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Automatic Changes for Simplified Tax Accounting Methods Provide Relief for Small Business Taxpayers: Rev. Proc. 2022-9 Overview

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The IRS and Treasury issued final regulations[1] that implement certain simplified methods of accounting that are available to small business taxpayers. These simplified methods, that the IRS refers to as the ''small business taxpayer exemption methods,'' permit a small business taxpayer to use simplified methods of accounting under §448[2] (use of the cash method of accounting); §263A (exception from applying §263A); §471 (exception from the requirement to maintain inventories); and §447 (use of the cash method for certain farmers). On December 16, 2021, the IRS issued Rev. Proc. 2022-9 that modifies and updates the accounting method change procedures under Rev. Proc. 2019-43 for taxpayers eligible to use the small business taxpayer exemption methods. On January 31, 2022, the IRS issued Rev. Proc. 2022-14, which also modifies and supersedes Rev. Proc. 2019-43, and provides the most recent list of accounting method changes eligible for the automatic consent procedures. The small business taxpayer exemption methods discussed below are now incorporated in the applicable sections of Rev. Proc. 2022-14.

BACKGROUND OF SMALL BUSINESS TAXPAYER PROVISIONS

The Tax Cuts and Jobs Act of 2017 (TCJA),[3] created a single gross receipts test for determining whether a taxpayer is a small business taxpayer and eligible to use the small business taxpayer exemption methods.[4] Under the TCJA, a taxpayer is considered a small business taxpayer if in any taxable year its average gross receipts for the three-year period prior to the current taxable year do not exceed $25 million (adjusted each year for inflation).[5] The rules for determining gross receipts under §448 are applicable to each small business taxpayer exemption method and require that the gross receipts of related parties be aggregated. Prior to the enactment of the TCJA, §448(a) prohibited C corporations and partnerships with a C corporation as a partner from using the cash method if the average annual gross receipts of the taxpayer for any three-taxable year period exceeded $5 million. If a taxpayer exceeded the threshold for any taxable year, it was required to use the accrual method and could not change back to the cash method in a year its average gross receipts were less than the threshold. However, under the revised test in the TCJA, a taxpayer with gross receipts close to the $25 million (as adjusted for inflation) threshold may be in the situation of having to file a method change each year that it exceeds or falls below the gross receipts threshold.

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This article may be cited as David Kalman, Brian Watkins, and Eric Lucas, *Automatic Changes for Simplified Tax Accounting Methods Provide Relief for Small Business Taxpayers: Rev. Proc. 2022-9 Overview*, 63 Tax Mgmt. Memo. No. 5 (Feb. 28, 2022).

[1] T.D. 9942, Small Business Taxpayer Exceptions Under Sections 263A, 448, 460 and 471, 86 Fed. Reg. 254 (Jan. 5, 2021).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] Pub. L. No. 115-97.

[4] *See* §448(b)(3), §448(c).

[5] §448(c)(1), §448(c)(4).

REV. PROC. 2022-9 HIGHLIGHTS (NOW INCORPORATED IN REV. PROC. 2022-14)

Section 446(e) requires taxpayers to secure the consent of the IRS before changing a method of accounting for federal income tax purposes. Changes to the small business taxpayer exemption methods are included Rev. Proc. 2022-14, the IRS's most recent list of method changes subject to automatic consent procedures. A taxpayer is generally precluded from filing a change in method of accounting under the automatic consent procedures if it filed the same accounting method change in the past five years.[6] However, for each small business taxpayer exemption method, Rev. Proc. 2022-14 generally waives the five-year eligibility rule for prior changes that were made in the first taxable year that the taxpayer was not a small business taxpayer. This is critical for those taxpayers with gross receipts close to the threshold and that may be forced to file method changes in the five-year window. Exceptions to the five-year waiver are noted under each change described below.

Section 3.04 of Rev. Proc. 2018-40 previously allowed a taxpayer to net an unfavorable §481 adjustment from a prior year method change with an §481 adjustment from a current year change. This option is now removed under each small business taxpayer exemption set forth in Rev. Proc. 2022-14. Thus, netting of the §481 adjustments is no longer permitted.

COMMON SMALL BUSINESS TAXPAYER EXEMPTION METHOD CHANGES UNDER REV. PROC. 2022-14

The following changes are the more common automatic changes applicable to small business taxpayers and taxpayers who were formerly small business taxpayers.

UNICAP Methods — §263A

The changes to the UNICAP Methods in Rev. Proc. 2022-14 are:

- A taxpayer that no longer satisfies the gross receipts exception and is changing to a §263A method described in the regulations; and
- A small business taxpayer that is changing from a §263A method. The five-year waiver of the eligibility rule does not apply if the taxpayer did not change to a §263A method in the first year it was no longer a small business taxpayer.

Overall Method

The changes to the overall accounting methods in Rev. Proc. 2022-14 are:

- A change to the accrual method in a year, other than the first year, a taxpayer no longer qualifies as a small business taxpayer (mandatory §448 year);
- A small business taxpayer that is not a tax shelter and wants to change to an overall accrual method of accounting;
- A new automatic change for a farmer who must change from the cash method to accrual method under §447;
- A new automatic change for small business taxpayers using an overall accrual method to use the accrual method only for purchases and sales of inventory and the cash method for all other items; and
- A syndicate that is considered a tax shelter is not eligible to use the small taxpayer exemption methods under §448(c). The final regulations provide an annual election to test an allocation of losses in the immediately preceding taxable year to determine if 35% of losses of a venture are allocated to limited partners or entrepreneurs and, therefore, not eligible for the small business exception.[7]

Inventory Methods

The changes to the inventory methods in Rev. Proc. 2022-14 are:

- A small business taxpayer change from an inventory method to account for inventories as (1) non-incidental materials and supplies (NIMS), (2) use its applicable financial statement (AFS) method, or (3) its books and records (the non-AFS method in Reg. §1.471-1(b)(6)); and
- A new automatic change for a taxpayer who no longer qualifies as a small business taxpayer to change from the NIMS method or the AFS and books and records method for valuing inventory to one of the permissible methods of inventory valuation described in §471(a) and Reg. §1.471-1(a). The five-year eligibility rule

[6] *See* Rev. Proc. 2015-13, §5.05.

[7] *See* Reg. §1.448-2(b)(2)(iii)(B) (annual election test).

ISSN 0148-8295

does not apply if this change is made for the first year when the taxpayer no longer qualifies as a small business taxpayer.

Other Changes

The additional noteworthy changes in Rev. Proc. 2022-14 are:

- A small business taxpayer who wants to change its method of accounting for exempt long-term construction contracts (those that qualify for the two-year rule) from the percentage of completion method (PCM) to an exempt contract method described in Reg. §1.460-4(c) or who wishes to stop capitalizing costs under §263A for certain home construction contracts described in §460(e)(1)(A); and
- A taxpayer making a concurrent change to an overall accrual method and to, from, or within a nonaccrual experience (NAE) method to file a single Form 3115, *Application for Change in Accounting Method*, for both changes.

Multiple changes related to the small business taxpayer exemption methods may generally be filed on a single Form 3115.

OBSERVATIONS AND CONCLUSION

When determining if a taxpayer is an eligible small business taxpayer, it must measure the gross receipts of all members of its aggregated group in determining whether the $25 million threshold applies. The aggregation rules for corporations and partnerships are described in §52 and §414. These rules are somewhat complex and, in many cases, will require related party gross receipts to be included in determining the taxpayer's eligibility for the small business taxpayer exemption methods.

The changes incorporated in Rev. Proc. 2022-14 are effective for method changes filed after December 16, 2021. A taxpayer in some years may be eligible for the small business taxpayer exemption methods and in other years may not be due to fluctuations in gross receipts or because of an inflation adjustment to the requisite threshold amount. This may cause the taxpayer to have to file accounting method changes in each year that the taxpayer is above or below the small taxpayer threshold.

The IRS guidance is helpful by allowing most of these accounting method changes to be filed under the automatic consent procedures. However, rather than providing a blanket waiver, the IRS created nuanced rules that will require a taxpayer to carefully evaluate any prior changes to determine whether the waiver is applicable, and the change is eligible for the automatic consent procedures.

Further, taxpayers making one change related to the small business taxpayer exemption methods should consider the need to make other changes to related methods. In particular, a taxpayer making a change to no longer apply §263A should also change its §471 inventory method.

ISSN 0148-8295