

SECTION 1. PURPOSE

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

SECTION 2. BACKGROUND AND CHANGES

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

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

.03 The cash method generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. Section 1.446-1(c)(1)(i).

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

.05 Section 1.162-3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.

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

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

obtain consent to change a method of accounting in accordance with section 446(e).

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

.09 Rev. Proc. 2000-22 is modified in the following respects:

(1) Section 3 is modified to make clear that this revenue procedure does not apply to taxpayers described in section 448(a)(3) (tax shelters).

(2) Section 4.02 is added to clarify the proper time to take into account the cost of inventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) that are treated as materials and supplies that are not incidental under section 1.162-3;

(3) The conformity requirement of section 5.07 has been removed. Taxpayers are reminded that they must comply with the requirements under section 446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See section 1.446-1(a)(4);

(4) Section 6.02(1) is modified to provide that qualifying taxpayers using an accrual method of accounting that are not required under section 471 to account for inventories may use the automatic consent provisions of this revenue procedure to change to the cash method;

(5) Section 6.02(2) is modified to provide that qualifying taxpayers (including taxpayers not currently accounting for inventories) may use the automatic consent provisions of this revenue procedure to change to the method of accounting for inventoriable items as materials and supplies that are not incidental under section 1.162-3;

(6) Section 6.03 is added to provide guidance on the computation of the adjustment required under section 481(a) in connection with the automatic changes in method of accounting under this revenue procedure; and

(7) Section 8 is modified in accordance with the removal of the conformity requirement of section 5.07.

SECTION 3. SCOPE

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

SECTION 4. SMALL TAXPAYER EXCEPTION

.01 Pursuant to the discretion under sections 446(b) and 471, and to simplify bookkeeping requirements for small taxpayers, the Commissioner, as a matter of administrative convenience, will except qualifying taxpayers from the requirements to use an accrual method under section 446 and to account for inventories under section 471. For purposes of this revenue procedure, notwithstanding section 1001 and the regulations thereunder, qualifying taxpayers that use the cash method include amounts in income attributable to open accounts receivable (i.e., receivables due in 120 days or less) as amounts are actually or constructively received. However, section 1001 may be applicable to other transactions. Qualifying taxpayers that do not want to account for inventories must treat inventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) in the same manner as materials and supplies that are not incidental under section 1.162-3. Section 263A does not apply to inventoriable items that are treated as materials and supplies that are not incidental.

.02 Under section 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year in which the taxpayer sells the merchandise or finished

goods. Thus, under the cash method, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later. Producers may use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw materials that were used to produce finished goods that are sold during the tax year, provided that method is used consistently.

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

SECTION 5. DEFINITIONS

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

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

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

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

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

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

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

Taxpayer A has gross receipts (as defined in section 5.02 of this revenue procedure) of \$200,000 in 1996, \$800,000 in 1997 and \$1,100,000 in 1998. To determine whether it qualifies for the small taxpayer exception set forth in section 4 of this revenue procedure beginning with the 1999 tax year, Taxpayer A

computes its average annual gross receipts for each prior tax year ending on or after December 17, 1998, that is, its 1998 tax year. Taxpayer A's average annual gross receipts for 1998 is \$700,000 ($\$200,000 (1996) + \$800,000 (1997) + \$1,100,000 (1998) = \$2,100,000/3$).

Taxpayer A's average annual gross receipts for each prior tax year ending after December 17, 1998, does not exceed \$1,000,000. Therefore, Taxpayer A qualifies for the small taxpayer exception for its 1999 tax year. By following the procedures set forth in section 6.02 of this revenue procedure, Taxpayer A may change to the cash method and a method of treating inventoriable items in the same manner as materials and supplies that are not incidental under section 1.162-3 for the tax year ending December 31, 1999.

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

SECTION 6. CHANGE IN ACCOUNTING METHOD

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

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

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

(a) The scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply.

However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate;

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

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

(d) Taxpayers filing Form 3115 for a change in method of accounting under section 6.02 of this revenue procedure are reminded to complete all applicable parts of the form, including Part II, line 17 (regarding information on gross receipts in previous years) and Part III (regarding the section 481(a)

adjustment). Such taxpayers must also complete Part I of Schedule A of Form 3115, but need not complete Part II. Taxpayers should write "Filed under Rev. Proc. 2001-10" at the top of the form.

(2) Automatic change to section 1.162-3. A qualifying taxpayer that does not want to account for inventories must make any necessary change from the taxpayer's current method of accounting for inventoriable items (including, if applicable, from the method of capitalizing costs under section 263A) to treat inventoriable items in the same manner as materials and supplies that are not incidental under section 1.162-3. For purposes of such a change, the rules of section 6.02(1) of this revenue procedure apply. Taxpayers may file a single Form 3115 for both changes described in sections 6.02(1) and (2).

.03 Section 481(a) adjustment. The net amount of the section 481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, a taxpayer that wants to treat inventory as materials and supplies that are not incidental under section 1.162-3 must take into account the difference resulting from this recharacterization in determining the section 481(a) adjustment.

.04 Taxpayers not within the scope of this revenue procedure. A taxpayer that ceases to qualify for the small taxpayer exception described in section 4 of this revenue procedure and otherwise is required to use an accrual method (e.g., a taxpayer otherwise required to account for inventories) must change to an accrual method and, if applicable, an inventory method that complies with sections 263A and 471 using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 99-49, if applicable, or the advance consent provisions of Rev. Proc. 97-27, 1997-1 C.B. 680 (or its successor).

SECTION 7. EFFECT ON OTHER DOCUMENTS

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

SECTION 8. EFFECTIVE DATE

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

DRAFTING INFORMATION

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