publications,* earlier, for information about getting these publications and forms.

Accounting Periods

You must use a tax year to figure your taxable income. A tax year is an annual accounting period for keeping records and reporting income and expenses. An annual accounting period does not include a short tax year (discussed later). You can use the following tax years:

- A calendar year; or
- A fiscal year (including a 52-53-week tax year).

Unless you have a required tax year, you adopt a tax year by filing your first income tax return using that tax year. A required tax year is a tax year required under the Internal Revenue Code or the Treasury Regulations. You cannot adopt a tax year by merely:

- Filing an application for an extension of time to file an income tax return;

- Filing an application for an employer identification number (Form SS-4); or
- Paying estimated taxes.

This section discusses:

- A calendar year.
- A fiscal year (including a period of 52 or 53 weeks).
- A short tax year.
- An improper tax year.
- A change in tax year.
- Special situations that apply to individuals.
- Restrictions that apply to the accounting period of a partnership, S corporation, or personal service corporation.
- Special situations that apply to corporations.

Calendar Year

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

If you adopt the calendar year, you must maintain your books and records and report your income and expenses from January 1st through December 31st 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 obtain approval from the IRS to change it, or are otherwise allowed to change it without IRS approval. See *Change in Tax Year*, later.

Generally, anyone can adopt the calendar year. However, you must adopt the calendar year if:

- You keep no books or records;
- You have no annual accounting period;
- Your present tax year does not qualify as a fiscal year; or
- You are required to use a calendar year by a provision in the Internal Revenue Code or Treasury Regulations.

Fiscal Year

A fiscal year is 12 consecutive months ending on the last day of any month except December 31st. If you are allowed to adopt a fiscal year, you must consistently maintain your books and records and report your income and expenses using the time period adopted.

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 52-53-week tax year must always end on the same day of the week. Your 52-53-week tax year must always end on:

- Whatever date this same day of the week last occurs in a calendar month, or

- Whatever date this same day of the week falls that is nearest to the last day of the calendar month.

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

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:

- Begin on the first day of the calendar month beginning nearest to the first day of the 52-53-week tax year, and

- 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, which (for purposes of this example) happens to be a Sunday. For this purpose, a 52-53-week tax year that begins on the last Tuesday of June, which (for purposes of this example) falls on June 25, is treated as beginning on July 1.

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):

- Are not in existence for an entire tax year, or
- Change your accounting period.

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

Not in Existence Entire Year

Even if a taxable entity was not in existence for the entire year, a tax return is required for the time it was 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. XYZ Corporation was organized on July 1. It elected the calendar year as its tax year. The corporation's first tax return will cover the short period from July 1 through December 31.

Example 2. A calendar year corporation dissolved on July 23. The corporation's final return will cover the short period from January 1 through July 23.

Death of individual. Although the return of the decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for the decedent may be made as though the decedent had lived throughout his last taxable year. The decedent’s 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. If the due date falls on a Saturday, Sunday, or legal holiday, file by the next business day. The decedent's final return will be a short period tax return that begins on January 1st, and ends on the date of death. In the case of a decedent who dies on December 31st, the last day of the regular tax year, a full calendar-year tax return is required.

Figuring Tax for Short Year

If the IRS approves a change in your tax year or if 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.

Figure tax for a short year under the general rule, explained below. 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 must be annualized. 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 (AGI) 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. Note. For tax years beginning after 2017 and before 2026, the dollar amount of your exemption is zero (-0-).

3. Subtract the amount in (2) from the amount in (1). The result 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. The result 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. The result is your tax for the short tax year.

Relief procedure. You 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) of the Internal Revenue Code and the related Treasury Regulation.

Alternative minimum tax. Individuals, 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 completing the following steps.

    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) of the Internal Revenue Code. 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 AMT for individuals, see the Instructions for Form 6251, Alternative Minimum Tax–Individuals.

Tax withheld from wages. You can claim 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 of tax withheld in any calendar year is allowed as a credit for the tax year beginning in the calendar year.

Improper Tax Year

Taxpayers that have adopted an improper tax year must change to a proper tax year. For example, if a taxpayer began business on

March 15 and adopted a tax year ending on March 14 (a period of exactly 12 months), this would be an improper tax year. See *Accounting Periods*, earlier, for a description of permissible tax years.

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

- If you are requesting a change to a calendar tax year, file an amended income tax return based on a calendar tax year that corrects the most recently filed tax return that was filed on the basis of an improper tax year. 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.
- If you are requesting a change to a fiscal tax year, file Form 1128 in

accordance with the form instructions to request IRS approval for the change.

Change in Tax Year

Generally, you must file Form 1128 to request IRS approval to change your tax year. See the Instructions for Form 1128 for exceptions. If you qualify for an automatic approval request, a user fee is not required.

Individuals

Generally, individuals must adopt the calendar year as their tax year. An individual can adopt a fiscal year if the individual maintains his or her books and records on the basis of the adopted fiscal year.

Partnerships, S Corporations, and Personal Service Corporations (PSCs)

Generally, partnerships, S corporations (including electing S corporations), and PSCs must use a required tax year. A required tax year is a tax year that is required under the Internal Revenue Code and Treasury Regulations. The entity does not have to use the required tax year if it receives IRS approval to use another permitted tax year or makes an election under section 444 of the Internal Revenue Code (discussed later).

Partnership

A partnership must conform its tax year to its partners' tax years unless any of the following apply.

- The partnership makes an election under section 444 of the Internal Revenue Code to have a tax year other than a required tax year by filing Form 8716.

- The partnership elects to use a 52-53-week tax year that ends with reference to either its required tax year or a tax year elected under section 444.
- The partnership can establish a business purpose for a different tax year.

The rules for the required tax year for partnerships are as follows.

- 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.
- 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.

- 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.

TIP *If a partnership changes to a required tax year because of these rules, it can get automatic approval by filing Form 1128.*

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 the calculation results in more than one tax year qualifying as the tax year with the least aggregate deferral, the partnership can choose any one of those tax years as its tax year. 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 12/31:	Year End	Profits Interest	Months of Deferral	Interest × Deferral
A	12/31	0.5	-0-	-0-
B	11/30	0.5	11	5.5
Total Deferral				5.5

Year End 11/30:	Year End	Profits Interest	Months of Deferral	Interest × Deferral

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 under the least aggregate deferral rules 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, it must file a Form 1128 with 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 1.706-1.”

More information. For more information about changing a partnership's tax year, and information about ruling requests, see the Instructions for Form 1128.

S Corporation

All S corporations, regardless of when they became an S corporation, must use a permitted tax year. A permitted tax year is any of the following.

- The calendar year.

- A tax year elected under section 444 of the Internal Revenue Code. See *Section 444 Election*, below, for details.
- A 52-53-week tax year ending with reference to the calendar year or a tax year elected under section 444.
- Any other tax year for which the corporation establishes a business purpose.

If an electing S corporation wishes to adopt a tax year other than a calendar year, it must request IRS approval using Form 2553, instead of filing Form 1128. For information about changing an S corporation's tax year and information about ruling requests, see the Instructions for Form 1128.

Personal Service Corporation (PSC)

A PSC must use a calendar tax year unless any of the following apply.

- The corporation makes an election under section 444 of the Internal Revenue Code. See *Section 444 Election*, below, for details.
- The corporation elects to use a 52-53-week tax year ending with reference to the calendar year or a tax year elected under section 444.
- The corporation establishes a business purpose for a fiscal year.

See the Instructions for Form 1120 and Pub. 542 for general information about PSCs. For information on adopting or changing tax years for PSCs and information about ruling requests, see the Instructions for Form 1128.

Section 444 Election

A partnership, S corporation, electing S corporation, or PSC can elect under section 444 of the Internal Revenue Code to use a tax year other than its required tax year. Certain restrictions apply to the election. A partnership or an S corporation that makes a section 444 election must make certain required payments and a PSC must make certain distributions (discussed later). The section 444 election does not apply to any partnership, S corporation, or PSC that establishes a business purpose for a different period, explained later.

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

- It is not a member of a tiered structure (defined in Treasury Regulations section 1.444-2T).

- It has not previously had a section 444 election in effect.
- 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 PSC 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 PSC 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 PSC is adopting or 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:

- Three months, or
- 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 PSC wishes to make the section 444 election.

If the partnership, S corporation, or PSC'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. 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 is 3 months, the number of months between September 30 and December 31.

Making the election. Make a section 444 election by filing Form 8716 with the Internal Revenue Service Center where the entity will file its tax return. See the instructions for Form 8716 for information on when to file.

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

Terminating 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 any of the following applies to the partnership, S corporation, or PSC.

- The entity changes to its required tax year.
- The entity liquidates.
- The entity becomes a member of a tiered structure.
- The IRS determines that the entity willfully failed to comply with the required payments or distributions.

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

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

corporation can continue the election of the PSC.

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

- The section 444 election is in effect.
- 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. See Form 8752 and its instructions for more information.

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

Required distribution for PSC. A PSC 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 PSC 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 PSC otherwise qualifies).

Making back-up 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 (or Form 2553) is filed, type or print "FORM 1128 (or FORM 2553) 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 and making the required payment with Form 8752. The due date for filing Form 8752 and making the payment is the later of the following dates.

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

A PSC 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."

52-53-Week Tax Year

A partnership, S corporation, or PSC can use a tax year other than its required tax year if it elects a 52-53-week tax year (discussed earlier) that ends with reference to either its required tax year or a tax year elected under section 444 (discussed earlier).

A newly formed partnership, S corporation, or PSC can adopt a 52-53-week tax year ending with reference to either its required tax year or a tax year elected under section 444 without IRS approval. However, if the entity wishes to change to a 52-53-week tax year or change from a 52-53-week tax year that references a particular month to a non-52-53-week tax year that ends on the last day of that month, it must request IRS approval by filing Form 1128.

Business Purpose Tax Year

A partnership, S corporation, or PSC establishes the business purpose for a tax year by filing Form 1128. See the Instructions for Form 1128 for details.

Corporations (Other Than S Corporations and PSCs)

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 PSC must use the required tax year rules, discussed earlier, to establish a tax year. Generally, a corporation that wants to change its tax year must obtain approval from the IRS under either the: **(a)** automatic approval procedures; or **(b)** ruling request procedures. See the Instructions for Form 1128 for details.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported on your tax return. 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 generally 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 reflects your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent accounting books, 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 reflects 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 reflects your income, your income will be refigured under the method that, in the opinion of the IRS, does clearly reflect income.

Methods you can use. Generally, you can figure your taxable income under any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- A hybrid method which combines elements of two or more of the above accounting methods.

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 of the Internal Revenue Code and the related regulations. The following publications also discuss special methods of reporting income or expenses.

- Publication 225, *Farmer's Tax Guide.*
- Publication 535, *Business Expenses.*
- Publication 537, *Installment Sales.*
- Publication 946, *How To Depreciate Property.*

Hybrid method. Generally, you can use any combination of cash, accrual, and special methods of accounting if the combination clearly reflects your income and you use it consistently. However, the following restrictions apply.

- If an inventory is necessary to account for your income, you must use an accrual method for purchases and sales. However, see *Exception for Small Business Taxpayers*, later. Generally, you can use the cash method for all other items of income and expenses. See *Inventories*, later.
- If you use the cash method for reporting your income, you must use the cash method for reporting your expenses.
- If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.
- Any combination that includes the cash method is treated as the cash method for purposes of section 448 of the Internal Revenue Code.

Business and personal items. You can account for business and personal items using different accounting methods. For example, you can determine your business income and expenses 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 business. No business is separate and distinct, unless a complete and separate set of books and records is maintained for each business.

Note. 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 (as explained under *Excluded Entities* and *Exceptions*, later) use the cash method of accounting. Generally, if you produce, purchase, or sell merchandise, you must keep an inventory and use an accrual method for sales and purchases of merchandise. See *Inventories*, later, for exceptions to this rule.

Income

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

Constructive receipt. Income is constructively received when an amount is credited to your account or made available to you without restriction. You do not need to 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. You are a calendar year taxpayer. Your bank credited, and made available, interest to your bank account in December 2021. You did not withdraw it or enter it into your books until 2022. You must include the amount in gross income for 2021, the year you constructively received the interest income.

You cannot hold checks or postpone taking possession of similar property from one tax year to another to postpone 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, generally, you 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. Instead, 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 is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule.

Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following.

- 12 months after the right or benefit begins, or

- The end of the tax year after the tax year in which payment is made.

If you have not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses you paid in advance, you must obtain approval from the IRS before using the general rule and/or the 12-month rule. See *Change in Accounting Method*, later.

Example 1. You are a calendar year taxpayer and pay $3,000 in 2021 for a business insurance policy that is effective for 3 years (36 months), beginning on July 1, 2021. The general rule that an expense paid in advance is deductible only in the year to which it applies is applicable to this payment because the payment does not qualify for the 12-month rule. Therefore, only $500 (6/36 x $3,000) is deductible in 2021, $1,000 (12/36 x $3,000) is deductible in 2022, $1,000

(12/36 x $3,000) is deductible in 2023, and the remaining $500 is deductible in 2024.

Example 2. You are a calendar year taxpayer and pay $10,000 on July 1, 2021, for a business insurance policy that is effective for only 1 year beginning on July 1, 2021. The 12-month rule applies. Therefore, the full $10,000 is deductible in 2021.

Excluded Entities

The following entities generally cannot use the cash method, including any combination of methods that includes the cash method. (However, see *Special rules for farming businesses*, later.)

- A corporation (other than an S corporation). However, see *Exceptions* below.
- A partnership with a corporation (other than an S corporation) as a partner. However, see *Exceptions* below.

- A tax shelter, as defined in section 448(d)(3).

Exceptions

The following entities can use the cash method of accounting.

- Any corporation or partnership, other than a tax shelter, that meets the gross receipts test explained below.
- A qualified personal service corporation (PSC).

Gross receipts test. A corporation or partnership, other than a tax shelter, that meets the gross receipts test can generally use the cash method. A corporation or a partnership meets the test if its average annual gross receipts for the 3 prior tax years were $26 million or less (indexed for inflation).

Determine an entity’s average annual gross receipts by:

1. Adding the gross receipts for the 3 prior tax years; and
2. Dividing the total by 3.

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 must aggregate their gross receipts to determine whether the gross receipts test is met.

Change to accrual method. A corporation or partnership that fails to meet the gross receipts test for any tax year cannot use the cash method and must change to an accrual method of accounting, effective for the tax year in which the entity fails to meet this test. The entity must file Form 3115 to request the change. See the Instructions for Form 3115.

Special rules for farming businesses. Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain corporations (other than S corporations) and partnerships that have a partner that is a corporation must use an accrual method for their farming business, unless they meet the gross receipts test discussed above.

See chapter 2 of Pub. 225, *Farmer's Tax Guide*, for more information.

Qualified Personal Service Corporation (PSC). A corporation that meets the function and ownership tests below is a qualified PSC and 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 (including 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 substantially all of its stock is owned, directly or indirectly, at all times during the year by one or more 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 PSCs. 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 PSC for any part of that tax year.

Accrual Method

Under an accrual method of accounting, you generally report income in the year it is 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

Generally, you include an amount in gross income for the tax year in which the all events test is met. This test is met when all events have occurred which fix your right to receive the income and you can determine the amount with reasonable accuracy. However, if you have an applicable financial statement (AFS), you include the amount in income no later than when the item of income is reported in your applicable financial statement (AFS). This is known as the AFS income inclusion rule, discussed next.

AFS income inclusion rule. Under this rule, you report an amount in your gross income on the earliest of the following events.

- When you receive payment.
- When the income amount is due to you.
- When you earn the income.
- When title passes.
- When included as revenue in your AFS if you have an AFS.

See Regulations section 1.451-3(a)(5) for a hierarchical list of financial statements. See Regulations section 1.451-3(b) for guidance in determining the appropriate AFS income amount when applying the inclusion rule. If your financial results are reported on the AFS for a group of entities, use the group's AFS to apply the AFS income inclusion rule. Generally, the AFS income inclusion rule is not applicable to you if you use a special method of accounting to report an item of income. See Regulations section 1.451-3(a)(13) for examples of special methods of accounting to which the AFS income inclusion rule generally does not apply.

AFS cost offset method. If you are required to account for income from the sale of inventory under the AFS income inclusion rule, you may be eligible to elect the AFS cost offset method. This method allows you to reduce the reported amount of income accelerated under this rule. See Regulations section 1.451-3(c) for more information on the application of this method. If you receive advance payments for the sale of inventory, you may elect to use the advance payment cost offset method. See *Advance Payments* below.

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.

Advance Payments

Generally, you report an advance payment for goods, services, or other items as income in the year you receive the payment. However, if you use an accrual method of accounting, you can elect to postpone including the advance payment in income until the next year. However, you cannot postpone including any payment beyond that tax year.

To be eligible for the deferral method, advance payments must meet the following requirements:

- Full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting;

- A portion of the advance payment is included in revenue in your applicable financial statement (AFS) for a subsequent tax year, or if you do not have an AFS, you earn a portion of the payment in a subsequent tax year; and
- You received the advance payment for goods, services, or such other items that the Secretary has identified.

You are considered to receive an item of gross income if you actually or constructively receive it or it is due and payable to you.

Certain gift card sales are considered advance payments and eligible for the deferral method. Certain types of prepayments are excluded from the definition of advance payments and are ineligible for this deferral method such as some types of rent or insurance premiums. See section 451(c)(B) for exclusions to the term “advance payment.”

See section 451(c) and Regulations section 1.451-8 for more information.

How to report payments. Generally, include an advance payment in income in the year in which you receive it. However, you may use the deferral method described above for qualifying advance payments.

Deferral method with AFS. Any advance payment you include in gross receipts on your tax return must be included no later than when the income is included on an AFS (or other financial statement specified by the IRS in the year of receipt). The remaining portion of the advance payment is included as gross income for the subsequent tax year independent of how it is treated on your AFS.

Non-AFS deferral method. If you do not have an AFS and elect to use this deferral method, you must include the advance payment in gross income in the year received, to the extent you have earned the amount. The remaining portion of the advance payment is included in gross income in the subsequent tax year.

IRS approval. The election to defer advance payments is effective for the tax year that it is first made and for all subsequent tax years unless you receive consent to revoke the election. You must file Form 3115 to obtain IRS approval to change your method of accounting for advance payment for services. See Form 3115 and the Instructions for Form 3115.

Acceleration of advance payments. If you have elected the deferral method for advance payments, certain conditions may occur that require you to accelerate inclusion of the advance payments into gross income. Examples include if you cease to exist, or if your obligation for the advance payment is satisfied. See Regulations sections 1.451-8(c)(4) and 1.451-8(d).

Advance Payment Cost Offset Method

If you receive advance payments for the sale of inventory, you may elect to use the advance payment cost offset method. If elected, this method of accounting applies to all advance payments received in your trade or business that satisfy the criteria. See Regulations section 1.451-8(e) for the criteria and other information related to this optional cost offset method.

Specified Goods Exception

The specified goods exception is for a taxpayer that receives prepayments but does not deliver the good for several years in the future. This exclusion applies if you require a customer to make an upfront payment under a contract in which all the following apply:

1. The contracted delivery month and year of the good occurs at least 2 tax years after an upfront payment;
2. You do not have the good or a substantially similar good on hand at the end of the year the upfront payment is received; and
3. You recognized all of the revenue from the sale of the good in your AFS in the year of delivery.

See Regulations section 1.451-8(f).

How to report payments. If you receive a prepayment that satisfies the specified goods exception, it is excluded from the treatment afforded to advance payments and instead is analyzed under sections 451(a) and (b), including the all events test and existing case laws that address the all events test. Under this analysis, the prepayment could be includible in the year of receipt.

If you are subject to this exception, you have the option to treat upfront payments that satisfy the criteria for the specified good exception as a typical advance payment under section 451(c). Under section 451(c), the advance payment is included in gross income under the full inclusion method or the 1-year deferral method.

Expenses

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

1. The all-events test 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

Generally, you 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 2020. You receive the supplies and the bill in December, but you pay the bill in January