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SHIFTING FROM ACCRUAL TO CASH ACCOUNTING

— by Neil E. Harl*

The change in recent years by the Internal Revenue Service relative to allowing a shift from accrual to cash accounting represents a dramatic shift in philosophy. In its latest pronouncement, the Internal Revenue Service has indicated that it will exercise its discretion to except a qualifying small business taxpayer from the requirements to use an accrual method of accounting and has published procedures for obtaining an automatic consent to change to the cash method of accounting.

General requirements

A “qualifying small business taxpayer” may use the cash method of accounting for all of its trade or businesses if the taxpayer satisfies any one of three tests and did not previously change (and was not previously required to have changed) from the cash method of accounting to an accrual method for a trade or business as a result of becoming ineligible to use the cash method of accounting. The three tests are:

1. the taxpayer’s principal business activity is described in an NAICS code other than mining activities; manufacturing; wholesale trade; retail trade; and the information industries;
2. the taxpayer’s principal business activity involves providing services, including providing property incident to those services;
3. the taxpayer’s principal business activity is custom manufacturing involving tangible personal property.

A “qualifying small business taxpayer is any taxpayer that is not prohibited from using the cash method of accounting with “average annual gross receipts” of $10,000,000 or less, determined for each taxable year ending on or after December 31, 2000, for the three taxable-year period ending with the applicable prior taxable year. If the taxpayer has not been in existence for three prior taxable years, the taxpayer must determine its average annual gross receipts for the number of years (including short taxable years) that the taxpayer has been in existence.

Qualifying small business taxpayers who are permitted to use the cash method of accounting under the 2002 Revenue Procedure and who do not want to account for inventories must treat all inventoriable items in the same manner as materials and supplies that are not incidental. Under the regulations, materials and supplies that are not incidental are deductible only in the year in which they are actually used or consumed in the taxpayer’s business. Inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer provides the items to a customer.

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the cost of such inventoriable items is deductible only in that year or in the year the taxpayer actually pays for the goods, whichever is later.

A taxpayer may determine the amount of the deduction for non-incidental supplies and materials by using either a specific identification method; a first-in, first-out method; or an average-cost method, if the method is used consistently.

Taxpayers wishing to change to the cash method, and not account for inventories, are to follow the automatic accounting method change procedures. The “scope” limitations do not apply except that, if the taxpayer is under examination, before an appeals office or before a federal court with respect to any income issue, additional filing requirements are imposed. Taxpayers should write “Filed under Rev. Proc. 2002-38” at the top of their Form 3115, Application for Change in Accounting Method.

Application to farm businesses

Rev. Proc. 2002-28 specifically states that the revenue procedure “does not apply to a farming business (within the meaning of I.R.C. § 263A(e)(4) of a qualifying small business taxpayer).” That specifically includes, in the definition of “farming business,” operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts or other crops or ornamental trees. An evergreen tree which is more than six years old at the time severed from the roots is not treated as an ornamental tree.

Despite that language, the revenue procedure acknowledges that a taxpayer engaged in the trade or business of farming generally is allowed to use the cash method of accounting “for any farming business,” unless the taxpayer is required to use an accrual method of accounting or is prohibited from using the cash method.

Therefore, while farmers can be on cash accounting, the automatic change method under Rev. Proc. 2002-28 is not available to “a farming business.” The revenue procedure does acknowledge, however, that if a qualifying small business taxpayer is engaged in the trade or business of farming, the procedure for an automatic change in accounting from accrual to cash may apply to the taxpayer’s non-farming trades or businesses, if any.

FOOTNOTES


2 See I.R.C. § 446.


4 Id.


7 Id., Sec. 401(1)(b).

8 Id., Sec. 401(1)(c).

9 See I.R.C. § 448.

10 Id., Sec. 501, 502.

11 Id., Sec. 501.


13 See I.R.C. § 471(a) (requires inventories “clearly to determine the income” of a taxpayer with inventories maintained conforming to “the best accounting practice in the trade or business and as most clearly reflecting income”).


16 Id.


19 Id.

20 I.R.B. 2002-18, 815.

21 Id. See I.R.C. § 263A(e)(4)(A) (the term “farming business” means “the trade or business of farming”).


24 See I.R.C. § 447.

25 See I.R.C. § 448.

26 I.R.B. 2002-18, 815.

27 Id., Sec. 3.02.

28 Id., Sec. 3.02.

CASES, REGULATIONS AND STATUTES by Robert P. Achenbach, Jr

ANIMALS

TRESPASS. A bull owned by the defendant broke through a fence on a neighbor’s ranch. An employee of the neighbor, the plaintiff, was injured while helping to capture and return the bull. The plaintiff sued under a theory of strict liability created by Montana Code § 81-4-215. The trial court granted summary judgment to the defendant on the basis that the statute did not create strict liability for trespassing animals. The court noted that the statute modified the common law rule of strict liability for trespassing animals by creating a “fence out” requirement for claiming damages from trespassing animals. The statute required property owners to erect legal fences, as defined in Montana Code § 81-4-101, in order to bring an action for trespass. The court also noted that the statute stated that “the owner of the animals is