

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part 1, §§ 162, 263A, 446, 471, 481; 1.162-3, 1.263A-1, 1.446-1, 1.471-1, 1.481-1, 1.481-4.)

Rev. Proc. 2000-22

SECTION 1. PURPOSE

This revenue procedure 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 account for inventories and to use an accrual method of accounting for purchases and sales of merchandise. This revenue procedure also provides the procedures by which a qualifying taxpayer may obtain automatic consent to change to the cash receipts and disbursements method of accounting (the cash method).

SECTION 2. BACKGROUND

.01 Section 446(c) of the Internal Revenue Code 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, subject to certain restrictions. For example, § 446(b) provides that the selected method must clearly reflect income. In addition, § 1.446-1(c)(2)(i) of the Income Tax Regulations requires that a taxpayer use an accrual method of accounting

with regard to purchases and sales of merchandise whenever § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under § 1.446-1(c)(2)(ii). Under § 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.

.02 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.

.03 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.

.04 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain personal 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 § 263A. See § 263A(b)(2)(B) and § 1.263A-2(b)(3)(iv).

.05 Section 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 § 446(e).

.06 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.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer with "average annual gross receipts" of \$1,000,000 or less (as defined in section 5.01 of this revenue procedure) that satisfies the "conformity" requirement (as described in section 5.07 of this revenue procedure).

SECTION 4. SMALL TAXPAYER EXCEPTION

Pursuant to the discretion under §§ 446(b) and 471, and to simplify bookkeeping requirements for small taxpayers, the Commissioner, as a matter of administrative convenience, will except taxpayers described in section 3 of this revenue procedure from any requirement to account for inventories under § 471 or to use an accrual method under § 446. A taxpayer described in section 3 that does not want to account

for inventories must treat merchandise inventory in the same manner as a material or supply that is not incidental under § 1.162-3. Section 263A does not apply to such merchandise inventory.

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 § 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 § 52 or subsection (m) or (o) of § 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 § 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 § 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 *Conformity.* A taxpayer satisfies the conformity requirement of this revenue procedure if the taxpayer does not regularly use any method other than the cash method to ascertain the income, profit or loss of the trade or business for purposes of its books and records and reports (including financial statements) to shareholders, partners, other proprietors, or beneficiaries and for credit purposes for the current and prior 3 tax years (excluding tax years ending before December 17, 2000). A taxpayer

that uses the cash method of accounting for purposes of its books and records and reports but, on an isolated basis, prepares financial reports using an accrual method (for example, on a one-time basis to obtain a bank loan) will not be considered to violate the conformity requirement.

.08 *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 § 1.471-1 to use inventory accounts and § 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 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 merchandise inventory in the same manner as a material or

supply that is not incidental under § 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 (that is, the average of A's gross receipts for 1999, 1998, and 1997) also must be \$1,000,000 or less and Taxpayer A must meet the conformity requirement of section 5.07 of this revenue procedure. 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 purchases and sales of merchandise in accordance with section 6.03 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 §§ 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 taxpayer that qualifies for the small taxpayer exception described in section 4 of this revenue procedure 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 July 14, 2000, files its original federal income tax return for such year, is not subject to 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 November 13, 2000. 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.

(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 § 481 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. 2000-22” at the top of the form.

(2) *Change to comply with § 1.162-3.* A taxpayer that qualifies for the small taxpayer exception described in section 4 of this revenue procedure that does not want to account for inventories must make any necessary change from the taxpayer’s inventory method (and, if applicable, from the method of capitalizing costs under § 263A) to treat merchandise inventory in the same manner as a material or supply that is not incidental under § 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 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 account for inventories must change to an inventory method that complies with §§ 263A and 471 and an accrual method with respect to purchases and sales of merchandise 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. 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 § 446 (and a taxpayer's failure to account for inventories under § 471) in an earlier year if the taxpayer consistently used the cash method (and consistently did not account for inventories) and 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), and the conformity requirement of section 5.07 (applied by testing the earlier year and the 3 tax years prior to such earlier year).

DRAFTING INFORMATION

The principal author of this revenue procedure is Cheryl Lynn Oseekey of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Oseekey on (202) 622-4970 (not a toll-free call).