§ 212.40 Use of guidance documents.

Guidance documents cannot create binding requirements that do not already exist by statute or regulation. Accordingly, non-compliance with guidance documents cannot be used as a basis for proving violations of applicable law. Guidance documents can do no more, with respect to prohibition of conduct, than articulate USAID's understanding of how a statute or regulation applies to particular circumstances.

Ruth Buckley,

Acting Performance Improvement Officer/ Acting Office Director, Bureau for Management Office of Management Policy, Budget and Operational Performance.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9942]

RIN 1545–BP53

Small Business Taxpayer Exceptions Under Sections 263A, 448, 460 and 471

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations to implement legislative changes to sections 263A, 448, 460, and 471 of the Internal Revenue Code (Code) that simplify the application of those tax accounting provisions for certain businesses having average annual gross receipts that do not exceed $25,000,000, adjusted for inflation. This document also contains final regulations regarding certain special accounting rules for long-term contracts under section 460 to implement legislative changes applicable to corporate taxpayers. The final regulations generally affect taxpayers with average annual gross receipts of not more than $25 million, as adjusted for inflation.

DATES:

Effective date: The regulations are effective on January 5, 2021.

Applicability dates: For dates of applicability, see §§ 1.263A–1(a)(2)(i), 1.263A–1(m)(6), 1.263A–2(g)(4), 1.263A–3(f)(2), 1.263A–4(g)(2), 1.263A–7(a)(4)(ii), 1.381(c)(5)–1(f), 1.446–1(c)(3), 1.448–2(h), 1.448–3(h), 1.460–1(h)(3), 1.460–3(d), 1.460–4(i), 1.460–6(k), and 1.471–1(c).

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.460–1 through 1.460–6, Innessa Glazman, (202) 317–7006; concerning all other regulations in this document, Anna Gleysteen, (202) 317–7007.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) to implement statutory amendments to sections 263A, 448, 460, and 471 of the Code made by section 13102 of Public Law 115–97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). These statutory amendments generally simplify the application of the method of accounting rules under those provisions to certain businesses (other than tax shelters) with average annual gross receipts that do not exceed $25,000,000, adjusted for inflation.

The uniform capitalization (UNICAP) rules of section 263A provide that, in general, the direct costs and the properly allocable share of the indirect costs of real or tangible personal property produced, or real or personal property described in section 1221(a)(1) acquired for resale, cannot be deducted but must either be capitalized into the basis of the property or included in inventory costs, as applicable. Before the enactment of the TCJA, certain types of taxpayers and certain types of property were exempt from UNICAP, but there was no generally applicable exemption based on gross receipts.

Section 448(a) generally prohibits C corporations, partnerships with a C corporation as a partner, and tax shelters from using the cash receipts and disbursements method of accounting (cash method). However, section 448(b)(3) provides that section 448(a) does not apply to C corporations and partnerships with a C corporation as a partner that meet the gross receipts test of section 448(c). Prior to the TCJA's enactment, a taxpayer met the gross receipts test of section 448(c) if, for all taxable years preceding the current taxable year, the average annual gross receipts of the taxpayer (or any predecessor) for any 3-taxable-year period did not exceed $5 million.

Section 460(a) provides that income from a long-term contract must be determined using the percentage-of-completion method (PCM). A long-term contract is defined in section 460(f) as generally any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into. Subject to special rules in section 460(b)(3), section 460(b)(1)(A) generally provides that the percentage of completion of a long-term contract is determined by comparing costs allocated to the contract under section 460(c) and incurred before the close of the taxable year with the estimated total contract costs. Prior to the TCJA, section 460(e)(1)(B) provided an exemption from the PCM for a long-term construction contract of a taxpayer who estimated that the contract would be completed within the 2-year period from the commencement of the contract (two-year rule), and whose average annual gross receipts for the 3-taxable-year period ending with the year preceding the year the contract was entered into did not exceed $10 million (Section 460(e) gross receipts test).

Section 471(a) requires inventories to be taken by a taxpayer when, in the opinion of the Secretary of the Treasury or his delegate (Secretary), taking an inventory is necessary to determine the income of the taxpayer. Section 1.471–1 requires the taking of an inventory at the beginning and end of each taxable year in which the production, purchase, or sale of merchandise is an income-producing factor. Additionally, when an inventory is required to be taken, § 1.446–1(c)(1)(iv) and (c)(2) require that an accrual method be used for purchases and sales. Prior to the enactment of the TCJA, there were no regulatory exceptions from the requirement to take an inventory under § 1.471–1.

The statutory amendments of the TCJA increase the gross receipts test amount under section 448(c) to $25,000,000, adjusted for inflation, for eligibility to use the cash method and also exempt taxpayers, other than a tax shelter under section 448(a)(3), meeting the gross receipts test (Section 448(c) Gross Receipts Test) from: (1) The UNICAP rules under section 263A; (2) the requirement to use the percentage-of-completion method under section 460 provided other requirements of section 460(e) are satisfied; and (3) the requirement to take inventories under section 471(a) if their inventory is treated as non-incidental materials and supplies, or if the method of accounting for their inventory conforms with the method reflected on their applicable financial statement (AFS), or if they do not have an AFS, their books and records prepared in accordance with their accounting procedures. These amendments generally apply to taxable years beginning after December 31, 2017. The amendments to section 460 apply to contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017.

On August 20, 2018, the Department of the Treasury (Treasury Department)

and the IRS issued Revenue Procedure 2018–40 (2018–34 IRB 320), which provided administrative procedures for a taxpayer, other than a tax shelter under section 448(a)(3), meeting the requirements of section 448(c) to obtain the consent to change the taxpayer's method of accounting to a method of accounting permitted by section 263A, 448, 460 or 471. The revenue procedure also requested comments for future guidance regarding the implementation of the TCJA modifications to sections 263A, 448, 460, and 471. The record of public comments received in response to Revenue Procedure 2018–40 may be requested by sending an email to *Notice.Comments@irs.gov.*

On August 5, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–132766–18) in the **Federal Register** (85 FR 47608), correction published in the **Federal Register** (85 FR 58307) on September 18, 2020, containing proposed regulations under sections 263A, 448, 460, and 471 (proposed regulations). The proposed regulations reflect consideration of the comments that were received in response to Revenue Procedure 2018–40.

The Treasury Department and the IRS received nine written comments responding to the proposed regulations. The Treasury Department and the IRS received one request to speak at a public hearing, which was later withdrawn. Therefore, no public hearing was held. Comments received before these final regulations were substantially developed, including all comments received on or before the deadline for comments on September 14, 2020, were carefully considered in developing these final regulations.

Copies of the comments received are available for public inspection at *http://www.regulations.gov* or upon request. After consideration of the comments received, this Treasury decision adopts the proposed regulations as revised in response to such comments. Those comments and the revisions are discussed in the Summary of Comments and Explanation of Revisions section of this preamble.

Summary of Comments and Explanation of Revisions

I. Overview

This Summary of Comments and Explanation of Revisions section summarizes the formal written comments that were received addressing the proposed regulations. However, comments merely summarizing or interpreting the proposed regulations or recommending statutory revisions generally are not discussed in this preamble. These final regulations provide guidance under sections 263A, 448, 460, and 471 to implement the TCJA's amendments to those provisions. These final regulations also modify §§ 1.381(c)(5)–1 and 1.446–1 to reflect these statutory amendments. The rationale for provisions in these final regulations that are not discussed in this Explanation of Revisions remains the same as described in the Explanation of Provisions section of the preamble to the proposed regulations.

A. Section 263A(i)

1. Costing Rules for Self-Constructed Assets

In response to Revenue Procedure 2018–40, a commenter stated that a small business taxpayer that is exempted from section 263A pursuant to section 263A(i) would be subject to the costing rules prior to the enactment of section 263A (pre-section 263A costing rules) for self-constructed assets used in the taxpayer's trade or business. However, according to the commenter, the pre-section 263A costing rules were unclear as to what costs are capitalizable to self-constructed assets. In light of this comment, the preamble to the proposed regulations requested comments on specific clarifications needed regarding the pre-section 263A costing rules. Only one comment was received in response to this request. The sole commenter noted that one of the reasons for the enactment of section 263A was that courts had reached different conclusions as to the types of costs that were required to be capitalized under the pre-section 263A costing rules. *Compare Adolph Coors Co.* v. *Commissioner,* 519 F.2d 1280 (10th Cir. 1975), cert. denied 423 U.S. 1087 (1976) (requiring the full inclusion of all overhead costs in the cost basis of self-constructed assets) *with Fort Howard Paper Co.* v. *Commissioner,* 49 T.C. 275 (1967) (requiring only the inclusion of overhead costs directly attributable to the self-constructed asset). The commenter suggested that taxpayers who used the exemption under section 263A(i) to not capitalize costs under section 263A be permitted to use an incremental costing method to determine the costs of self-constructed assets, consistent with the approach in *Fort Howard Paper.* The commenter stated that identifying indirect costs not directly attributable to the construction of specific self-constructed assets would be difficult.

After considering this comment, the Treasury Department and the IRS have determined that the requested clarification is beyond the scope of these regulations, which is to implement section 263A(i) as enacted by TCJA. For taxpayers that elect under section 263A(i) to not apply section 263A, the requirement to capitalize certain costs to self-constructed assets comes from other provisions of the Code, such as section 263(a). TCJA did not amend such provisions and thus the clarification of permissible capitalization methods and the types of costs required to be capitalized to self-constructed assets under such provisions is beyond the scope of these final regulations.

2. Changes to Regulations Under Section 448

Under section 448(a)(3), a tax shelter is prohibited from using the cash method. Section 448(d)(3) cross references section 461(i)(3) to define the term ''tax shelter.'' Section 461(i)(3)(B), in turn, includes a cross reference to the definition of ''syndicate'' in section 1256(e)(3)(B), which defines a syndicate as a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of that entity during the taxable year are *allocable* to limited partners or limited entrepreneurs. Sections 1.448–1T(b)(3) (for taxable years beginning before January 1, 2018) and proposed 1.448–2(b)(2)(iii) (for taxable years beginning after December 31, 2017) narrow this definition by providing that a taxpayer is a syndicate only if more than 35 percent of its losses are *allocated* to limited partners or limited entrepreneurs. Consequently, a partnership or other entity (other than a C corporation) may be considered a syndicate under section 448 only for a taxable year in which it has losses.

Proposed § 1.448–2(b)(2)(iii)(B) permits a taxpayer to elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate under section 448(d)(3) for the current taxable year. Under the proposed regulations, a taxpayer that makes this election must apply the rule to all subsequent taxable years, and for all purposes for which status as a tax shelter under section 448(d)(3) is relevant, unless the Commissioner permits a revocation of the election.

Several comments were received concerning issues related to tax shelters, including the definition of ''syndicate,'' under proposed § 1.448–2(b)(2)(i)(B). Some commenters recommend using the authority granted under section 1256(e)(3)(C)(v) to provide a deemed active participation rule to disregard certain interests held by limited

entrepreneurs or limited partners for applying the Section 448(c) Gross Receipts Test if certain conditions were met. For example, conditions of the rule could include that the entity had not been classified as a syndicate within the last three taxable years, and that the average taxable income of the entity for that period was greater than zero.

The final regulations do not adopt this recommendation. The Treasury Department and the IRS have determined that it would be inappropriate to provide an exception to the active participation rules in section 1256(e)(3)(C)(v) by ''deeming'' active participation for small business taxpayers. The Treasury Department and the IRS believe that the deeming of active participation in this context would be overbroad and would run counter to Congressional intent. Sections 448(b)(3) and (d)(3), 461(i)(3) and 1256(e)(3)(C) were not modified by the TCJA, and the legislative history to section 13012 of the TCJA does not indicate any Congressional intent to modify the definition of ''tax shelter'' or ''syndicate.'' By not modifying those provisions, Congress presumably meant to exclude tax shelters, including syndicates, from being eligible to use the cash method of accounting and the small business taxpayer exemptions in section 13102 of the TCJA, even while otherwise expanding eligibility to meet the Section 448(c) Gross Receipts Test.

Other comments requested clarification generally of what ''active participation'' means and the circumstances, if any, under which a member of a limited liability company is treated as a ''limited partner'' or ''limited entrepreneur'' under section 461(k)(4). The Treasury Department and the IRS have determined that such guidance is outside the scope of these final regulations, which are to implement the changes made by section 13102 of the TCJA.

The Treasury Department and the IRS remain aware of the increased relevance of the definition of tax shelter under section 448(d)(3) after enactment of the TCJA and the practical concerns regarding the determination of tax shelter status for the taxable year. To ameliorate these practical concerns, these final regulations modify the syndicate election provided in proposed § 1.448–2(b)(2)(iii)(B) to provide additional relief by making the election an annual election. The Treasury Department and the IRS have determined that an annual election appropriately balances the statutory language with the consistency requirement for use of a method of accounting under section 446(a) and § 1.446–1. A cash method taxpayer that is generally profitable year-to-year may experience an unforeseen taxable loss for an anomalous year but return to its profitable position in subsequent years. If the taxpayer allocated more than 35 percent of the taxable loss to limited partners or limited entrepreneurs, the taxpayer would be required to change from the cash method to another method for the anomalous year in accordance with section 448(a)(3). However, that taxpayer would otherwise not be prohibited under section 448(a)(3) to use the cash method in the next profitable taxable year. An annual election under § 1.448–2(b)(2)(iii)(B) allows a taxpayer to elect in the loss year to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate under section 448(d)(3) for the current taxable year. The Treasury Department and the IRS have determined that permitting taxpayers to continue to use the cash method, as well as other methods impacted by a determination under section 448(d)(3), in such situations is consistent with the requirements under section 446(a).

This election applies for all provisions of the Code that specifically refer to section 448(a)(3) to define tax shelter, such as the small business exemptions under sections 163(j)(3), 263A(i)(1), 460(e)(1)(B) and 471(c)(1). A taxpayer is required to file a statement with the original timely filed Federal income tax return, with extensions, to affirmatively make this election under § 1.448–2(b)(2)(iii)(B) for such taxable year. The election is valid only for the taxable year for which it is made, and once made, cannot be revoked. The Treasury Department and the IRS intend to issue procedural guidance to address the revocation of an election made under proposed § 1.448–2(b)(2)(iii)(B) as a result of the application of the final regulations.

Other commenters noted for some taxpayers who took advantage of the small business exception in section 448(b)(3) to change to the cash method, the change in method of accounting resulted in a negative section 481(a) adjustment, which triggered an allocated loss and made the taxpayer a tax shelter under section 448(a)(3). As a result, the taxpayers became ineligible to use the cash method for the year in which the negative section 481(a) adjustment was recognized but may be otherwise eligible to use the cash method for future years. Under proposed § 1.448–2(g)(3), these taxpayers would be ineligible for the automatic change procedures to make a subsequent change back to the cash method once they are no longer tax shelters within a five-year period. The commenters recommend relief for taxpayers with this situation.

The commenters propose an exception to the tax shelter rules for a taxpayer that satisfies the Section 448 Gross Receipts Test if a negative section 481(a) adjustment from a change in method of accounting under the small business taxpayer exemptions (for example, sections 263A(i), 471(c), 448(b)) results in the taxpayer being considered a tax shelter under section 448(d)(3) and proposed § 1.448–2(b)(2)(iii). These final regulations do not adopt this suggestion. As described in the Preamble to the proposed regulations, the Treasury Department and the IRS have determined that no exception was provided in the TCJA to limit the definition of tax shelter in section 448(d)(3) for taxpayers making method changes related to the small business taxpayer exemptions. However, the Treasury Department and the IRS expect that the annual election under § 1.448–2(b)(2)(iii)(B), described earlier, will provide relief for many taxpayers in this situation.

Additionally, the Treasury Department and the IRS have reconsidered the 5-year restriction on automatic method changes in light of these comments. Section 446(a), unmodified by the TCJA, provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer *regularly* computes his income in keeping his books. A taxpayer that changes its method of accounting for the same item with regular frequency (for example, annually or every other taxable year) is not adhering to the consistency requirement of section 446. The consistency requirement of section 446(a) is distinct from the authority granted the Commissioner under section 446(b) to determine whether the method of accounting used by a taxpayer clearly reflects income. *See e.g., Advertisers Exchange, Inc.* v. *Commissioner,* 25 T.C. 1086, 1092 (1956) (''Consistency is the key and is required regardless of the method or system of accounting used.'') (citations omitted); *Huntington Securities Corporation* v. *Busey,* 112 F.2d 368, 370 (1940) (''. . . whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change.'')

The Treasury Department and the IRS are aware that the 5-year restriction in proposed § 1.448–2(g)(3) could be burdensome for a small business taxpayer that was required to change from the cash method as a result of

section 448(a)(3) or not meeting the Section 448 Gross Receipts Test in a taxable year but that becomes eligible to use the cash method under section 448 in the subsequent taxable year. Proposed § 1.448–2(g)(3) would have required this small business taxpayer to request consent to change back to the cash method using the non-automatic change procedures in Revenue Procedure 2015–13 (or successor). These final regulations remove the 5-year restriction on making automatic method changes for certain situations.

Sections 263A(i)(3), 448(d)(7), 460(e)(2)(B) and 471(c)(4) provide that certain changes in method of accounting for the small business exemptions are made with the consent of the Secretary. A taxpayer must follow the applicable administrative procedures related to a change in method of accounting notwithstanding the deemed consent of the Secretary. *See, e.g., Capital One Financial Corporation and Subsidiaries* v. *Commissioner of Internal Revenue,* 130 T.C. 147, 157 (2008) (''a taxpayer forced to change its method of accounting under section 448 must still file a Form 3115 with its return''). The Treasury Department and the IRS intend to provide procedural rules relating to changes in method of accounting to implement the final regulations using the automatic method change procedures of Revenue Procedure 2015–13. Those procedural rules will address whether a waiver of the 5-year overall method eligibility rule in section 5.01(1)(e) of Revenue Procedure 2015–13 is appropriate for small business taxpayers that were required to change from the cash method in one taxable year but are not subsequently limited by section 448.

The Treasury Department and the IRS have determined that taxpayers that are voluntarily changing (that is, not required by section 448 to no longer use the cash method) between overall methods are distinguishable from taxpayers that are required to change from the cash method to another method because they no longer meet the Section 448(c) Gross Receipts Test or become a tax shelter under section 448(d)(3). The procedural guidance is expected to address both fact patterns. Additionally, the Treasury Department and the IRS intend for the procedural guidance to address similar fact patterns for taxpayers making changes related to the regulations under sections 263A(i), 460(e)(1)(B) and 471(c), as discussed in this Summary of Comments and Explanation of Revisions.

3. Section 471 Small Business Taxpayer Exemptions

A. Inventory Treated as Non-Incidental Materials and Supplies

The preamble to the proposed regulations notes that the Treasury Department and the IRS interpret the statutory language of section 471(c)(1)(B) to mean that the property excepted from section 471(a) by that provision continues to be inventory property even though the general inventory rules under section 471(a) are not required to be applied to that property. Section 471(c)(1)(B) provides that a qualifying taxpayer's ''method of accounting for *inventory* for such taxable year'' (emphasis added) will not be treated as failing to clearly reflect income if the method ''treats *inventory* as non-incidental materials and supplies'' (emphasis added). The Treasury Department and the IRS read the repeated use of the word ''inventory'' to mean that Congress intended that inventory property remains inventory property while relieving taxpayers from the general inventory rules of section 471(a). To reduce confusion about the nature of property treated as non-incidental materials and supplies under section 471(c)(1)(B)(i), these final regulations refer to the method under that provision of the Code as the ''section 471(c) NIMS inventory method.''

The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as providing three distinct benefits for taxpayers. First, the provision significantly expanded the types of taxpayers permitted to treat their inventory as non-incidental materials and supplies. Under prior administrative guidance, as discussed later in section 3.A.i of this Summary of Comments and Explanation of Revisions, taxpayers with gross receipts of no more than $1 million and taxpayers in certain industries (generally not producers or resellers) with gross receipts of no more than $10 million were permitted to treat their inventory as non-incidental materials and supplies. Section 471(c) greatly expanded the availability of this method of accounting to taxpayers in all types of trades or businesses, including producers and resellers, by reference to the increased cap on gross receipts under the Section 448(c) Gross Receipts Test. Second, treating inventory as non-incidental materials and supplies under § 1.471–1(b)(5) provides simplification and burden reduction for taxpayers by requiring only certain costs to be capitalized to inventory. For example, a taxpayer using the section 471(c) NIMS inventory method does not capitalize direct labor costs or any indirect costs to inventory costs. See discussion of direct labor costs later in section 3.A.iii of this Summary of Comments and Explanation of Revisions. Simplification does not indicate that the nature of the property was changed by the TCJA, or that the intent of Congress was to provide immediate expensing of inventory costs. Thirdly, taxpayers, other than a tax shelter under section 448(a)(3), treating inventory as non-incidental materials and supplies under § 1.471–1(b)(5) are eligible to use the overall cash method of accounting for purchases and sales of merchandise, rather than being required to use an accrual method. *See* § 1.446–1(a)(4)(i).

i. Definition of the Term ''Used or Consumed''

The preamble to the proposed regulations provides that the Treasury Department and IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative guidance existing at the time of its enactment (that is, Revenue Procedure 2001–10 (2001–2 IRB 272) and Revenue Procedure 2002–28 (2002–18 IRB 815)) and making that method available to significantly more taxpayers. Accordingly, the proposed regulations provided that items of inventory treated as materials and supplies under section 471(c) are used or consumed in the taxable year in which the taxpayer provides the item to a customer, and the cost of such item is recovered in that taxable year or the taxable year in which the taxpayer pays for or incurs such cost, whichever is later.

Comments were received on the definition of ''used or consumed'' in proposed § 1.471–1(b)(4)(i) as it relates to producers. A commenter asserted that the meaning of the term ''used or consumed'' for a producer using the section 471(c) NIMS inventory supplies method should be consistent with the meaning of the term ''used or consumed'' in § 1.162–3. The commenter states that a producer's raw materials are ''used or consumed'' when the raw materials enter the taxpayer's production process. The commenter states that under section 471(c)(1)(B)(i) and § 1.162–3(a)(1), only section 263A would limit a producer's ability to recover the cost of its raw materials when the raw materials are first used in the production process, and the final regulations should be modified to provide that a producer does not wait until the finished product is provided to a customer to recover the costs of its raw materials. In addition, the commenter states that the policy considerations

underlying this provision were to provide small business taxpayers with simplification, and the definition of ''used or consumed'' for producers in proposed § 1.471–1(b)(4)(i) does not result in simplification.

The Treasury Department and IRS decline to change the definition of used or consumed for a producer in these final regulations. As discussed previously, the Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative guidance existing at the time of enactment of TCJA (that is, Revenue Procedure 2001–10 and Revenue Procedure 2002–28) and making it applicable to significantly more taxpayers, in addition to the other benefits discussed in section 3.A of this Summary of Comments and Explanation of Revisions. The commenter's recommendation that the term ''used or consumed'' for a producer should be treated as occurring when the raw material is used or consumed in the taxpayer's production process would allow a producer to recover production costs earlier than was previously allowed under the administrative guidance of Revenue Procedure 2001–10 and Revenue Procedure 2002–28. Additionally, the commenter's recommendation suggests that the term ''used or consumed'' should be interpreted literally by looking to actual use or consumption by the taxpayer. However, under such an interpretation a reseller, unlike a producer, would not be able to recover any inventory costs as a reseller does not acquire raw materials for use in a production process nor does it use or consume finished inventory; rather a reseller acquires and resells finished inventory, unchanged, to customers. The Treasury Department and the IRS have determined that the statute and legislative history do not support a reading of the provision that would provide such a disparity in the recovery of inventory costs between producers and resellers.

In addition, the commenter's argument interprets the words ''inventory treated as non-incidental materials and supplies'' to mean that the components used to produce the finished goods inventory, rather than the finished goods inventory itself, are treated as materials and supplies. The interpretation advocated by the commenter would result in producers being permitted to recover the cost inputs of their units of inventory in the same manner as they recover the costs of their materials and supplies (that is, when the cost input is used or consumed in producing the unit of inventory). The Treasury Department and the IRS do not believe Congress intended to break down the traditional definition of the word ''inventory,'' particularly since that position benefits only a certain group of taxpayers (producers). The Treasury Department and the IRS determined that the definition for used or consumed should provide an equitable rule for the timing of the recovery of the inventory between producers and resellers. Accordingly, these final regulations adopt the proposed regulations without change.

ii. De Minimis Safe Harbor Under § 1.263(a)–1(f)

Several comments were received regarding the applicability of the *de minimis* safe harbor under § 1.263(a)–1(f) (*de minimis* safe harbor) to inventory treated as non-incidental materials and supplies. The commenters assert that the final regulations should permit a taxpayer that uses the section 471(c) NIMS inventory method to use the *de minimis* safe harbor for its inventory treated as non-incidental materials and supplies. The commenters point to footnote 465 of the Bluebook, which described the law, both before and after TCJA, as generally permitting deduction of the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations in accordance with § 1.162–3(a)(1). Furthermore, under § 1.162–3(a)(1), a taxpayer may also be able to elect to deduct such non-incidental materials and supplies in the taxable year the amount is paid under the *de minimis* safe harbor election under § 1.263(a)–1(f). General Explanation of Public Law 115–97, at 113 fn. 465.

The Treasury Department and the IRS were aware of footnote 465 in the Bluebook when drafting the proposed regulations, but have a different understanding of the rule for ''inventory treated as non-incidental materials and supplies'' under Section 471(c)(1)(B)(i) as explained in section 3.A.i of this Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative procedures that established the non-incidental materials and supplies method for inventoriable items, and prior pronouncements of §§ 1.162–3 and 1.263(a)–1(f) that these regulations do not apply to inventory property, including inventory property treated as non-incidental materials and supplies. *See, e.g.,* Tangible Property Regulations—Frequently Asked Questions, available at *https://www.irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations#Ademinimis.*

A commenter states that the *de minimis* safe harbor was created after Revenue Procedure 2001–10 and Revenue Procedure 2002–28 were released, and therefore, did not address the issue of the applicability of the *de minimis* safe harbor. The Treasury Department and the IRS agree with the timeline described by the commenter. However, as discussed in the immediately preceding paragraph, the IRS' position on the *de minimis* safe harbor has been addressed in a prior pronouncement. As described previously in section 3.A of this Summary of Comments and Explanation of Revisions, inventory treated as non-incidental materials and supplies retains its character as inventory property. The *de minimis* safe harbor, which is a regulatory election rather than a statutory one, does not apply to inventory. Section 1.263(a)–1(f)(2)(i).

Finally, the Treasury Department and the IRS note that for amounts paid to qualify for the *de minimis* safe harbor, the amounts must have been expensed on the taxpayer's applicable financial statement or books and records, as applicable. Sections 1.263(a)–1(f)(1)(i)(B) and (ii)(B). This applicable financial statement or books and records expensing requirement under § 1.263(a)–1(f) would be an impediment to the application of the *de minimis* safe harbor under the section 471(c) NIMS inventory method for taxpayers who maintain records of their inventory in their applicable financial statement or books and records, even if the section 471(c) NIMS inventory method permitted the use of the *de minimis* safe harbor method. In addition, there is no need for the separate *de minimis* safe harbor because small business taxpayers may use the inventory method provided in section 471(c)(1)(B) which generally provides that a taxpayer who expenses inventory costs in its applicable financial statement or books and records may generally expense that cost for Federal income tax purposes. For example, a small business taxpayer that expenses the cost of ''freight-in'' in its books and records and wants to expense the item for Federal income tax purposes may generally do so using the non-AFS section 471(c) inventory method, as permitted by section 471(c)(1)(B)(ii) and discussed later in section 3.C.ii of this Summary of Comments and Explanation of Revisions.

iii. Direct Labor

Proposed § 1.471–1(b)(4)(ii) provides that inventory costs includible in the

section 471(c) NIMS inventory method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed or that is not otherwise recoverable, in whole or in part, but for § 1.471–1(b)(4), under another provision of the Code.

Some comments were received on the types of direct costs required to be included as an inventory cost under the section 471(c) NIMS inventory method. These commenters recommended the final regulations exclude direct labor costs from the definition of an inventory cost under proposed § 1.471–1(b)(4)(ii). The commenters reasoned that the preamble to the proposed regulation indicated that section 471(c)(1)(B)(i) was generally a codification of Revenue Procedure 2001–10 and Revenue Procedure 2002–28. However, the commenters point out that this administrative guidance did not provide for direct labor or overhead costs to be included in the non-incidental materials and supplies method.

One commenter asserted that inventory treated as non-incidental materials and supplies are not inventory property but are to be characterized as a material and supply. The commenter discussed Example 1, in Section III.D of Notice 88–86 (1988–2 CB 401) to determine the treatment of non-incidental materials and supplies prior to the enactment of section 263A. Example 1 involves an architect providing design services that include blueprints and drawings and deals with the provision of *de minimis* amounts of property by a service provider. This commenter cites to Notice 88–86 to provide, by analogy, that inventory treated as non-incidental materials and supplies under section 471(c)(1)(B)(i) should not include direct labor costs.

The Treasury Department and the IRS disagree with the application by analogy to Example 1 in Section III.D of Notice 88–86. That example illustrates that an individual providing services, such as an architect, is not a producer despite providing a *de minimis* amount of property to the client as part of the provision of services. As discussed in section 3.A of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS believe that inventory property treated as non-incidental materials and supplies retains its character as inventory property, and so Example 1 is inapposite.

The Treasury Department and the IRS acknowledge that there was uncertainty under Revenue Procedure 2001–10 and Revenue Procedure 2002–28 as to whether direct labor and overhead costs were required to be capitalized under the non-incidental materials and supplies method permitted by those revenue procedures. The Treasury Department and the IRS are also aware that tracking of direct labor costs may be burdensome, and in some cases, difficult to do for many small businesses. The Treasury Department and the IRS agree with the commenters' request that direct labor costs be excluded from the inventory costs required to be included in inventory treated as non-incidental materials and supplies. As a result, these final regulations provide that inventory costs includible in the section 471(c) NIMS inventory method are direct material costs of the property produced or the costs of property acquired for resale.

B. Treatment of Inventory by Taxpayers With an Applicable Financial Statement (AFS)

Under proposed § 1.471–1(b)(5), a taxpayer other than a tax shelter, that has an AFS and that meets the Section 448(c) Gross Receipts Test is not required to take an inventory under section 471(a), and may choose to treat its inventory as reflected in its AFS. Proposed § 1.471–1(b)(5)(ii) defines AFS by reference to section 451(b)(3) and the accompanying regulations, which included the additional AFS rules provided in proposed § 1.451–3(h).

In section 4.C.i of the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on a proposed consistency rule for a taxpayer with an AFS that has a financial accounting year that differs from the taxpayer's taxable year, and on other issues related to the application of proposed § 1.451–3(h) to the AFS section 471(c) inventory method. The Treasury Department and the IRS proposed to require a taxpayer with an AFS that uses the AFS section 471(c) inventory method to consistently apply the same mismatched reportable period method of accounting provided in proposed § 1.451–3(h)(4) for its AFS section 471(c) inventory method of accounting that is used for section 451 purposes. No comments were received on the consistency rule or other issues related to the application of proposed § 1.451–3(h) to the AFS section 471(c) inventory method.

These final regulations adopt this consistency rule. The Treasury Department and the IRS have determined that a taxpayer using an accrual method with an AFS that has a mismatched reporting period with its taxable year should apply the same mismatched reportable period method of accounting for revenue recognition purposes and inventory purposes because there is better matching of income and cost of goods sold by applying the same reportable period method.

C. Treatment of Inventory by Taxpayers Without an AFS

Under proposed § 1.471–1(b)(6), a taxpayer, other than a tax shelter, that does not have an AFS and that meets the Section 448(c) Gross Receipts Test is not required to take an inventory under section 471(a), and may choose to use the non-AFS section 471(c) inventory method to account for its inventory. The non-AFS section 471(c) inventory method is the method of accounting for inventory reflected in the taxpayer's books and records that are prepared in accordance with the taxpayer's accounting procedures and that properly reflect the taxpayer's business activities for non-tax purposes. For example, a books and records method that determines ending inventory and cost of goods sold that properly reflects the taxpayer's business activities for non-Federal income tax purposes is to be used under the taxpayer's non-AFS section 471(c) inventory method.

(i) Definition of Books and Records

Some comments were received on the non-AFS section 471(c) inventory method and the standard used in proposed § 1.471–1(b)(6) for ''books and records.'' One commenter reasoned that the purpose of section 471(c)(1)(B)(ii) was to provide simplification, and the reliance on the definition of books and records used in case law is too complex, creates audit risks, and uncertainties as to what books and records means. The commenter recommended using a standard in which ''books and records'' is a flexible term and something the taxpayer and his accounting professional can agree on that is consistent from year to year. For example, the commenter suggests that any financial statement reporting of inventory that is consistently applied be acceptable as books and records.

Some comments discuss the issue of work papers and physical counts of inventory, and whether either should be used if a taxpayer is expensing these items for books and records purposes. The commenters asserted that even though a taxpayer takes a physical count of inventory, the taxpayer should be allowed to expense the inventory for Federal income tax purposes if the inventory is expensed on its books and records.

The Treasury Department and the IRS decline to change the definition of the

term ''books and records'' in these final regulations, and the rules continue to generally include both work papers and physical counts of inventory. The term books and records is used elsewhere in the Code and regulations, and there is no indication in the statute or legislative history to section 471(c)(1)(B)(ii) that a different definition is intended from the general usage of this term used elsewhere in the Code. Consequently, these final regulations use the well-established definition of books and records of a taxpayer, which includes the totality of the taxpayer's documents and electronically-stored data. See, for example, *United States* v. *Euge,* 444 U.S. 707 (1980). See also *Digby* v. *Commissioner,* 103 T.C. 441 (1994), and § 1.6001–1(a).

Certain commenters requested that the final regulations provide additional clarification on the significance of the taking of a physical count of inventory under the non-AFS section 471(c) inventory method. For example, commenters requested that Example 1 in proposed § 1.471–1(b)(6)(iii) be modified to provide that the physical count is ignored if the taxpayer does not provide inventory information to a creditor. These final regulations provide additional examples, including variations on Example 1, to clarify the relevance of a physical count of inventory under the non-AFS section 471(c) inventory method. For example, a taxpayer that takes a physical count of inventory for reordering purposes but does not allocate cost to such inventory is not required to use the physical count for the non-AFS section 471(c) inventory method, regardless of whether the information is otherwise used for an internal report purpose or provided to an external third party, such as a creditor. Alternatively, a taxpayer that takes an end-of-year physical count and uses this information in its accounting procedures to allocate costs to inventory is required to use this inventory information for the non-AFS section 471(c) inventory method regardless of whether the taxpayer makes reconciling entries to expense these costs in its financial statements. Thus, the examples in these final regulations clarify the principle that a taxpayer may not ignore its regular accounting procedures or portions of its books and records under the non-AFS section 471(c) inventory method.

(ii) Inventory Costs

The proposed regulations defined ''inventory costs'' for the non-AFS section 471(c) inventory method generally as costs that the taxpayer capitalizes to property produced or property acquired for resale in its books and records. Certain commenters requested that the final regulations clarify how a taxpayer treats costs to acquire or produce tangible property that the taxpayer does not capitalize in its books and records because the proposed regulations did not specifically address these costs.

These final regulations clarify in § 1.471–1(b)(6)(i) that costs that are generally required to be capitalized to inventory under section 471(a) but that the taxpayer is not capitalizing in its books and records are not required to be capitalized to inventory. The Treasury Department and the IRS have also determined that, under this method, such costs are not treated as amounts paid to acquire or produce tangible property under § 1.263(a)–2, and therefore, are generally deductible when they are paid or incurred if such costs may be otherwise deducted or recovered notwithstanding § 1.471–1(b)(4) under another provision of the Code and Regulations. Additionally, these final regulations clarify that costs capitalized for the non-AFS section 471(c) inventory method are those costs that related to the production or resale of the inventory to which they are capitalized in the taxpayer's books and records. Similar clarifications have been made in § 1.471–1(b)(5) regarding the AFS section 471(c) inventory method.

Applicability Dates

These final regulations are applicable for taxable years beginning on or after January 5, 2021. However, a taxpayer may apply these regulations for a taxable year beginning after December 31, 2017, and before January 5, 2021, provided that if the taxpayer applies any aspect of these final regulations under a particular Code provision, the taxpayer must follow all the applicable rules contained in these regulations that relate to that Code provision for such taxable year and all subsequent taxable years, and must follow the administrative procedures for filing a change in method of accounting in accordance with § 1.446–1(e)(3)(ii). For example, a taxpayer that wants to apply § 1.263A–1(j) to be exempt from capitalizing costs under section 263A must apply § 1.448–2 to determine whether it is eligible for the exemption. The same taxpayer must apply § 1.448–2 to determine whether it is eligible to apply § 1.471–1(b) to be exempt from the general inventory rules under section 471(a). However, it may choose not to apply § 1.471–1(b) even though it chooses to apply § 1.263A–1(j) and § 1.448–2.

Alternatively, a taxpayer may rely on the proposed regulations for a taxable year beginning after December 31, 2017 and before January 5, 2021, provided that if the taxpayer applies any aspect of the proposed regulations under a particular Code provision, the taxpayer must follow all of the applicable rules contained in the proposed regulations that relate to that Code provision for such taxable year, and follow the administrative procedures for filing a change in method of accounting in accordance with § 1.446–1(e)(3)(ii).

Statement of Availability of IRS Documents

The IRS notices, revenue rulings, and revenue procedures cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov.*

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

I. Paperwork Reduction Act

Section 1.448–2(b)(2)(iii)(B) imposes a collection of information for an election to use prior year's allocated taxable income or loss to determine whether a partnership or other entity (other than a C corporation) is a ''syndicate'' for purposes of section 448(d)(3) for the current tax year. The election is made by attaching a statement to the taxpayer's original Federal income tax return (including extensions) for the taxable year that the election is made. The election is an annual election and, if made for a taxable year, cannot be revoked. The collection of information is voluntary for purposes of obtaining a benefit under the proposed regulations. The likely respondents are businesses or other for-profit institutions, and small businesses or organizations.

Estimated total annual reporting burden: 224,165 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 224,165.

Estimated annual frequency of responses: Once.

Other than the election statement, these regulations do not impose any additional information collection

requirements in the form of reporting, recordkeeping requirements or third-party disclosure statements. However, because the exemptions in sections 263A, 448, 460 and 471 are methods of accounting under the statute, taxpayers are required to request the consent of the Commissioner for a change in method of accounting under section 446(e) to implement the statutory exemptions. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method*. Taxpayers may request these changes using reduced filing requirements by completing only certain parts of Form 3115. See Revenue Procedure 2018–40 (2018–34 IRB 320). Revenue Procedure 2018–40 provides procedures for a taxpayer to make a change in method of accounting using the automatic change procedures of Revenue Procedure 2015–13 (2015–5 IRB 419) in order to use the exemptions provided in sections 263A, 460 and/or 471. See also the revenue procedure accompanying these regulations for similar method change procedures to make a change in method of accounting to comply with these final regulations.

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(c)) (PRA), the reporting burden associated with the collection of information for the election statement and Form 3115 will be reflected in the PRA submission associated with the income tax returns under the OMB control number 1545–0074 (in the case of individual filers of Form 3115) and 1545–0123 (in the case of business filers of Form 3115).

In 2018, the IRS released and invited comment on a draft of Form 3115 in order to give members of the public the opportunity to benefit from certain specific provisions made to the Code. The IRS received no comments on the forms during the comment period. Consequently, the IRS made the forms available in January 2019 for use by the public. The IRS notes that Form 3115 applies to changes of accounting methods generally and is therefore broader than sections 263A, 448, 460 and 471.

As discussed earlier, the reporting burdens associated with the proposed regulations are included in the aggregated burden estimates for OMB control numbers 1545–0074 (in the case of individual filers of Form 3115), 1545–0123 (in the case of business filers of Form 3115 subject to Revenue Procedure 2019–43 and business filers that make the election under proposed § 1.448–2(b)(2)(iii)(B)). The overall burden estimates associated with these OMB control numbers are aggregate amounts related to the entire package of forms associated with the applicable OMB control number and will include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in these regulations. These numbers are therefore not specific to the burden imposed by these regulations. The burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the TCJA. No burden estimates specific to the forms affected by the regulations are currently available. For the OMB control numbers discussed in the preceding paragraphs, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the final regulations and other regulations that affect the compliance burden for that form.

II. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and that are likely to have a significant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present an initial regulatory flexibility analysis (IRFA) of the proposed rules. At the proposed rule stage, the Treasury Department and the IRS had not determined whether the proposed rules, when finalized, would likely have a significant economic impact on a substantial number of small entities. The determination of whether the voluntary exemptions under sections 263A, 448, 460, and 471, and the regulations providing guidance with respect to such exemptions, will have a significant economic impact on a substantial number of small entities requires further study. However, because there is a possibility of significant economic impact on a substantial number of small entities, an IRFA was provided at the proposed rule stage. In accordance with section 604 of the RFA, following is the final regulatory flexibility analysis.

1. Reasons for and Objectives of the Rule

As discussed earlier in the preamble, these regulations largely implement voluntary exemptions that relieve small business taxpayers from otherwise applicable restrictions and requirements under sections 263A, 448, 460, and 471.

Section 448 provides a general restriction for C corporations and partnerships with C corporation partners from using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions from certain of these rules and expanded the scope of existing statutory exemptions from certain of these rules to reduce compliance burdens for small taxpayers. The regulations clarify the exemption qualification requirements and provide guidance with respect to the applicable methods of accounting should a taxpayer choose to apply one or more exemptions.

The objective of the regulations is to provide clarity and certainty for small business taxpayers implementing the exemptions. Under the Code, small business taxpayers were able to implement these provisions for taxable years beginning after December 31, 2017 (or, in the case of section 460, for contracts entered into after December 31, 2017) even in the absence of these regulations. Thus, the Treasury Department and the IRS expect that, at the time these regulations are published, many small business taxpayers may have already implemented some aspects of the regulations.

2. Significant Issues Raised by the Public Comments in Response to the IRFA and Comments Filed by the Chief Counsel for Advocacy of the Small Business Administration

No public comments were received in response to the IRFA. Additionally, no comments were filed by the Chief Counsel for Advocacy of the Small Business Administration in response to the proposed regulations.

3. Affected Small Entities

The voluntary exemptions under sections 263A, 448, 460 and 471 generally apply to taxpayers that meet the $25 million (adjusted for inflation) gross receipts test in section 448(c) and

are otherwise subject to general rules under sections 263A, 448, 460, or 471.

A. Section 263A

The Treasury Department and the IRS expect that the addition of section 263A(i) will expand the number of small business taxpayers exempted from the requirement to capitalize costs, including interest, under section 263A. Under section 263A(i), taxpayers (other than tax shelters) that meet the $25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to deduct certain costs that are otherwise required to be capitalized to the basis of property. Section 263A applies to taxpayers that are producers, resellers, and taxpayers with self-constructed assets. The Treasury Department and the IRS estimate that there are between 3,200,000 and 3,575,000 respondents with gross receipts of not more than $25 million (adjusted for inflation) that have inventories. The Treasury Department and the IRS estimate that of these taxpayers there are between 28,900 and 38,900 respondents with gross receipts of not more than $25 million (adjusted for inflation) that are eligible to change their method of accounting to no longer capitalize costs under section 263A. These estimates come from information collected on: Form 1125–A, *Cost of Goods Sold,* and attached to Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income* or Form 1120–S, *U.S. Income Tax Return for an S Corporation,* on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with self-constructed assets. In addition, these data also do not include other business entities, such as a business reported on Schedule C, *Profit or Loss Form Business,* of an individual's Form 1040, *U.S. Individual Income Tax Return.*

Under section 263A, as modified by the TCJA, small business entities that qualified for Section 263A small reseller exception will no longer be able to use this exception. The Treasury Department and the IRS estimate that nearly all taxpayers that qualified for the small reseller exception will qualify for the small business taxpayer exemption under section 263A(i) since the small reseller exception utilized a $10 million gross receipts test. The Treasury Department and the IRS estimate that there are between 28,900 and 38,900 respondents with gross receipts of not more than $25 million that are eligible for the exemption under section 263A(i). These estimates come from information collected on: Form 1125–A, *Cost of Goods Sold,* and attached to Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income* or Form 1120–S, *U.S. Income Tax Return for an S Corporation* on which the taxpayer also indicated it had additional section 263A costs. These data provide an upper bound for the number of taxpayers affected by the repeal of the small reseller exception and enactment of section 263A(i) because the data includes taxpayers that were not previously eligible for the small reseller exception, such as producers and taxpayers with gross receipts of more than $10 million.

The regulations modify the $50 million gross receipts test in § 1.263A–1(d)(3)(ii)(B)(1) by using the Section 448 Gross Receipts Test. The $50 million gross receipts amount is used by taxpayers to determine whether they are eligible to treat negative adjustments as additional section 263A costs for purposes of the simplified production method (SPM) under section 263A. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities using the SPM.

Section 1.263A–9 modifies the current regulation to increase the eligibility threshold to $25 million for the election permitting taxpayers to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt for purposes of capitalizing interest under section 263A(f). The Treasury Department and the IRS estimate that there are between 28,900 and 38,900 respondents with gross receipts of not more than $25 million that are eligible to make this election. These estimates come from information collected on: Form 1125–A, *Cost of Goods Sold,* attached to Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income* or Form 1120–S, *U.S. Income Tax Return for an S Corporation,* on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS expect that many taxpayers eligible to make the election for purposes of section 263A(f) will instead elect the small business exemption under section 263A(i). Additionally, taxpayers who chose to apply section 263A even though they qualify for the small business exemption under section 263A(i) may not have interest expense required to be capitalized under section 263A(f). As a result, although these data do not include taxpayers with self-constructed assets that are eligible for the election, the Treasury Department and the IRS estimate that this data provides an upper bound for the number of eligible taxpayers.

B. Section 448

The Treasury Department and the IRS expect that the changes to section 448(c) by the TCJA will expand the number of taxpayers permitted to use the cash method. Section 448(a) provides that C corporations, partnerships with C corporations as partners, and tax shelters are not permitted to use the cash method of accounting; however section 448(c), as amended by the TCJA, provides that C corporations or partnerships with C corporations as partners, other than tax shelters, are not restricted from using the cash method if their average annual gross receipts are $25 million (adjusted for inflation) or less. Prior to the amendments made by the TCJA, the applicable gross receipts threshold was $5 million. Section 448 does not apply to S corporations, partnerships without a C corporation partner, or any other business entities (including sole proprietorships reported on an individual's Form 1040). The Treasury Department and the IRS estimate that there are between 587,000 and 605,000 respondents with gross receipts of not more than $5 million presently using an accrual method, and between 70,000 and 76,500 respondents with gross receipts of more than $5 million but not more than $25 million that are permitted to use to the cash method. These estimates come from information collected on Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income* and Form 1120–S, *U.S. Income Tax Return for an S Corporation.*

Under the regulations, taxpayers that would meet the gross receipts test of section 448(c) and seem to be eligible to use the cash method but for the definition of ''syndicate'' under section 448(d)(3), may elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a ''syndicate'' for purposes of section 448(d)(3) for the current taxable year. The Treasury Department and IRS estimate that 224,165 respondents may potentially make this election. This estimate comes from information collected on the Form 1065, *U.S. Return of Partnership Income* and Form 1120–S, *U.S. Income Tax Return for an S Corporation.,* and the Form 1125–A, *Cost of Goods Sold,* attached to the Forms 1065 and 1120–S. The Treasury Department and the IRS estimate that these data provide an upper bound for the number of eligible taxpayers because

not all taxpayers eligible to make the election will choose to do so.

C. Section 460

The Treasury Department and the IRS expect that the modification of section 460(e)(1)(B) by the TCJA will expand the number of taxpayers exempted from the requirement to apply the percentage-of-completion method to long-term construction contracts. Under section 460(e)(1)(B), as modified by the TCJA, taxpayers (other than tax shelters) that meet the $25 million (adjusted for inflation) gross receipts test in section 448(c) are not required to use PCM to account for income from a long-term construction contract expected to be completed in two years. Prior to the modification of section 460(e)(1)(B) by the TCJA, a separate $10 million dollar gross receipts test applied. The Treasury Department and the IRS estimate that there are between 15,400 and 19,500 respondents with gross receipts of between $10 million and $25 million who are eligible to change their method of accounting to apply the modified exemption. This estimate comes from information collected on the Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income* and Form 1120–S, *U.S. Income Tax Return for an S Corporation* in which the taxpayer indicated its principal business activity was construction (NAICS codes beginning with 23). These data available do not distinguish between long-term contracts and other contracts, and also do not include other business entities that do not file Form 1120, *U.S. Corporation Income Tax Return,* Form 1065, *U.S. Return of Partnership Income,* and Form 1120–S, *U.S. Income Tax Return for an S Corporation,* such as a business reported on Schedule C, *Profit or Loss from Business,* of an individual's Form 1040, *U.S. Individual Income Tax Return.*

D. Section 471

The Treasury Department and the IRS expect that the addition of section 471(c) will expand the number of taxpayers exempted from the requirement to take inventories under section 471(a). Under section 471(c), taxpayers (other than tax shelters) that meet the $25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to apply certain simplified inventory methods rather than those otherwise required by section 471(a). The Treasury Department and the IRS estimate that there are between 3,200,000 and 3,575,000 respondents with gross receipts of not more than $25 million that are exempted from the requirement to take inventories, and will treat their inventory either as non-incidental materials and supplies, or conform their inventory method to the method reflected in their AFS, or if they do not have an AFS, in their books and records. This estimate comes from data collected on the Form 1125–A, *Cost of Goods Sold.* Within that set of taxpayers, the Treasury Department and the IRS estimate that there are between 10,500 and 11,500 respondents that may choose to conform their method of accounting for inventories to their method for inventory reflected in their AFS. This estimate comes from IRS-collected data on taxpayers that filed the Form 1125–A, *Cost of Goods Sold,* in addition to a Schedule M3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More,* that indicated they had an AFS. These data provide a lower bound because they do not include other business entities, such as a business reported on Schedule C, *Profit or Loss from Business,* of an individual's Form 1040, *U.S. Individual Income Tax Return,* that are not required to file the Form 1125–A, *Cost of Goods Sold.*

4. Projected Reporting, Recordkeeping, Other Compliance Requirements, and Costs

The Treasury Department and the IRS have not performed an analysis with respect to the projected reporting, recordkeeping, and other compliance requirements associated with the statutory exemptions under sections 263A, 448, 460, and 471 and the final regulations implementing these exemptions. The taxpayer may expend time to read and understand the final regulations. The cost to comply with these regulations are reflected in modest reporting activities. Taxpayers needing to make method changes pursuant to these regulations will be required to file a Form 3115. The Treasury Department and the IRS are minimizing the cost to comply with the regulations by providing administrative procedures that allow taxpayers to make multiple changes in method of accounting related to the statutory exemptions under sections 263A, 448, 460, and 471 for the same tax year on a single Form 3115, instead of filing a separate Form 3115 for each exemption. Although there is a nominal implementation cost, the Treasury Department and the IRS anticipate that the statutory exemptions and the final regulations implementing these exemptions will reduce overall the reporting, recordkeeping, and other compliance requirements of affected taxpayers relative to the requirements that exist under the general rules in sections 263A, 448, 460, and 471. For example, a taxpayer that applies section 471(c)(1)(B)(i) to treat inventory as non-incidental materials and supplies will only need to capitalize the direct material cost of producing inventory instead of also having to capitalize the direct labor and indirect costs of producing inventory under the general rules of section 471(a). Additionally, a taxpayer that applies section 471(c)(1)(B)(ii) can follow the inventory method used in its applicable financial statement, or its books and records if it does not have an applicable financial statement, in lieu of keeping a separate inventory method under the general rules of section 471(a).

5. Steps Taken To Minimize the Economic Impact on Small Entities

As discussed earlier in the preamble, section 448 provides a general restriction for C corporations, partnerships with C corporation partners, and tax shelters from using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions and expanded the scope of existing statutory exemptions from these rules to reduce compliance burdens for small taxpayers (for example, reducing the burdens associated with applying complex accrual rules under section 451 and 461, maintaining inventories, identifying and tracking costs that are allocable to property produced or acquired for resale, identifying and tracking costs that are allocable to long-term contracts, applying the look-back method under section 460, etc.). For example, a small business taxpayer with average gross receipts of $20 million may pay an accountant an annual fee of approximately $2,375 to perform a 25 hour analysis to determine the section 263A costs that are capitalized to inventory produced during the year. If this taxpayer chooses to apply the exemption under section 263A and these regulations, it will no longer need to pay an accountant for the annual section 263A analysis.

The regulations implementing these exemptions are completely voluntary because small business taxpayers may continue using an accrual method of accounting, and applying the general rules under sections 263A, 460 and 471 if they so choose. Thus, the exemptions increase the flexibility small business taxpayers have regarding their accounting methods relative to other

businesses. The regulations provide clarity and certainty for small business taxpayers implementing the exemptions.

As described in more detail earlier in the preamble, the Treasury Department and the IRS considered a number of alternatives under the final regulations. For example, in providing rules related to inventory exemption in section 471(c)(1)(B)(i), which permits the taxpayer to treat its inventory as non-incidental materials and supplies, the Treasury Department and the IRS considered whether inventoriable costs should be recovered by (i) using an approach similar to the approach set forth under Revenue Procedure 2001–10 (2001–2 IRB 272) and Revenue Procedure 2002–28 (2002–28 IRB 815), which provided that inventory treated as non-incidental materials and supplies was ''used and consumed,'' and thus recovered through costs of goods sold by a cash basis taxpayer, when the inventory items were provided to a customer, or when the taxpayer paid for the items, whichever was later, or (ii) using an alternative approach that treated inventory as ''used and consumed'' and thus recovered through costs of goods sold by the taxpayer, in a taxable year prior to the year in which the inventory item is provided to the customer (for example, in the taxable year in which an inventory item is acquired or produced). The alternative approach described in (ii) would produce a savings equal the amount of the cost recovery multiplied by an applicable discount rate (determined based on the number of years the cost of goods sold recovery would be accelerated under this alternative). The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) and its legislative history generally as codifying the rules provided in the administrative guidance existing at the time TCJA was enacted. Based on this interpretation, the Treasury Department and the IRS have determined that section 471(c) materials and supplies are ''used and consumed'' in the taxable year the taxpayer provides the goods to a customer, and are recovered through costs of goods sold in that year or the taxable year in which the cost of the goods is paid or incurred (in accordance with the taxpayer's method of accounting), whichever is later. The Treasury Department and the IRS do not believe this approach creates or imposes undue burdens on taxpayers.

III. Section 7805(f)

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this Treasury Decision was submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial, direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Drafting Information

The principal author of these regulations is Anna Gleysteen, IRS Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.263A–0 is amended by:

■ 1. Revising the entry in the table of contents for § 1.263A–1(b)(1).

■ 2. Redesignating the entries in the table of contents for § 1.263A–1(j), (k), and (l) as the entries for § 1.263A–1(k), (l), and (m).

■ 3. Adding a new entry in the table of contents for § 1.263A–1(j).

■ 4. Revising the newly designated entries for § 1.263A–1(k), (l), and adding an entry for (m)(6).

■ 5. Revising the entries in the table of contents for § 1.263A–3(a)(2)(ii).

■ 6. Adding entries for § 1.263A–3(a)(5) and revising the entry for § 1.263A–3(b).

■ 7. Redesignating the entries in the table of contents for § 1.263A–4(a)(3) and (4) as the entries for § 1.263A–4(a)(4) and (5).

■ 8. Adding in the table of contents a new entry for § 1.263A–4(a)(3).

■ 9. Revising the entry in the table of contents for § 1.263A–4(d) introductory text.

■ 10. Redesignating the entry in the table of contents for § 1.263A–4(d)(5) as the entry for § 1.263A–4(d)(7).

■ 11. Adding in the table of contents a new entry for § 1.263A–4(d)(5).

■ 12. Adding an entry in the table of contents for § 1.263A–4(d)(6).

■ 13. Adding an entry in the table of contents for § 1.263A–4(e)(5).

■ 14. Revising the entry in the table of contents for § 1.263A–4(f) introductory text.

■ 15. Adding an entry in the table of contents for § 1.263A–4(g).

■ 16. Revising the entry in the table of contents for § 1.263A–7(a)(4).

The revisions and additions read as follows:

§ 1.263A–0 Outline of regulations under section 263A.

* * * * *

§ 1.263A–1 Uniform Capitalization of Costs.

* * * * *

(b) * * *

(1) Small business taxpayers.

* * * * *

(j) Exemption for certain small business taxpayers.

(1) In general.

(2) Application of the section 448(c) gross receipts test.

(i) In general.

(ii) Gross receipts of individuals, etc.

(iii) Partners and S corporation shareholders.

(iv) Examples.

(A) Example 1

(B) Example 2

(3) Change in method of accounting.

(i) In general.

(ii) Prior section 263A method change.

(k) Special rules

(1) Costs provided by a related person.

(i) In general

(ii) Exceptions

(2) Optional capitalization of period costs.

(i) In general.

(ii) Period costs eligible for capitalization.

(3) Trade or business application

(4) Transfers with a principal purpose of tax avoidance. [Reserved]

(l) Change in method of accounting.

(1) In general.

(2) Scope limitations.

(3) Audit protection.

(4) Section 481(a) adjustment.

(5) Time for requesting change.

(m) * * *

(6) Exemption for certain small business taxpayers.

§ 1.263A–3 Rules Relating to Property Acquired for Resale.

(a) * * *

(2) * * *

(ii) Exemption for small business taxpayers.

* * * * *

(5) *De minimis* production activities.

(i) In general.
(ii) Definition of gross receipts to determine *de minimis* production activities.
(iii) Example.
(b) [Reserved].
* * * * *

§ 1.263A–4 Rules for Property Produced in a Farming Business.

(a) * * *
(3) Exemption for certain small business taxpayers.
* * * * *
(d) Election not to have section 263A apply under section 263A(d)(3).
* * * * *
(5) Revocation of section 263A(d)(3) election to permit exemption under section 263A(i).
(6) Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.
* * * * *
(e) * * *
(5) Special temporary rule for citrus plants lost by reason of casualty.
(f) Change in method of accounting.
* * * * *
(g) Effective date.
(1) In general.
(2) Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).

§ 1.263A–7 Changing a method of accounting under section 263A.

(a) * * *
(4) Applicability dates.
(i) In general.
(ii) Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).
* * * * *

■ **Par. 3.** Section 1.263A–1 is amended by:
■ 1. Revising paragraph (a)(2) subject heading.
■ 2. In paragraph (a)(2)(i), revising the second sentence and adding a new third sentence.
■ 3. Revising paragraph (b)(1).
■ 4. In the second sentence of paragraph (d)(3)(ii)(B)(*1*), the language ''§ 1.263A–3(b)'' is removed and the language ''§ 1.263A–1(j)''is added in its place.
■ 5. Redesignating paragraphs (j) through (l) as paragraphs (k) through (m).
■ 6. Adding a new paragraph (j).
■ 7. In newly-redesignated paragraph (m), adding paragraph (m)(6).

The revisions and addition read as follows:

§ 1.263A–1 Uniform capitalization of costs.

(a) * * *

(2) *Applicability dates.* (i) * * * In the case of property that is inventory in the hands of the taxpayer, however, these sections are applicable for taxable years beginning after December 31, 1993. The small business taxpayer exception described in paragraph (b)(1) of this section and set forth in paragraph (j) of this section is applicable for taxable years beginning after December 31, 2017. * * *

* * * * *

(b) * * * (1) *Small business taxpayers.* For taxable years beginning after December 31, 2017, see section 263A(i) and paragraph (j) of this section for an exemption for certain small business taxpayers from the requirements of section 263A.

* * * * *

(j) *Exemption for certain small business taxpayers*—(1) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test under section 448(c) and § 1.448–2(c) (section 448(c) gross receipts test) for any taxable year (small business taxpayer) is not required to capitalize costs under section 263A to any real or tangible personal property produced, and any real or personal property described in section 1221(a)(1) acquired for resale, during that taxable year. This section 448(c) gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(2) *Application of the section 448(c) gross receipts test*—(i) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (j)(2)(ii) and (iii) of this section, the section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(iii) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share, as determined under section 704, of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(iv) *Examples.* The operation of this paragraph (j) is illustrated by the following examples:

(A) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business,* of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(B) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(3) *Change in method of accounting*—(i) *In general.* A change from applying the small business taxpayer exemption under paragraph (j) of this section to not applying the exemption under this paragraph (j), or *vice versa,* is a change in method of accounting under section 446(e) and § 1.446–1(e). A taxpayer changing its method of accounting under paragraph (j) of this section may do so only with the consent of the Commissioner as required under section 446(e) and § 1.446–1. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. For rules relating to the clear reflection

of income and the pattern of consistent treatment of an item, see section 446 and § 1.446–1. The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under § 1.446–1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also § 601.601(d)(2) of this chapter).

(ii) *Automatic consent for certain method changes.* Certain changes in method of accounting made under paragraph (j) of this section may be made under the procedures to obtain the automatic consent of the Commissioner to change a method of accounting. See Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also § 601.601(d)(2) of this chapter)). In certain situations, special terms and conditions may apply.

* * * * *

(m) * * *

(6) *Exemption for certain small business taxpayers.* The second and third sentence in paragraph (a)(2)(i), paragraphs (b)(1) and (j) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (m)(6), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

■ **Par. 4.** Section 1.263A–2 is amended by:

■ 1. Adding a sentence at the end of paragraph (a) introductory text.

■ 2. Revising paragraph (a)(1)(ii)(C).

■ 3. Revising paragraph (g) subject heading.

■ 4. Adding paragraph (g)(4).

The additions and revisions read as follows:

§ 1.263A–2 Rules relating to property produced by the taxpayer.

(a) * * * For taxable years beginning after December 31, 2017, see § 1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and § 1.448–2(c).

(1) * * *

(ii) * * *

(C) Home construction contracts. Section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date, and, for contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017, the taxpayer meets the gross receipts test of section 448(c) and § 1.448–2(c) for the taxable year in which such contract is entered into. Except as otherwise provided in this paragraph (a)(1)(ii)(C), section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under Federal income tax principles.

* * * * *

(g) *Applicability dates.** * *

(4) The rules set forth in the last sentence of the introductory text of paragraph (a) of this section and in paragraph (a)(1)(ii)(C) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(4), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

■ **Par. 5.** Section 1.263A–3 is amended:

■ 1. In paragraph (a)(1), by revising the second sentence.

■ 2. By revising paragraphs (a)(2)(ii) and (iii).

■ 4. In paragraph (a)(3), by removing the language ''small reseller'' and adding in its place the language ''small business taxpayer''.

■ 5. In paragraph (a)(4)(ii), removing the language ''(within the meaning of paragraph (a)(2)(iii) of this section)'' and adding in its place the language ''(within the meaning of paragraph (a)(5) of this section)''.

■ 6. By adding paragraph (a)(5).

■ 7. By removing and reserving paragraph (b).

■ 8. By revising paragraph (f).

The revisions and additions read as follows:

§ 1.263A–3 Rules relating to property acquired for resale.

(a) * * * (1) * * * However, for taxable years beginning after December 31, 2017, a small business taxpayer, as defined in § 1.263A–1(j), is not required to apply section 263A in that taxable year. * * *

(2) * * *

(ii) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see § 1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and § 1.448–2(c).

(iii) *De minimis production activities.* See paragraph (a)(5) of this section for rules relating to an exception for resellers with *de minimis* production activities.

* * * * *

(5) *De minimis production activities*—(i) *In general.* In determining whether a taxpayer's production activities are *de minimis,* all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed *de minimis* if—

(A) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(B) The labor costs allocable to the trade or business's production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(ii) *Definition of gross receipts to determine de minimis production activities.* Gross receipts has the same definition as for purposes of the gross receipts test under § 1.448–2(c), except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

(iii) *Example: Reseller with de minimis production activities.* Taxpayer N is in the retail grocery business. In 2019, N's average annual gross receipts for the three previous taxable years are greater than the gross receipts test of section 448(c). Thus, N is not exempt from the requirement to capitalize costs under section 263A. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N produces no other goods in its retail grocery business. N's gross receipts from its bakeries are 5 percent of the entire grocery business. N's labor costs from its bakeries are 3 percent of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10 percent, N's production activities are *de minimis.* Further, because N's production activities are incident to its resale activities, N may use the simplified resale method, as provided in paragraph (a)(4)(ii) of this section.

* * * * *

(f) *Applicability dates.* (1) Paragraphs (d)(3)(i)(C)(*3*), (d)(3)(i)(D)(*3*), and (d)(3)(i)(E)(*3*) of this section apply for taxable years ending on or after January 13, 2014.

(2) The rules set forth in the second sentence of paragraph (a)(1) of this section, paragraphs (a)(2)(ii) and (iii) of

this section, the third sentence of paragraph (a)(3) of this section, and paragraphs (a)(4)(ii) and (a)(5) of this section apply for taxable years beginning on or after January 5, 2021 . However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (f)(2), provided the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

■ **Par. 6.** Section 1.263A–4 is amended:
■ 1. In paragraph (a)(1), by revising the last sentence.
■ 2. In paragraph (a)(2)(ii)(A)(1), by removing the language ''section 464(c)'' and adding in its place the language with ''section 461(k)''.
■ 3. By redesignating paragraphs (a)(3) and (4) as paragraphs (a)(4) and (5) respectively.
■ 4. By adding new paragraph (a)(3).
■ 5. By revising the paragraph (d) subject heading.
■ 6. In paragraph (d)(1), by revising the last sentence and adding a new sentence at the end of the paragraph.
■ 7. In paragraph (d)(3)(i), by removing the last sentence.
■ 8. By revising paragraph (d)(3)(ii).
■ 9. By redesignating paragraph (d)(5) as paragraph (d)(7).
■ 10. By adding new paragraphs (d)(5) and (6)
■ 11. By adding paragraph (e)(5).
■ 12. By redesignating paragraph (f) as paragraph (g).
■ 13. By adding new paragraph (f).
■ 14. By revising the subject headings of newly-redesignated paragraphs (g) and (g)(1), and by revising newly-designated paragraph (g)(2).

The revisions and additions read as follows:

§ 1.263A–4 Rules for property produced in a farming business.

(a) * * * (1) * * * Except as provided in paragraphs (a)(2), (a)(3), and (e) of this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

* * * * *

(3) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see § 1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and § 1.448–2(c).

* * * * *

(d) *Election not to have section 263A apply under section 263A(d)(3)*—(1) * * * Except as provided in paragraph (d)(5) and (6) of this section, the election is a method of accounting under section 446. An election made under section 263A(d)(3) and this paragraph (d) is revocable only with the consent of the Commissioner.

* * * * *

(3) * * *

(ii) *Nonautomatic election.* Except as provided in paragraphs (d)(5) and (6) of this section, a taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) of this section must obtain the consent of the Commissioner to make the election by filing a Form 3115, *Application for Change in Method of Accounting,* in accordance with § 1.446–1(e)(3).

* * * * *

(5) *Revocation of section 263A(d)(3) election to permit exemption under section 263A(i).* A taxpayer that elected under section 263A(d)(3) and paragraph (d)(3) of this section not to have section 263A apply to any plant produced in a farming business that wants to revoke its section 263A(d)(3) election, and in the same taxable year, apply the small business taxpayer exemption under section 263A(i) and § 1.263A–1(j) may revoke the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(b) of this chapter). A revocation of the taxpayer's section 263A(d)(3) election under this paragraph (d)(5) is not a change in method of accounting under sections 446 and 481 and §§ 1.446–1 and 1.481–1 through 1.481–5.

(6) *Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.* A taxpayer whose method of accounting is to not capitalize costs under section 263A based on the exemption under section 263A(i), that becomes ineligible to use the exemption under section 263A(i), and is eligible and wants to elect under section 263A(d)(3) for this same taxable year to not capitalize costs under section 263A for any plant produced in the taxpayer's farming business, must make the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(b) of this chapter). An election under section 263A(d)(3) made in accordance with this paragraph (d)(6) is not a change in method of accounting under sections 446 and 481 and §§ 1.446–1 and 1.481–1 through 1.481–5.

* * * * *

(e) * * *

(5) *Special temporary rule for citrus plants lost by reason of casualty.* Section 263A(d)(2)(A) provides that if plants bearing an edible crop for human consumption were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States). The rules of this paragraph (e)(5) apply to certain costs that are paid or incurred after December 22, 2017, and on or before December 22, 2027, to replant citrus plants after the loss or damage of citrus plants. Notwithstanding paragraph (e)(2) of this section, in the case of replanting citrus plants after the loss or damage of citrus plants by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner described in section 263A(d)(2)(A) if—

(i) The owner described in section 263A(d)(2)(A) has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which such amounts were paid or incurred and the taxpayer holds any part of the remaining equity interest; or

(ii) The taxpayer acquired the entirety of the equity interest in the land of that owner described in section 263A(d)(2)(A) and on which land the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

(f) *Change in method of accounting.* Except as provided in paragraphs (d)(5) and (6) of this section, any change in a taxpayer's method of accounting necessary to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and § 1.446–1 through 1.446–7 and § 1.481–1 through § 1.481–3 apply.

(g) *Applicability dates*—(1) *In general.* * * *

(2) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).* Paragraphs (a)(3), (d)(5), (d)(6), and (e)(5) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

■ **Par. 7.** § 1.263A–7 is amended:
■ 1. By revising paragraph (a)(3)(i).
■ 2. By redesignating paragraph (a)(4) as paragraph (a)(4)(i).
■ 3. By adding a paragraph (a)(4) subject heading.
■ 4. By revising the newly-designated paragraph (a)(4)(i) subject heading.
■ 5. By adding paragraph (a)(4)(ii).
■ 6. In paragraph (b)(1), by removing the language ''Rev. Proc. 97–27 (1997–21 I.R.B.10)'' and adding in its place the language ''Revenue Procedure 2015–13 (2015–5 IRB 419)''.
■ 7. In paragraph (b)(2)(ii), by removing the language ''Rev. Proc. 2002–9 (2002–1 C.B. 327) and Rev. Proc. 97–27 (1991–1 C.B. 680)'' and adding the language ''Revenue Procedure 2015–13, 2015–5 IRB 419 (or successor)'' in its place.

The revisions and additions read as follows:

§ 1.263A–7 Changing a method of accounting under section 263A.

(a) * * *

(3) * * *

(i) For taxable years beginning after December 31, 2017, resellers of real or personal property or producers of real or tangible personal property whose average annual gross receipts for the immediately preceding 3-taxable-year period, or lesser period if the taxpayer was not in existence for the three preceding taxable years, annualized as required, exceed the gross receipts test of section 448(c) and the accompanying regulations where the taxpayer was not subject to section 263A in the prior taxable year;

* * * * *

(4) *Applicability dates*—(i) *In general.** * *

(ii) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).* Paragraph (a)(3)(i) of this section applies to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (a)(4)(ii), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

* * * * *

■ **Par. 8.** Section 1.263A–8 is amended by adding a sentence to the end of paragraph (a)(1) to read as follows:

§ 1.263A–8 Requirement to capitalize interest.

(a) * * * (1) * * * However, a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test of section 448(c) for the taxable year is not required to capitalize costs, including interest, under section 263A. See § 1.263A–1(j).

* * * * *

■ **Par. 9.** Section 1.263A–9 is amended by adding a sentence to the end of paragraph (e)(2) to read as follows:

§ 1.263A–9 The avoided cost method.

* * * * *

(e) * * *

(2) * * *A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the taxpayer is a small business taxpayer, as defined in § 1.263A–1(j).

* * * * *

■ **Par. 10.** Section 1.263A–15 is amended by adding paragraph (a)(4) to read as follows:

§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

(a) * * *

(4) The last sentence of each of § 1.263A–8(a)(1) and § 1.263A–9(e)(2) apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the last sentence of each of § 1.263A–8(a)(1) and § 1.263A–9(e)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

* * * * *

■ **Par. 11.** Section 1.381(c)(5)–1 is amended:
■ 1. In paragraph (a)(6), by designating *Examples 1* and *2* as paragraphs (a)(6)(i) and (ii), respectively.
■ 2. In newly-designated paragraphs (a)(6)(i) and (ii), by redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(a)(6)(i)(i) and (ii)	(a)(6)(i)(A) and (B)
(a)(6)(ii)(i) and (ii)	(a)(6)(ii)(A) and (B)

■ 3. In newly designated paragraphs (a)(6)(ii)(A) and (B), by removing the language ''small reseller'' and adding in its place the language ''small business taxpayer'' everywhere it appears.
■ 4. By adding a sentence to the end of paragraph (f).

The addition reads as follows:

§ 1.381(c)(5)–1 Inventory method.

* * * * *

(f) * * * The designations of paragraphs (a)(6)(ii)(A) and (B) of this section and removal of the term ''small reseller'' and replacement with the term ''small business taxpayer'' apply to taxable years beginning on or after January 5, 2021.

■ **Par. 12.** § 1.446–1 is amended:
■ 1. In paragraph (a)(4)(i), by revising the first sentence.
■ 2. By revising paragraph (c)(2)(i).
■ 3. By adding paragraph (c)(3).

The revisions and additions read as follows:

§ 1.446–1 General rule for methods of accounting.

(a) * * *

(4) * * *

(i) Except in the case of a taxpayer qualifying as a small business taxpayer for the taxable year under section 471(c), in all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in progress, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. * * *

* * * * *

(c) * * *

(2) * * *

(i) In any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless:

(A) The taxpayer qualifies as a small business taxpayer for the taxable year under section 471(c), or

(B) Otherwise authorized under paragraph (c)(2)(ii) of this section.

* * * * *

(3) *Applicability date.* The first sentence of paragraph (a)(4)(i) of this section and paragraph (c)(2)(i) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the rules provided in the first sentence of this paragraph (c)(3), provided that the taxpayer follows all the applicable rules contained in the regulations under section 446 for such taxable year and all subsequent taxable years.

* * * * *

■ **Par. 13.** Section 1.448–1 is amended by adding new first and second sentences to paragraphs (g)(1) and (h)(1) to read as follows:

§ 1.448–1 Limitation on the use of the cash receipts and disbursements method of accounting.

* * * * *

(g) * * * (1) * * * The rules provided in paragraph (g) of this section

apply to taxable years beginning before January 1, 2018. See § 1.448–2 for rules relating to taxable years beginning after December 31, 2017. * * *

* * * * *

(h) * * * (1) * * * The rules provided in paragraph (h) of this section apply to taxable years beginning before January 1, 2018. See § 1.448–2 for rules relating to taxable years beginning after December 31, 2017. * * *

* * * * *

§ 1.448–2 [Redesignated as § 1.448–3]

■ **Par. 14.** Section 1.448–2 is redesignated as § 1.448–3.

■ **Par. 15.** A new § 1.448–2 is added to read as follows:

§ 1.448–2 Limitation on the use of the cash receipts and disbursements method of accounting for taxable years beginning after December 31, 2017.

(a) *Limitation on method of accounting*—(1) *In general.* The rules of this section relate to the limitation on the use of the cash receipts and disbursements method of accounting (cash method) by certain taxpayers applicable for taxable years beginning after December 31, 2017. For rules applicable to taxable years beginning before January 1, 2018, see §§ 1.448–1 and 1.448–1T.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a:

(i) C corporation;

(ii) Partnership with a C corporation as a partner, or a partnership that had a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986; or

(iii) Tax shelter.

(3) *Treatment of combination methods*—(i) *In general.* For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method is considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(ii) *Example.* The following example illustrates the operation of this paragraph (a)(3). In 2020, A is a C corporation with average annual gross receipts for the prior three taxable years of greater than $30 million, is not a tax shelter under section 448(a)(3) and does not qualify as a qualified personal service corporation, as defined in paragraph (e) of this section. For the last 20 years, A used an accrual method for items of income and expenses related to purchases and sales of inventory, and the cash method for items related to its provision of services. A is using a combination of accounting methods that include the cash method. Thus, A is subject to section 448. A is prohibited from using the cash method for any item for 2020 and is required to change to a permissible method.

(b) *Definitions.* For purposes of this section—

(1) *C corporation*—(i) *In general.* The term *C corporation* means any corporation that is not an S corporation (as defined in section 1361(a)(1)). For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511(b) is treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from Federal income taxes under section 501(a) is treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(ii) [Reserved]

(2) *Tax shelter*—(i) *In general.* The term *tax shelter* means any—

(A) Enterprise, other than a C corporation, if at any time, including taxable years beginning before January 1, 1987, interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale;

(B) Syndicate, within the meaning of paragraph (b)(2)(iii) of this section; or

(C) Tax shelter, within the meaning of section 6662(d)(2)(C).

(ii) *Requirement of registration.* For purposes of paragraph (b)(2)(i)(A) of this section, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or state law. This rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.

(iii) *Syndicate*—(A) *In general.* For purposes of paragraph (b)(2)(i)(B) of this section, the term *syndicate* means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(2)(iii), the term *limited entrepreneur* has the same meaning given such term in section 461(k)(4). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 461(k)(2) applies in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256(e)(3)(C) applies in all other cases. Moreover, for purposes of paragraph (b)(2) of this section, the losses of a partnership, entity, or enterprise (entities) means the excess of the deductions allowable to the entities over the amount of income recognized by such entities under the entities' method of accounting used for Federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or assets described in section 1221(a)(2) are not taken into account.

(B) *Irrevocable annual election to test the allocation of losses from prior taxable year*—(*1*) *In general.* For purposes of paragraph (b)(2)(iii)(A) of this section, to determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation. An election under this paragraph (b)(2)(iii)(B) applies only to the taxable year for which the election is made. Except as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), a taxpayer that makes an

election under this paragraph (b)(2)(iii)(B) must apply this election for other provisions of the Code that specifically apply the definition of tax shelter in section 448(a)(3).

(*2*) *Time and manner of making election.* A taxpayer makes this election for the taxable year by attaching a statement to its timely filed original Federal income tax return (including extensions) for such taxable year. The statement must state that the taxpayer is making the election under § 1.448–2(b)(2)(iii)(B). In the case of an S corporation or partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election under this paragraph (b)(2)(iii)(B) may not be made by the taxpayer in any other manner. For example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting. A taxpayer may not revoke an election under this paragraph (b)(2)(iii)(B).

(*3*) *Administrative guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) that provides alternative procedures for complying with paragraph (b)(2)(iii)(B)(*2*) of this section.

(C) *Examples.* The following examples illustrate the rules of paragraph (b)(2)(iii) of this section. For purposes of the examples, the term ''losses'' has the meaning stated in paragraph (b)(2)(iii)(A) of this section.

(*1*) *Example 1.* Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. For 2019, B is profitable and has no losses to allocate to its limited partner. For 2020, B is not profitable and allocates 60 percent of its losses to its general partner and 40 percent of its losses to its limited partner. For 2021, B is not profitable and allocates 50 percent of its losses to its general partner and 50 percent of its losses to its limited partner. For taxable year 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because B was profitable for 2019 and did not allocate any losses to its limited partner in 2019. For 2021, B is a syndicate because B allocated 50 percent of its 2021 losses to its limited partner under paragraph (b)(2)(ii)(3)(A) of this section. Even if B made an election under paragraph (b)(2)(iii)(B) of this section to use prior year allocated amounts, B is a syndicate for 2021 because B allocated 40 percent of its 2020 losses to its limited partner in 2020. Because B is a syndicate under paragraph (b)(2)(iii)(A) of this section for 2021, B is a tax shelter prohibited from using the cash method for taxable year 2021 under paragraph (b)(2)(i)(B) of this section.

(*2*) *Example (2).* Same facts as Example (1) in paragraph (b)(2)(iii)(C)(1) of this section, except for 2021, B is profitable and has no losses to allocate to its limited partner. For 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because it did not any allocate any losses to its limited partner in 2019. For 2021, B chooses not to make the election under paragraph (b)(2)(iii)(B) of this section. For 2021, B is not a syndicate because it does not have any 2021 losses to allocate to a limited partner. For taxable years 2019, 2020 and 2021, B is not a syndicate under paragraph (b)(2)(iii)(A) of this section and is not prohibited from using the cash method for taxable years 2019, 2020 or 2021 under paragraph (b)(2)(i)(B) of this section.

(iv) *Presumed tax avoidance.* For purposes of (b)(2)(i)(C) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses. Payments for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment are an example of one type of such prepayment.

(v) *Taxable year tax shelter must change accounting method.* A tax shelter must change from the cash method for the taxable year that it becomes a tax shelter, as determined under paragraph (b)(2) of this section.

(vi) *Determination of loss amount.* For purposes of section 448(d)(3), the amount of losses to be allocated under section 1256(e)(3)(B) is calculated without regard to section 163(j).

(c) *Exception for entities with gross receipts not in excess of the amount provided in section 448(c)*—(1) *In general.* Except in the case of a tax shelter, this section does not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if such corporation or partnership (or any predecessor thereof) meets the gross receipts test of paragraph (c)(2) of this section.

(2) *Gross receipts test*—(i) *In general.* A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of paragraph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.

(ii) *Aggregation of gross receipts.* The aggregation rules in § 1.448–1T(f)(2)(ii) apply for purposes of aggregating gross receipts for purposes of this section.

(iii) *Treatment of short taxable year.* The short taxable year rules in § 1.448–1T(f)(2)(iii) apply for purposes of this section.

(iv) *Determination of gross receipts.* The determination of gross receipts rules in § 1.448–1T(f)(2)(iv) apply for purposes of this section.

(v) *Gross receipts test amount*—(A) *In general.* For purposes of paragraph (c) of this section, the term *gross receipts test amount* means $25,000,000, adjusted annually for inflation in the manner provided in section 448(c)(4). The inflation adjusted gross receipts test amount is published annually in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(B) *Example.* Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017–2019 taxable years are $20 million, $16 million, and $30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is $22 million (($20 million

+ $16 million + $30 million)/3) = $22 million. A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is $26 million for 2020.

(d) *Exception for farming businesses*—(1) *In general.* Except in the case of a tax shelter, this section does not apply to any farming business. A taxpayer engaged in a farming business and a separate non-farming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the non-farming business.

(2) *Farming business*—(i) *In general.* For purposes of paragraph (d) of this section, the term *farming business* means—

(A) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees),

(B) The raising, harvesting, or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i)(A) of this section),

(C) The raising of timber, or

(D) Processing activities which are normally incident to the growing, raising, or harvesting of agricultural products.

(ii) *Example.* Assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(iii) *Processing activities excluded from farming businesses*—(A) *In general.* For purposes of this section, a farming business does not include the processing of commodities or products beyond those activities normally incident to the growing, raising, or harvesting of such products.

(B) *Examples.* (*1*) *Example 1.* Assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce breads, cereals, and similar food products which the taxpayer sells to customers.

(*2*) *Example 2.* Assume that a taxpayer is in the business of raising livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation.

(e) *Exception for qualified personal service corporation.* The rules in § 1.448–1T(e) relating to the exception for qualified personal service corporations apply for taxable years beginning after December 31, 2017.

(f) *Effect of section 448 on other provisions.* Except as provided in paragraph (b)(2)(iii)(B) of this section, nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of § 1.446–1(c)(2) that, in general, an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects the taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e).

(g) *Treatment of accounting method change and rules for section 481(a) adjustment*—(1) *In general.* Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting, the change shall be treated as a change initiated by the taxpayer to compute the adjustment required under section 481. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448 (mandatory section 448 year). A taxpayer may have more than one mandatory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also § 601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.

(2) *Section 481(a) adjustment.* The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under § 1.446–1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also § 601.601(d)(2) of this chapter).

(h) *Applicability dates.* The rules of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the rules provided in this section

provided that the taxpayer follows all the applicable rules contained in the regulations under section 448 for such taxable year and all subsequent taxable years.

■ **Par. 16.** Newly-redesignated § 1.448–3 is amended by revising paragraphs (a)(2) and (h) to read as follows:

§ 1.448–3 Nonaccrual of certain amounts by service providers.

(a) * * *

(2) The taxpayer meets the gross receipts test of section 448(c) and § 1.448–1T(f)(2) (in the case of taxable years beginning before January 1, 2018), or § 1.448–2(c) (in the case of taxable years beginning after December 31, 2017) for all prior taxable years.

* * * * *

(h) *Applicability dates.* (1) Except as provided in paragraph (h)(2) of this section, this section is applicable for taxable years ending on or after August 31, 2006.

(2) The rules of paragraph (a)(2) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (h)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 448 for such taxable year and all subsequent taxable years.

■ **Par. 17.** Section 1.460–0 is amended by:

■ 1. Adding an entry for § 1.460–1(h)(3).

■ 2. Revising the entries for § 1.460–3(b)(3), § 1.460–3(b)(3)(i) and (ii), and adding entries for § 1.460–3(b)(3)(ii)(A), (B), (C) and (D).

■ 3. Removing the entry for § 1.460–3(b)(3)(iii).

■ 4. Adding entries for § 1.460–3(d), § 1.460–4(i), and § 1.460–6(k).

The additions and revisions read as follows:

§ 1.460–0 Outline of regulations under section 460.

* * * * *

§ 1.460–1 Long-term contracts.

* * * * *

(h) * * *

(3) Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).

* * * * *

§ 1.460–3 Long-term construction contracts.

* * * * *

(b) * * *

(3) Gross receipts test of section 448(c)

(i) In general

(ii) Application of gross receipts test

(A) In general

(B) Gross receipts of individuals, etc.

(C) Partners and S corporation shareholders

(D) Examples

(*1*) Example 1.

(*2*) Example 2.

(iii) Method of accounting.

* * * * *

(d) Applicability dates.

§ 1.460–4 Methods of Accounting for long-term contracts.

* * * * *

(i) Applicability date.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(k) Applicability date.

■ **Par. 18.** Section 1.460–1 is amended by adding three sentences to the end of paragraph (f)(3) and adding paragraph (h)(3) to read as follows:

§ 1.460–1 Long-term contracts.

* * * * *

(f) * * *

(3) * * * A taxpayer may adopt any permissible method of accounting for each classification of contract. Such adoption is not a change in method of accounting under section 446 and the accompanying regulations. For example, a taxpayer that has had only contracts classified as nonexempt long-term contracts and has used the PCM for these contracts may adopt an exempt contract method in the taxable year it first enters into an exempt long-term contract.

* * * * *

(h) * * *

(3) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).* Paragraph (f)(3) of this section, and § 1.460–5(d)(1) and (d)(3), apply for contracts entered into in taxable years beginning on or after January 5, 2021. However, for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, and before January 5, 2021, a taxpayer may apply paragraph (f)(3) of this section, and § 1.460–5(d)(1) and (d)(3), provided that the taxpayer also applies the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

* * * * *

■ **Par. 19.** Section 1.460–3 is amended by revising paragraphs (b)(1)(ii) and (b)(3), and adding paragraph (d) to read as follows:

§ 1.460–3 Long-term construction contracts.

* * * * *

(b) * * *

(1) * * *

(ii) Other construction contract, entered into after December 31, 2017, in a taxable year ending after December 31, 2017, by a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), who estimates at the time such contract is entered into that such contract will be completed within the 2-year period beginning on the contract commencement date, and who meets the gross receipts test described in paragraph (b)(3) of this section for the taxable year in which such contract is entered into.

* * * * *

(3) *Gross receipts test*—(i) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash method under section 448(a)(3), meets the gross receipts test of this paragraph (b)(3) if it meets the gross receipts test of section 448(c) and § 1.448–2(c)(2). This gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(ii) *Application of gross receipts test*—(A) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (b)(3)(ii)(B) and (C) of this section, the gross receipts test of section 448(c) and the accompanying regulations are applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(C) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the pro rata share of S corporation gross

receipts taken into account by the S corporation under section 1363(b).

(D) *Example.* The operation of this paragraph (b)(3) is illustrated by the following examples:

(*1*) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business,* of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (b)(3)(ii)(B) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (b)(3) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(*2*) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (b)(3)(ii)(B) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(3)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(iii) *Method of accounting.* A change in the method of accounting used for exempt construction contracts described in paragraph (b)(1)(ii) of this section is a change in method of accounting under section 446 and the accompanying regulations. For rules distinguishing a change in method from adoption of a method, see § 1.460–1(f)(3). A taxpayer changing its method of accounting must obtain the consent of the Commissioner in accordance with § 1.446–1(e)(3). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and § 1.446–1. A change in method of accounting shall be implemented pursuant to the applicable administrative procedures to obtain the consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (IRB) (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see § 601.601(d)(2) of this chapter)). A taxpayer that uses the percentage of completion method for exempt contracts described in paragraph (b)(1)(ii) of this section that wants to change to another exempt contract method is to use the applicable administrative procedures to obtain the automatic consent of the Commissioner to change such method under section 446(e) as published in the IRB. A taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis, and thus, a section 481(a) adjustment will not be permitted or required. See § 1.460–4(g).

* * * * *

(d) *Applicability Dates.* Paragraphs (b)(1)(ii) and (b)(3) of this section apply, for contracts entered into in taxable years beginning on or after January 5, 2021. However, for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (d), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

■ **Par. 20.** Section 1.460–4 is amended by revising the first sentence of paragraph (f)(1) and adding paragraph (i) to read as follows:

§ 1.460–4 Methods of Accounting for long-term contracts.

* * * * *

(f) * * * (1) * * * Under section 56(a)(3), a taxpayer subject to the AMT must use the PCM to determine its AMTI from any long-term contract entered into on or after March 1, 1986, that is not a home construction contract, as defined in § 1.460–3(b)(2). * * *

* * * * *

(i) *Applicability date.* Paragraph (f)(1) of this section applies to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (i), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

* * * * *

■ **Par. 21.** Section 1.460–5 is amended:

■ 1. In paragraph (d)(1), by removing the language ''(concerning contracts of homebuilders that do not satisfy the $10,000,000 gross receipts test described in § 1.460–3(b)(3) or will not be completed within two years of the contract commencement date)''.

■ 2. By revising paragraph (d)(3).

The revision reads as follows:

§ 1.460–5 Cost allocation rules.

* * * * *

(d) * * *

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A, unless the taxpayer estimates, when entering into the contract, that it will be completed within two years of the contract commencement date, and the taxpayer satisfies the gross receipts test of section 448(c) described in § 1.460–3(b)(3) for the taxable year in which the contract is entered into.

* * * * *

■ **Par. 22.** Section 1.460–6 is amended:

■ 1. In paragraph (b)(2) introductory text, by removing the language ''section 460(e)(4)'' and adding in its place the language ''section 460(e)(3)''.

■ 2. By revising the first and last sentences of paragraph (b)(2)(ii).

■ 3. By designating the undesignated text after paragraph (b)(3)(ii) as paragraph (b)(3)(iii).

■ 4. In newly designated paragraph (b)(3)(iii), by adding a sentence to the end of the paragraph.

■ 5. In paragraph (c)(1)(i), by revising the fifth sentence.

■ 6. In paragraph (c)(2)(i), by revising the third sentence.

■ 7. In paragraph (c)(2)(iv), by revising the first sentence.

■ 8. In paragraph (c)(3)(ii), by revising the first sentence.

■ 9. In paragraph (c)(3)(vi), by revising the first sentence.

■ 10. In paragraph (d)(2)(i), by removing the language ''whether or not the taxpayer would have been subject to the alternative minimum tax'' and adding in its place the language ''for taxpayers subject to the alternative minimum tax without regard to whether tentative minimum tax exceeds regular tax for the redetermination year''.

■ 11. By revising paragraph (d)(4)(i)(A).

■ 12. By designating paragraph (h)(8)(ii) *Example 7* as paragraph (h)(8)(iii).

■ 13. By revising newly designated paragraph (h)(8)(iii).

■ 14. By adding paragraph (k).

The revisions and additions read as follows:

§ 1.460–6 Look-back method.

* * * * *

(b) * * *

(2) * * *

(ii) is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer, other than a tax shelter

prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), who meets the gross receipts test of section 448(c) and § 1.460–3(b)(3) for the taxable year in which such contract is entered into. * * * The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, for those taxpayers subject to the AMT in taxable years prior to the filing taxable year in which the look-back method is required, unless the contract is exempt from required use of the percentage of completion method under section 56(a)(3).

(3) * * *

(iii) * * * For contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, a taxpayer's gross receipts are determined in the manner required by regulations under section 448(c).

* * * * *

(c) * * *

(1) * * *

(i) * * * Based on this reapplication, the taxpayer determines the amount of taxable income (and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. * * *

* * * * *

(2) * * * (i) * * * The taxpayer then must determine the amount of taxable income (and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. * * *

* * * * *

(iv) * * * In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c), are recomputed only for each year in which allocable contract costs were incurred. * * *

* * * * *

(3) * * *

(ii) * * * Under the method described in this paragraph (c)(3) (actual method), a taxpayer first must determine what its regular and, when applicable, its alternative minimum tax and base erosion minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). * * *

* * * * *

(vi) * * * For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the taxes, if any, imposed under sections 55 and 59A (relating to alternative and base erosion minimum tax, respectively) must be taken into account. * * *

* * * * *

(d) * * *

(4) * * * (i) * * *(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. The pass-through entity determines the amount of any hypothetical underpayment or overpayment for a redetermination year using the highest rate of tax in effect for corporations under section 11. However, for redetermination years beginning before January 1, 2018, the pass-through entity uses the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). Further, the pass-through entity uses the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (that is, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

* * * * *

(h) * * *

(8) * * *

(iii) *Example 7.* X, a calendar year C corporation, is engaged in the construction of real property under contracts that are completed within a 24-month period. Its average annual gross receipts for the prior 3-taxable-year period does not exceed $25,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (CCM) for regular tax purposes. However, X is engaged in the construction of commercial real property and, for years beginning before January 1, 2018, is required to use the percentage of completion method (PCM) for alternative minimum tax (AMT) purposes. Assume that for 2017, 2018, and 2019, X has only one long-term contract, which is entered into in 2017 and completed in 2019 and that in 2017 X's average annual gross receipts for the prior 3-taxable-years do not exceed $10,000,000. Assume further that X estimates gross income from the contract to be $2,000, total contract costs to be $1,000, and that the contract is 25 percent complete in 2017 and 70 percent complete in 2018, and 5 percent complete in 2019. In 2019, the year of completion, gross income from the contract is actually $3,000, instead of $2,000, and costs are actually $1,000. Because X was required to use the PCM for 2017 for AMT purposes, X must apply the look-back method to its AMT reporting for that year. X has elected to use the simplified marginal impact method. For 2017, X's income using estimated contract price and costs is as follows:

TABLE 1 TO PARAGRAPH (h)(8)(iii)

Estimates	2017
Gross Income	$500 = ($2,000 × 25%)
Deductions	$(250) = ($1,000 × 25%)
Contract Income—PCM.	$250

(A) When X files its federal income tax return for 2019, the contract completion year, X applies the look-back method. For 2017, X's income using actual contract price and costs is as follows:

TABLE 2 TO PARAGRAPH (h)(8)(iii)(A)

Actual	2017
Gross Income	$750 = ($3,000 × 25%)
Deductions	$(250) = ($1,000 × 25%)
Contract Income—PCM.	$500

(B) Accordingly, the reallocation of contract income under the look-back method results in an increase of income for AMT purposes for 2017 of $250 ($500–$250). Under the simplified marginal impact method, X applies the highest rate of tax under section 55(b)(1) to this increase, which produces a hypothetical underpayment for 2017 of $50 (.20 × $250). Interest is charged to X on this $50 underpayment from the due date of X's 2017 return until the due date of X's 2019 return. X, a C corporation, is not subject to the AMT in 2018. X does not compute alternative minimum taxable income or use the PCM in that year. Accordingly, look-back does not apply to 2018.

* * * * *

(k) *Applicability date.* Paragraphs (b)(2), (b)(2)(ii), (b)(3)(iii), (c)(1)(i), (c)(2)(i), (c)(2)(iv), (c)(3)(ii), (c)(3)(vi), (d)(2)(i), (d)(4)(i)(A), and (h)(8)(iii) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (k), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years. Further, a taxpayer may apply those portions of paragraphs (b)(2)(ii) and (b)(3)(iii) of this section that relate to section 460(e)(1)(B) for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

■ **Par. 23.** § 1.471–1 is amended by:

■ 1. Designating the undesignated paragraph as paragraph (a).

■ 2. Adding a heading to newly designated paragraph (a) and revising the first sentence.

■ 3. Adding paragraphs (b) and (c).

The revision and addition read as follows:

§ 1.471–1 Need for inventories.

(a) *In general.* Except as provided in paragraph (b) of this section, in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

(b) *Exemption for certain small business taxpayers*—(1) *In general.* Paragraph (a) of this section shall not apply to a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), in any taxable year if the taxpayer meets the gross receipts test described in paragraph (b)(2) of this section, and uses as a method of accounting for its inventory a method that is described in paragraph (b)(3) of this section.

(2) *Gross receipts test*—(i) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash method under section 448(a)(3), meets the gross receipts test of this paragraph (b)(2) if it meets the gross receipts test of section 448(c) and § 1.448–2(c). This gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(ii) *Application of the gross receipts test*—(A) *In general.* In the case of any taxpayer that is not a corporation or partnership, and except as otherwise provided in paragraphs (b)(2)(ii)(B) and (C) of this section, the gross receipts test of section 448(c) and the accompanying regulations are applied in the same manner as each trade or business of the taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or businesses are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as: personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(C) *Partners and S corporation shareholders*—(*1*) *In general.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(*2*) [Reserved]

(D) *Examples.* The operation of this paragraph (b)(2) is illustrated by the following examples:

(*1*) *Example 1.* Taxpayer A, a calendar year S corporation, is a reseller and maintains inventories. In 2017, 2018, and 2019, A's gross receipts were $10 million, $11 million, and $13 million respectively. A is not prohibited from using the cash method under section 448(a)(3). For 2020, A meets the gross receipts test of paragraph (b)(2) of this section.

(*2*) *Example 2.* Taxpayer B operates two separate and distinct trades or businesses that are reported on Schedule C, *Profit or Loss from Business,* of B's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (b)(2)(ii)(B) of this section, for 2020, neither of B's trades or businesses meets the gross receipts test of paragraph (b)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(*3*) *Example 3.* Taxpayer C is an individual who operates three separate and distinct trades or business that are reported on Schedule C of C's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (b)(2)(ii)(B) of this section, C's gross receipts are the combined amount derived from all three of C's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(3) *Methods of accounting under the small business taxpayer exemption.* A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:

(i) Using a method that treats its inventory as non-incidental materials and supplies (section 471(c) NIMS inventory method), as described in paragraph (b)(4) of this section; or

(ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the taxpayer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in

paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method).

(4) *Inventory treated as non-incidental materials and supplies*—(i) *In general.* The costs of inventory treated as non-incidental materials and supplies are recovered through cost of goods sold only in the taxable year in which the inventory is used or consumed in the taxpayer's business, or in the taxable year in which the taxpayer pays for or incurs the cost of the inventory, whichever is later. Inventory treated as non-incidental materials and supplies is used or consumed in the taxpayer's business in the taxable year in which the taxpayer provides the inventory to its customer. The costs of inventory are treated as non-incidental materials and supplies under this paragraph (b)(4) are not eligible for the *de minimis* safe harbor election under § 1.263(a)–1(f)(2).

(ii) *Identification and valuation of inventory treated as non-incidental materials and supplies.* A taxpayer may determine the amount of the costs of its inventory treated as non-incidental materials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See § 1.471–2(d). A taxpayer that uses the section 471(c) NIMS inventory method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify inventory treated as non-incidental materials and supplies, or to value that inventory treated as non-incidental materials and supplies. The inventory costs includible in the section 471(c) NIMS inventory method are the direct material costs of the property produced or the costs of property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code.

(iii) *Allocation methods.* A taxpayer treating its inventory as non-incidental materials and supplies under this paragraph (b)(4) may allocate the costs of such inventory by using specific identification or any other reasonable method.

(iv) *Example.* Taxpayer D is a baker that reports its baking trade or business on Schedule C, *Profit or Loss From Business,* of the Form 1040, *Individual Tax Return,* and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than $100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) NIMS inventory method. D purchases $50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells those peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b)(4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

(5) *AFS section 471(c) inventory method*—(i) *In general.* A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) inventory method described in this paragraph to account for its inventory costs for the taxable year. For purposes of the AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that a taxpayer capitalizes to inventory property produced or property acquired for resale in its AFS. For purposes of the AFS section 471(c) inventory method, costs that are generally required to be capitalized to inventory under section 471(a) but that the taxpayer does not capitalize to inventory on its AFS are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) inventory method recovers its inventory costs in accordance with the inventory method used in its AFS.

(ii) *Definition of Applicable Financial Statement (AFS).* The term applicable financial statement (AFS) is defined in section 451(b)(3) and the accompanying regulations. See § 1.451–3(a)(5). The rules relating to additional AFS issues provided in § 1.451–3(h) apply to the AFS section 471(c) inventory method. In the case of a taxpayer with a financial accounting year that differs from the taxpayer's taxable year, the taxpayer must consistently use the same method of accounting described in § 1.451–3(h)(4)(i)(A) through (C) that is used for section 451(b) purposes to also determine its inventory for the taxable year under this paragraph (b)(5)(ii). A taxpayer has an AFS for the taxable year if all of the taxpayer's taxable year is covered by an AFS.

(iii) *Timing of inventory costs.* Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in § 1.446–1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See § 1.446–1(c)(1)(ii) and section 461 and the accompanying regulations.

(iv) *Example.* H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) inventory method of accounting. In H's 2019 AFS, H incurred $2 million in purchases of office supplies held for resale and recovered the $2 million as cost of goods sold. On January 5, 2020, H makes payment on $1.5 million of these office supplies. For purposes of the AFS section 471(c) inventory method of accounting, H can recover the $2 million of office supplies in 2019 because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

(6) *Non-AFS section 471(c) inventory method*—(i) *In general.* A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) inventory method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) inventory method is the method of accounting used for inventory in the taxpayer's books and records that properly reflect its business activities for non-tax purposes and are prepared in

accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that the taxpayer capitalizes to inventory property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. Costs that are generally required to be capitalized to inventory under section 471(a), but that the taxpayer does not capitalize in its books and records are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the non-AFS section 471(c) inventory method recovers its applicable costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) inventory method.

(ii) *Timing and amounts of costs.* Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not recover any costs that have not been paid or incurred under the taxpayer's overall method of accounting, as described in § 1.446–1(c)(1). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See § 1.446–1(c)(1)(ii), and section 461 and the accompanying regulations.

(iii) *Examples.* The following examples illustrate the rules of paragraph (b)(6) of this section.

(A) *Example 1.* Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of $15 million and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) inventory method of accounting. E uses the overall cash method, and the non-AFS section 471(c) inventory method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E uses this physical count as part of its books and records for purposes of capitalizing and allocating costs to inventory. E also makes representations to its creditor of the cost of inventory on hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity. Instead, E must use the physical inventory count taken at the end of 2019 to determine how its capitalized costs are allocated and recovered.

(B) *Example 2.* Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does not use the physical count to capitalize and allocate costs to inventory and does not make any representations about inventory on hand to any creditors. Although E pays or incurs costs that are generally required to be capitalized to inventory under section 471(a), because such costs are not capitalized to inventory in E's books and records, they are not required to be capitalized to inventory under paragraph (b)(6)(i) of this section.

(C) *Example 3.* Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does not use the physical count to capitalize and allocate costs to inventory in its electronic bookkeeping software and does not make any representations about inventory on hand to any external parties. E does use the physical count to value inventory on hand for internal reports to its shareholders. The internal reports to its shareholders are part of E's books and records and must be taken into account for E's non-AFS section 471(c) inventory method. E recovers its inventory costs consistent with its non-AFS section 471(c) inventory method.

(D) *Example 4.* Taxpayer F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F's financial statements show $500,000 of direct and indirect material costs. F pays its supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

(E) *Example 5.* Taxpayer G is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return. In 2020, G's baking business has average annual gross receipts for the prior 3-taxable years of less than $100,000 and is not otherwise prohibited from using the cash method under section 448(a)(3). G does not have an AFS for the 2020 taxable year. For Federal income tax purposes, G uses the overall cash method of accounting and the non-AFS section 471(c) inventory method. In G's books and records for 2020 that properly reflects its business activities for non-tax purposes, G capitalizes the cost of its cookie ingredients to inventory but immediately expenses the cost of labor for G's employee who bakes the cookies. Under paragraphs (b)(6)(i) and (ii) of this section, G treats as an inventory cost the cost of its cookie ingredients and recovers such costs in accordance with the accounting procedures used to prepare its books and records, or, if later, when paid. Additionally, although the cost of direct labor is generally required to be capitalized to inventory under section 471(a), because such cost is not capitalized to inventory in G's books and records, it is not required to be capitalized to inventory under paragraph (b)(6)(i) of this section. Further, because such direct labor cost is generally deductible under section 162, and not otherwise required to be capitalized under section 263(a), G may deduct the cost of labor in the year G pays that expense.

(F) *Example 6.* Taxpayer H is a partnership engaged in the resale of beer, wine, and liquor. In 2020, H has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). H does not have an AFS for the 2020 taxable year. For Federal income tax purposes, H uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, H uses the overall cash method. As part of its regular business practice, H's employees take regular physical counts of the inventory on the shop floor and in the storeroom, however H's method of accounting for inventory for its books and records does not allocate costs between ending inventory and cost of goods sold, and instead expenses the cost of the inventory in the year it was paid for. Prior to December 2020, H acquires and pays for $500,000 of beer, wine, and liquor. In addition, on

December 1, 2020, H acquires $50,000 in beer and wine, and pays for this beer and wine on December 20, 2020. H may recover as deductions in 2020 the $550,000 of inventory costs.

(G) *Example 7.* Taxpayer J is a partnership engaged in the resale of beer, wine, and liquor. In 2020, J has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). J does not have an AFS for the 2020 taxable year. For Federal income tax purposes, J uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, J uses the overall cash method. J maintains a point-of-sale computer system that tracks acquisition costs and inventory levels of the beer, wine, and liquor. The ledger is periodically reconciled with physical counts performed by J's employees. J must use the physical inventory count and ledger to determine its ending inventory. J includes in cost of goods sold for 2020 those inventory costs that are not properly allocated to ending inventory.

(7) *Effect of section 471(c) on other provisions.* Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, an accrual method taxpayer that includes inventory costs in its AFS is required to satisfy section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section. Finally, nothing in section 471(c) permits the deduction or recovery of any cost that a taxpayer is otherwise precluded from deducting or recovering under any other provision in the Code or Regulations.

(8) *Method of accounting*—(i) *In general.* A change in the method of treating inventory under this paragraph (b) is a change in method of accounting under sections 446 and 481 and the accompanying regulations. A taxpayer changing its method of accounting under paragraph (b) of this section may do so only with the consent of the Commissioner as required under section 446(e) and § 1.446–1. For example, a taxpayer using the AFS section 471(c) inventory method or non-AFS section 471(c) inventory method that wants to change its method of accounting for inventory in its AFS, or its books and records, respectively, is required to secure the consent of the Commissioner before using this new method for Federal income tax purposes. However, a change from having an AFS to not having an AFS, or vice versa, without a change in the underlying method for inventory for financial reporting purposes that affects Federal income tax is not a change in method of accounting for such inventory under section 446(e). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and § 1.446–1. The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under § 1.446–1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also § 601.601(d)(2) of this chapter).

(ii) *Automatic consent for certain method changes.* Certain changes in method of accounting made under paragraph (b) of this section may be made under the procedures to obtain the automatic consent of the Commissioner to change a method of accounting. See Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see § 601.601(d)(2) of this chapter)). In certain situations, special terms and conditions may apply.

(c) *Applicability dates.* This section applies for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply this section provided that the taxpayer follows all the applicable rules contained in this section for such taxable year and all subsequent taxable years.

Douglas W. O'Donnell,

Acting Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2020.

David J. Kautter,

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