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Changing From Accrual to Cash Accounting: Watch Your Step

-by Neil E. Harl*

As is well known, the Internal Revenue Service is not a fan of cash accounting (even though the Department of the Treasury approved cash accounting for farmers and ranchers in 1918)\(^1\) nor is Congress totally enamored with the idea at the present time.\(^2\) Nonetheless, the regulations and rulings have, since 1918, provided a procedure for shifting from accrual to cash accounting for eligible taxpayers.

The current authority for cash accounting is in I.R.C. § 446(c)(1) which states, as the first option for permissible methods of accounting “...the cash receipts and disbursements method.”

The “simplified procedure” for filing Form 3115

A few days after the release of Rev. Proc. 2015-14,\(^3\) IRS announced a “simplified procedure” which allows small businesses to change a method of accounting under the final tangible property regulations on a prospective basis for the first taxable year beginning on or after January 1, 2014.\(^4\) The announcement also waived the requirement for small business taxpayers to complete and file a Form 3115 under the simplified procedure.\(^5\) An eligible taxpayer is permitted to make the desired changes on its federal tax return without including a separate Form 3115 or separate statement for its trades or businesses. Rev. Proc. 2015-20\(^6\) focuses on relief from filing Form 3115 for the 2014 tax year for small business taxpayers with total assets of less than $10 million and average annual gross receipts of $10 million or less in the three preceding years. However, Rev. Proc. 2015-20\(^7\) does not alter the provisions in Rev. Proc. 2015-14\(^8\) that govern a shift from accrual to cash accounting.

Shifting from accrual to cash accounting

As noted, a shift from accrual to cash accounting is presently governed by Rev. Proc. 2015-14\(^9\). Section 14.03(1)(b) of that Revenue Procedure deals with the “qualifying small business taxpayer” which, if a taxpayer is eligible, does not require a Form 3115 to be filed. The taxpayer simply makes the necessary adjustment on the tax return.\(^10\) However, that subsection states that a farmer (or rancher) is not eligible to shift from accrual to cash accounting under that subsection but may still be eligible under Section 14.13 of the same Revenue Procedure, Rev. Proc. 2015-14.

Section 14.13, entitled, “Change to Overall Cash Method for Farmers, states, in subsection (1)(a) that this change applies to a taxpayer engaged in the trade or business of farming that wants to change to the overall cash receipts and disbursements method. It appears that a

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shift from accrual to cash accounting is not within the exception for a “qualifying small business taxpayer,” however.\(^4\) For such a change in accounting (accrual to cash), the taxpayer is required to file a Form 3115 and compute an I.R.C. § 481 adjustment (except in changing from the “crop” method of accounting)\(^2\) which requires the taxpayer to take into account “… those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.” The designated “automatic accounting change” for this type of change for the Form 3115 (if the Form 3115 is required to be filed) is “128.”

If a Form 3115 is required to be filed, and depending upon whether Section 481(a) requires payment, such amount is to be paid, if a positive figure, and “taken into account” if it is a negative figure. The last sentence of that subsection of the Internal Revenue Code, states, as an exception to the “taxable years” clause, that the passage does not apply to “… an adjustment attributable to a change in the method of accounting initiated by the taxpayer.”

Subsection 14.13(1)(b) of Rev. Proc. 2015-14\(^3\) reminds taxpayers that the rules for this change do not apply to those required to use accrual accounting under I.R.C. § 447 or those prohibited from using the cash method by I.R.C. § 448. The scope of that prohibition is discussed below.

As noted, Rev. Proc. 2015-14\(^4\) states that farming businesses may be eligible under Rev. Proc. 2015-14, § 14.03(1)(a) (which places a limit of $1,000,000 or less of average annual gross receipts for eligibility) but not § 14.03(1)(b) (a $10,000,000 ceiling).\(^5\) Yet, the same subsection states that a farming business that is not eligible under § 14.03(5) may still be eligible to change to the overall cash method under § 14.13 if it meets the requirements of that section.\(^6\)

Complications from I.R.C. §§ 447, 448

Section 14.13(1)(b)\(^7\) states that an accounting change under Section 14.13 of Rev. Proc. 2015-14\(^8\) does not apply to those pursuing an accrual method under I.R.C. § 447 or prohibited from using the cash method by § 448.

I.R.C. § 447 addresses allowable methods of accounting for corporations engaged in farming. The first subsection states that “except as otherwise provided by law, the taxable income from farming of (1) a corporation engaged in the trade or business of farming, or (2) a partnership engaged in the trade or business of farming, if a corporation is a partner in such partnership, shall be computed on an accrual method of accounting.”\(^9\) The provision does not apply to “… the trade or business of operating a nursery or sod farm or to the raising or harvesting of trees (other than fruit and nut trees).”\(^10\) However, I.R.C. § 447(c) states that “for purposes of subsection (a), a corporation shall be treated as not being a corporation if it is – (1) an S corporation, or (2) a corporation the gross receipts of which meet the requirements of subsection (d).” That appears to mean that, for S corporations standing alone, the way is clear for a shift to cash accounting.

The reference to subsection (d) invokes a subsection dealing with controlled groups.\(^11\) Thus, the question is whether the reference in Subsection (c)(2) – “a corporation the gross receipts of which meet the requirements of subsection (d)” applies just to C corporations or to both C and S corporations. Turning to subsection (d), because the statute refers in subsection 447(c)(2) to “corporation” in the disjunctive “or” (after carefully specifying that S corporations are blanketed into eligibility for cash accounting in § 447(c)(1)), leads one to the conclusion that that those drafting the statute did not mean to define “corporation” to give S corporations a “free pass” to cash accounting under § 447(a) when it comes to subsection (d) controlled groups unless the S corporation can meet the tests in § 447(d) based on gross receipts. There are no regulations that reach a different conclusion.

So, in the absence of formal guidance to the contrary, it appears that there is no problem for cash accounting for S corporations standing alone. However, S corporations must run the gauntlet of tests of controlled group status along with C corporations if a controlled group or groups are involved.

ENDNOTES


2 See Camp, Proposed Tax Reform Act of 2014, which would have banned cash accounting for those with average gross receipts (for the preceding three years) of more than $10 million.

3 2015-1 C.B. 450.


5 Id.

6 2015-1 C.B. 694.

7 2015-1 C.B. 694.

8 2015-1 C.B. 450.

9 2015-1 C.B. 450.

10 Id.


12 See 1 Harl, Farm Income Tax Manual § 1.07[1][c] (Matthew Bender 2015 ed.).

13 2015-1 C.B. 450.

14 2015-1 C.B. 450.


18 2015-1 C.B. 450.

19 I.R.C. § 447(a).

20 I.R.C. § 447(d).