Chapter 3: Small Business Issues

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

TRUST FUND RECOVERY PENALTY

A trust fund tax is the money withheld from an employee's wages (income, social security, and Medicare taxes) by an employer. These amounts are called trust fund taxes because the employer actually holds the employee's money in trust until the employer makes a federal tax deposit in the required amount. Trust fund taxes also include other collected taxes (e.g., excise taxes). Trust fund taxes that are not paid to the IRS may be assessed **personally** against one or more "responsible persons."

The trust fund recovery penalty (TFRP) is not a penalty in the usual sense. It is a means provided by IRC §6672 to facilitate the collection of trust fund taxes and enhance voluntary compliance. It is an alternative method of collecting unpaid trust fund taxes when the taxes are not fully collectible from the business that failed to pay the taxes. Congress enacted §6672 to encourage the prompt payment of tax withholdings and to ensure the ultimate collection of the taxes from a secondary source.[1]

Note. Employers may also be subject to penalties for failure to file and late payments, as well as interest on the unpaid balance.

IDENTIFYING TRUST FUND TAXES

TFRPs are based on liabilities reported on the following tax forms.[2]

- Form 720, *Quarterly Federal Excise Tax Return*
- Form 941, *Employer's Quarterly Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 944, *Employer's Annual Federal Tax Return*
- Form 945, *Annual Return of Withheld Federal Income Tax*
- Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*
- Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*
- Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*
- Form CT-1, *Employer's Annual Railroad Retirement Tax Return*

1. IRM 8.25.1.1 (2012).
2. IRM 8.25.1.3 (2012).

RESPONSIBLE PERSONS

The TFRP may be assessed against any person who:[3]

1. Is **responsible** for:
   a. Collecting,
   b. Truthfully accounting for, and
   c. Paying over taxes held in trust, and
2. **Willfully** fails to collect or pay them.

In *Slodov v. U.S.,*[4] the Supreme Court interpreted the statutory language to apply to all "persons responsible for collection of third-party taxes and not . . . [only] to those persons in a position to perform all three of the enumerated duties." Thus, the Code deems anyone who is required to collect **or** account for **or** remit taxes a **responsible person.**[5]

A responsible person may be one of the following.[6]

- An officer or an employee of a corporation
- A member or employee of a partnership
- A corporate director or shareholder
- A member of a board of trustees of a nonprofit organization
- Another person with the authority and control over funds to direct their disbursement
- Another corporation or third-party payer
- Payroll service providers (PSP) or responsible parties within a PSP
- Professional employer organizations (PEO) or responsible parties within a PEO
- Responsible parties within the common law employer (client of PSP/PEO)

Responsibility is based on whether a person exercised independent judgment with respect to the business's financial affairs. An employee is **not a responsible person if the employee's duty was solely to pay the bills** as directed by a superior, rather than to determine which creditors would be paid.

> **Example 1.** Clarissa is a non-owner employee who works as a secretary in the office of Merit Business Supply. She signs checks and tax returns at the direction of and for the convenience of the owner or a supervisor who is a non-owner. Clarissa is directed to pay certain vendors, even though payroll taxes are unpaid. She is not a responsible person for the TFRP because she works under the dominion and control of her superiors, and she is not permitted to exercise independent judgment.[7]

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3. IRC §6672(a).
4. *Slodov v. U.S.,* 436 U.S. 238 (1978).
5. *Johnson v. U.S.,* No. 12-1739 (4th Cir. 2013), citing *Plett v U.S.,* 185 F.3d 216 (4th Cir. 1999).
6. *Employment Taxes and the Trust Fund Recovery Penalty (TFRP).* [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employment-Taxes-and-the-Trust-Fund-Recovery-Penalty-%28TFRP%29] Accessed on Oct. 15, 2013.
7. Adapted from an example in IRM 5.7.3.3.1.2 (2010).

The ability to select one creditor over another is not a prerequisite to being deemed a responsible person. Officers and higher-level employees of a company who are non-owners may be required to terminate their employment to avoid being responsible for the TFRP. For example, in *Howard v. U.S.,*[8] a corporate officer was held to be the person responsible for paying trust fund taxes even though his superior ordered him not to pay the taxes and he informed the IRS of the matter. Despite the taxpayer's claim that his actions were not voluntary, the court determined that his failure to pay taxes was willful because he could have refused to comply with his superior's orders and risk dismissal from his job. The District Court had described the corporate CEO as "even more responsible" than the corporate officer. However, the CEO was apparently no longer within reach of the IRS. The Circuit Court observed that §6672 "looks only to 'responsible persons,' not to 'the most responsible person,' for satisfaction."

Commonwealth National Bank of Dallas, et al. v. U.S.,[9] was a case involving an employer, the employer's bank, and the bank president, who were all liable for the TFRP. The liability was not confined to the employer and its officers but extended to those responsible for controlling corporate disbursements, which included the lender bank. The bank controlled how the funds were spent, including deciding which creditors were paid.

Persons serving as volunteers solely in an honorary capacity as directors and trustees of tax-exempt organizations are generally not considered responsible persons unless:

- They participated in the day-to-day operations of the organization, and
- They had actual knowledge of the failure to withhold or pay over the trust fund taxes.

This does not apply if it would result in no person being determined to be responsible for the TFRP.[10]

The responsible person is **willful** if they:

- Must have been, or should have been, aware of the outstanding taxes, and
- Either intentionally disregarded the law or were plainly indifferent to its requirements.

Paying other creditors with available funds when the business is unable to pay the employment taxes is an indication of **willfulness.** In *Erwin v. U.S.,* the court noted that "when a responsible person learns that withholding taxes have gone unpaid in past quarters for which he was responsible, he has a duty to use all current and future unencumbered funds available to the corporation to pay back those taxes."[11]

> **Note.** Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes,* is an interview questionnaire used to determine responsible party status.

Outsourcing Payroll

Many employers outsource their payroll and associated tax duties to third-party payers such as PSPs and reporting agents (RA). Though most of these businesses are reputable, there have been many individuals and companies that have been prosecuted for stealing funds intended for the payment of payroll taxes.

> **Note.** Examples of these successful prosecutions can be found at **www.irs.gov/uac/Examples-of-Employment-Tax-Investigations-Fiscal-Year-2013.**

8. *Howard v. U.S.,* 711 F.2d 729 (5th Cir. 1983).
9. *Commonwealth National Bank of Dallas, et al. v. U.S.,* 665 F.2d 743 (5th Cir. 1982).
10. IRM 5.7.3.3.1.1 (2006).
11. *Erwin v. U.S.,* 591 F.3d 313 (4th Cir. 2010).

The TFRP may be assessed against a third-party payer. In determining the potential **responsibility** and **willfulness** of a third-party payer, the following factors are considered.[12]

- **Responsibility.** The person(s) within the third-party payer who had significant control over the payment of the client's employment taxes must be identified.
- **Willfulness.** Willfulness means the act is intentional, deliberate, voluntary, reckless, and knowing, as opposed to accidental. It is not required that the person had evil intent or bad motives.

However, the employers who outsource their payroll functions are still legally responsible for any payroll taxes due. This is true even in situations in which the employer forwards tax amounts to a PSP or RA to make the required deposits or payments.[13] The factors considered in determining responsibility and willfulness of a responsible person within the employing organization when there is a third-party payer arrangement are the following.[14]

- **Responsibility.** The use of a third-party payer does not relieve the employer and the employer's employees from the responsibility of ensuring that all of the employer's federal employment tax obligations are met.
- **Willfulness.** Willfulness means the act is intentional, deliberate, voluntary, reckless, and knowing, as opposed to accidental. It is not required that the person had evil intent or bad motives. Additional factors considered when determining willfulness include the following.
  - Whether the responsible person had knowledge of a pattern of noncompliance by the third-party payer at the time the delinquencies were accruing
  - Whether the client had received prior IRS notices indicating that employment tax returns were not filed, or were inaccurate, or that employment taxes were not paid
  - The actions the client took to ensure that its federal employment tax obligations were met after becoming aware of the tax delinquencies (e.g., timely reporting the problems to the IRS, ensuring current tax debts were timely reported and paid, and working with the IRS on a reasonable plan to resolve past debts)
  - Whether the third-party payer used fraud or deception to conceal the noncompliance from detection by the client

The IRS identified steps that employers can take to protect themselves from unscrupulous third-party payers.[15]

- Ensure the PSP or RA uses the electronic federal tax payment system (EFTPS) to make tax deposits. EFTPS gives employers easy online access to their payment history when deposits are made under their employer identification number (EIN), which enables them to monitor whether their third-party payer is properly carrying out their tax deposit responsibilities.
- Refrain from substituting the third-party payer's address for the employer's address as the address on record with the IRS. Doing this ensures that the employer will continue to receive bills, notices, and other account-related correspondence from the IRS. It also gives employers a way to monitor the third-party payer and spot any improper diversion of funds.
- Contact the IRS about any bills or notices as soon as possible. This is especially important if it involves a payment that the employer believes was made or should have been made by a third-party payer.
- Become familiar with the tax due dates that apply to employers.

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12. IRM 5.7.3.3.3 (2012).
13. IRS FS-2013-9 (Jul. 2013).
14. IRM 5.7.3.3.3 (2012).
15. IRS FS-2013-9 (Jul. 2013).

- Employers who use RAs should be aware of special rules that apply. RAs are generally required to use EFTPS and file payroll tax returns electronically. They are also required to provide a written statement to employers that details the employer's responsibilities, including a reminder that the employer is still legally required to timely file returns and pay any tax due.

> **Caution.** Tax practitioners should be aware that continuing their control of client funds when unpaid taxes exist could lead to the practitioner being identified as the responsible party and becoming subject to the TFRP.

AMOUNT OF TFRP

Under IRC §6672, the TFRP is equal to the total amount of tax evaded, not collected, or not accounted for and paid. The TFRP applies only to the income tax withheld from employees and the employee's portion of FICA; it does not apply to the **employer's** portion of employment taxes. It also applies to excise taxes that are collected.[16]

The IRS's policy is to collect the full tax only once from:

- The business,
- One or more of its responsible persons, or
- The business **and** one or more responsible individuals.[17]

The TFRP must generally be assessed within three years from the date a return is filed or the due date of the return, whichever is later.[18]

RELIEF FOR LATE S ELECTIONS

QUALIFYING FOR S ELECTION

An entity must meet certain prerequisites to qualify as a small business corporation (S corporation).[19] The following requirements must be met to qualify for the S election.[20]

- The corporation must be a domestic corporation or a domestic entity eligible to be treated as a corporation.
- There can be no more than 100 shareholders.
- The corporation cannot have more than one class of stock.
- All shareholders must be qualified shareholders.
- The corporation adopted or will adopt a certain tax year.
- Each shareholder consents to the election.

> **Observation.** LLCs may also qualify to make an S election. This is discussed in the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Entity Selection.

> **Note.** For a detailed explanation of these requirements, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: S Corporation. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

16. IRM 8.25.1.2 (2012).
17. IRM 5.19.14.1.2 (2013).
18. IRM 5.19.14.1.5 (2013).
19. IRC §1361(a)(1).
20. IRC §1361(b)(1).

TIMELY S ELECTION

If all the preceding prerequisites are met, the corporation can obtain subchapter S tax treatment by making the appropriate election. The S election is made by filing Form 2553, *Election by a Small Business Corporation.* The election must generally be made no later than two months and 15 days after the beginning of the tax year in which the election is to take effect, or it can be made at any time during the tax year preceding the tax year that the election is to take effect.[21] Under IRC §1362(b)(3), if an S election is made later than two months and 15 days after the beginning of the tax year and on or before the 15th day of the third month of the following tax year, then the S election is treated as made for that following tax year.

LATE ELECTIONS

IRC §1362(b)(5) allows the IRS to accept late S elections. Rev. Proc. 2013-30 consolidated and simplified a number of previous revenue procedures and now provides the exclusive simplified methods for taxpayers to request relief for a late S election.

Note. Rev. Proc. 2013-30 also contains provisions for taxpayers to make late elections for classification as an electing small business trust (ESBT), a qualified subchapter S trust (QSST), a qualified subchapter S subsidiary (QSub), or a corporation.

General Requirements for Relief

In order to qualify for relief, all the following requirements must be met.

- The requesting entity intended to be classified as an S corporation as of the effective date.
- The requesting entity requests relief under Rev. Proc. 2013-30 within **three years and 75 days** after the effective date.
- The failure to qualify as an S corporation as of the effective date was solely because the election under subchapter S was not timely filed by the due date of the S election.
- The requesting entity has **reasonable cause** for its failure to make a timely election and has acted diligently to correct the mistake upon its discovery.

Election Form. The requesting entity may request relief for a late election by completing Form 2553. The Form 2553 must state "FILED PURSUANT TO REV. PROC. 2013-30" at the top. The completed Form 2553 must be signed by the following persons.

- An officer of the corporation who is authorized to sign
- All persons who were shareholders at any time during the period that began on the first day of the tax year for which the election is to be effective and ends on the day the completed Form 2553 is filed

21. IRC §1362(b)(3).

The Form 2553 must be filed with the IRS Service Center in one of the following ways.

- **Attach the election form to the S corporation's current year Form 1120S.** If the S corporation filed all Forms 1120S, *U.S. Income Tax Return for an S Corporation,* for tax years between the effective date of the election and the current year, the Form 2553 can be attached to the current year Form 1120S. The current year Form 1120S must be filed within three years and 75 days after the effective date. An extension to file the current year Form 1120S does not extend the due date for the relief provided under Rev. Proc. 2013-30. The top of the Form 1120S must state "INCLUDES LATE ELECTION FILED PURSUANT TO REV. PROC. 2013-30," or the return must comply with the specific Form 1120S instructions. Also, the top margin of the first page of Form 2553 must state "FILED PURSUANT TO REV. PROC. 2013-30."

- **Attach the election form to one of the S corporation's late-filed prior year Forms 1120S.** If the S corporation did not file Form 1120S for the tax year that includes the effective date of the election or any subsequent year, the Form 2553 may be attached to the Form 1120S for the year that includes the effective date if both of the following conditions are met.
    - The Form 1120S for the tax year that includes the effective date of the election is filed within three years and 75 days after the effective date.
    - All other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief.

Example 2. Chi Energy Technologies Corporation intended to make an S election with an effective date of March 1, 2012, but it failed to file any income tax returns for 2012 or any subsequent tax year. It can attach a Form 2553 to its late-filed Form 1120S for 2012 only if the 2012 Form 1120S is filed before May 15, 2015 (which is three years and 75 days following the March 1, 2012 effective date). All other delinquent Forms 1120S must be filed at the same time and consistently with the requested relief. Chi Energy Technologies' 2012 Form 1120S must state "INCLUDES LATE ELECTION FILED PURSUANT TO REV. PROC. 2013-30" at the top.

- **File the election form independent of Form 1120S.** The requesting entity can submit the Form 2553 directly to the applicable IRS Service Center within three years and 75 days after the effective date of the election.

Supporting Documents. The following supporting documents must be attached to the Form 2553.

- A statement that describes:
    - The **reasonable cause** for the failure to timely file the election, and
    - The **diligent actions** taken to correct the mistake upon its discovery
- Statements from all shareholders during the period between the effective date of the S election and the date the Form 2553 is filed stating that they have reported their income on all affected returns consistent with the S election for the year the election should have been filed and all subsequent years

The supporting documents must each contain a dated declaration that states the following.

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

Relief Available after Deadline

If **more than three years and 75 days have passed** since the effective date of the election, the corporation may still qualify for relief. If all of the following conditions are satisfied, there is **no time limit** on the effective date of a late S election.

- The corporation meets all other general requirements for relief described earlier.
- The corporation is not seeking late corporate classification election relief concurrently with a late S election.
- The corporation fails to qualify as an S corporation solely because the Form 2553 was not timely filed.
- The corporation and all of its shareholders reported their income consistent with S status for the year the S election should have been made and for all subsequent tax years.
- At least six months passed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation.
- The IRS has not notified the corporation or any of its shareholders regarding the S status within six months of the date on which the Form 1120S for the first year was timely filed.
- The completed Form 2553 is accompanied by statements from all shareholders during the period between the intended effective date of the S election and the date the Form 2553 is filed that they have reported their income on all affected returns consistent with the S election for the year the election should have been filed and all subsequent years. The statements must be signed under penalties of perjury.

Effective Date

The effective date of Rev. Proc. 2013-30 is September 3, 2013. It applies to requests for late S election requests for relief pending on that date and to requests received thereafter.

Relief if Rev. Proc. 2013-30 Not Applicable

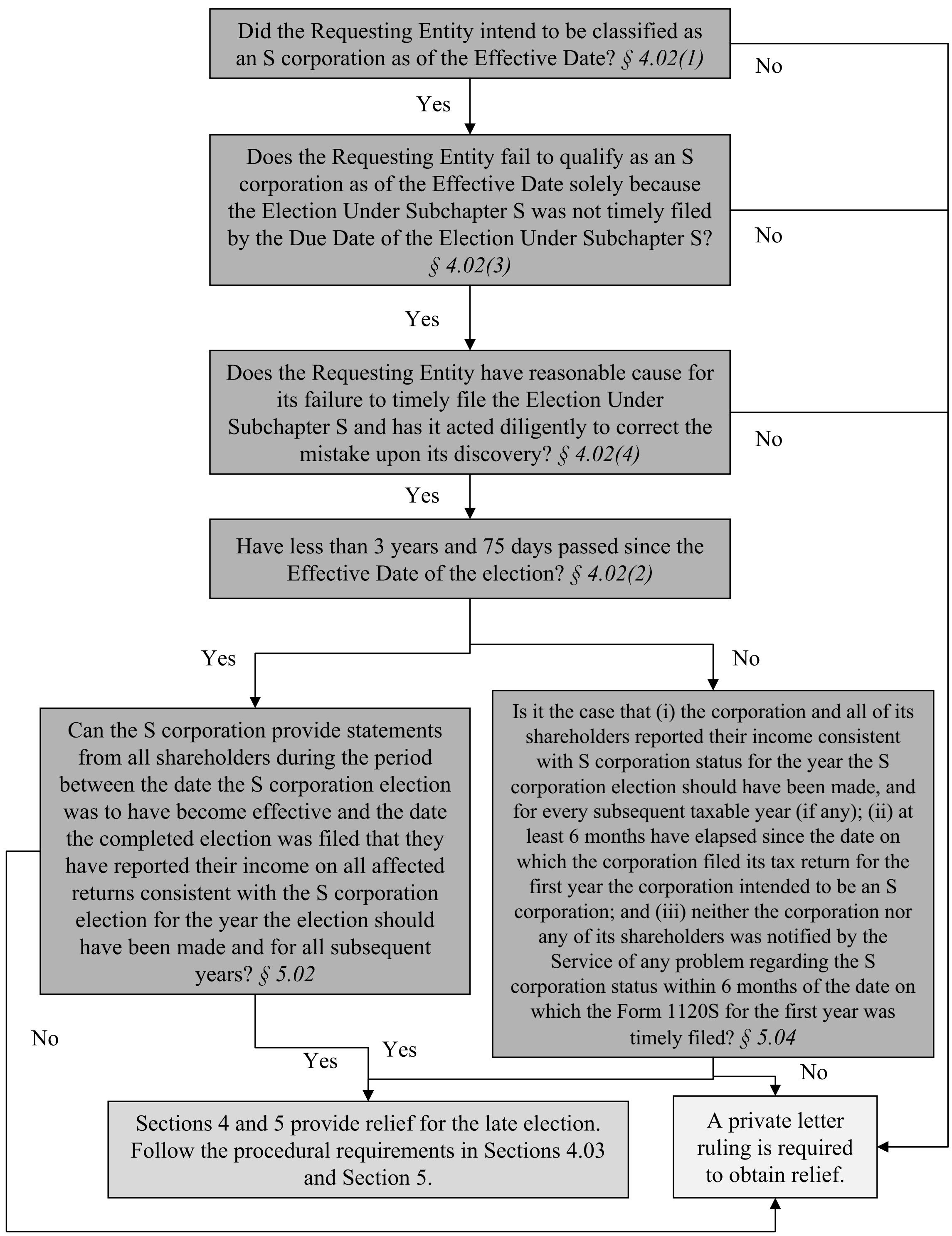
An entity that does not meet the requirements for relief explained previously or that is denied relief under Rev. Proc. 2013-30 may apply for relief by requesting a letter ruling. The requirements for requesting a letter ruling are explained in Rev. Proc. 2014-1.

> **Note.** Generally, the IRS is lenient in allowing late elections.

Flowchart

Rev. Proc. 2013-30 contains the following flowchart, which illustrates the process for obtaining relief for late S corporation elections.

Relief for Late S Corporation Elections



TAX ASPECTS OF FRANCHISES

A franchise is a contract with a company (franchisor) that gives the purchaser (franchisee) the right to use that company's name and sell its product or service within a particular geographical area. It gives small business owners the name recognition of an established brand and experienced guidance to help succeed in its industry. The company may also provide the following types of assistance.

- Finding a location
- Start-up training
- Periodic workshops or seminars
- Operating manuals
- Business models
- Ongoing support
- Proprietary software
- Advertising
- Payroll services
- Credit card processing

The purchaser pays the franchising company an initial franchise fee and agrees to operate the business in accordance with the contract. Often the contract requires the purchaser to pay a percentage of its sales to the company, contribute to a cooperative advertising fund, and buy certain products from the company.

Because many taxpayers are involved in franchising, practitioners must have an understanding of the tax consequences of these arrangements. The following material covers common aspects of franchises, from inception to end. It is frequently helpful for the practitioner to have a copy of the actual franchise agreement that exists between the parties. In addition, understanding the tax treatment of the typical provisions in a franchise agreement will assist in negotiating better terms if the tax practitioner is advising the taxpayer on the franchise acquisition.

PURCHASING A FRANCHISE

A purchaser may contract directly with the franchising company or buy an existing contract from a third party. An initial purchase typically includes the following.

- Franchise fee
- Goodwill (if purchasing a franchised store from an outgoing franchisee)
- Equipment
- Materials and supplies
- Lease or purchase of real estate

It is important that the purchase price of the various assets be properly allocated in order to establish the correct basis for depreciation and amortization. Allocation can be made according to items specified in the franchise agreement, using the fair market value of the assets, or by completing Form 8594, *Asset Acquisition Statement.*

Initial Franchise Fee

The initial franchise fee is an intangible asset which is amortized ratably over 15 years, starting with the month the franchise was acquired.[22] The costs to renew must also be capitalized and amortized over 15 years.[23] Franchise fees that are based on productivity, which are discussed later in this chapter, can be deducted as a business expense.[24]

Goodwill and Other Intangibles

Goodwill and most other intangibles acquired as part of a purchase must also be amortized ratably over 15 years, beginning with the month of purchase. Other amortizable intangibles include the following.[25]

- Going concern value
- Trademark or trade name
- Noncompete agreements
- Workforce in place
- Customer lists and other information bases
- Any patent, copyright, formula, process, design, pattern, knowhow, format, and similar items
- Customer-based intangibles
- Supplier-based intangibles

Equipment

Equipment is usually depreciated over five or seven years under MACRS. The actual life depends on the industry and the specific equipment.

> **Note.** For a thorough discussion of depreciation concepts, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 4: Depreciation Basics; and the 2011 *University of Illinois Federal Tax Workbook,* Chapter 1: Depreciation. These chapters can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Materials and Supplies

Materials and supplies may be expensed or capitalized.

> **Note.** For information about the proper method to use for expensing materials and supplies, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Capitalization or Repair.

Real Estate

A portion of the purchase price may be allocated to the **right to lease or sublease** real estate. The cost of this right is generally capitalized and amortized over the term of the lease. For amortization purposes, the term of the lease includes the current term plus all renewal periods. However, this applies only if **less than 75%** of the cost of obtaining the lease is attributable to the original lease term remaining on the purchase date.[26]

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22. IRC §197(a).
23. IRC §197(f)(4)(B).
24. IRC §1253.
25. IRC §197(d).
26. Treas. Reg. §1.178-1(b)(1).

Example 3. Marcella paid $20,000 to obtain a lease with 20 years remaining on the original lease term and two options to renew for five years each. The $20,000 cost included $14,000 for the original lease and $6,000 for the renewal options. Because $14,000 is less than 75% of the total paid for the lease ($14,000 ÷ $20,000 = 70%), Marcella must amortize the $20,000 over 30 years (20 years original lease term + (5 year renewal period × 2)).

Example 4. Use the same facts as **Example 3,** except that Marcella paid $16,000 for the original lease and $4,000 for the renewal option. Marcella can amortize the entire $20,000 cost over the remaining 20-year term of the original lease because the $16,000 cost of obtaining the original lease was not less than 75% of the total cost of the lease ($16,000 ÷ $20,000 = 80%).

Treasury regulations state that the allocation of the lease cost to the original term and any renewal terms is based on the facts and circumstances of each situation.[27] In some cases, it may be appropriate to determine the portion of the cost of acquiring a lease by applying the principles used to calculate the present value of an annuity.[28]

The cost of real estate **purchased** should be allocated among the components of the property. The cost of the land must be identified, because it is not depreciable. The taxpayer may want to obtain a cost-segregation study to further allocate the price between personal property and real property.

Note. For more information on cost segregation, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 1: Depreciation. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

OPERATING A FRANCHISE

A business operating under a franchise agreement may pay many different types of fees to the franchisor. Often, these fees are also called franchise fees. The tax consequences for fees based on operations differ from fees that purchase a right. Franchise fees are currently deductible as a business expense if the payments are part of a series of payments that are:[29]

- Contingent on productivity, use, or disposition of the item;
- Payable at least annually for the entire term of the franchise agreement; and
- Substantially equal in amount or payable under a fixed formula.

Example 5. Collier purchases a fast-food franchise on February 1, 2014. Under the terms of the agreement, he has the right to use the franchise name, Submariner Sandwiches, and has access to support from the franchisor. He pays an initial franchise fee of $50,000 and is required to pay 8% of the store's monthly gross sales to the franchisor.

The $50,000 initial franchise fee must be **amortized over 15 years,** starting in February 2014.

The monthly franchise fees equal to 8% of gross sales are **currently deductible** because they are contingent on productivity, payable at least annually, and based on a fixed formula.

Franchise agreements also typically require the franchisee to pay **cooperative advertising fees.** Cooperative advertising may be charged as a flat fee but is usually a percentage of the franchisee's gross sales. These fees fund the establishment and maintenance of the franchisor's trade name, which is a critical component of the growth and success of the franchise system. Advertising fees are mostly used for national or regional campaigns that benefit all the franchisees in the system.

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27. Treas. Reg. §1.178-1(b)(5).
28. Ibid.
29. IRS Pub. 535, *Business Expenses.*

Some franchisors also require franchisees to make payments to a local advertising fund or place advertisements directly in various types of local media. The franchisor often pays a portion of the franchisee's local advertising and promotion fees. It is common for some franchisors to make the rebate or credit after the franchisee submits proof of meeting the franchisor's required advertising criteria, but some franchisors pay the rebates or credits in advance of the franchisee placing the advertising.[30] The franchisee's right to the cooperative advertising allowance generally arises when the advertising is performed and not at the time documentation is provided to the franchisor or when payment is received by the franchisee.[31] Generally, an accrual method franchisee that has the right to reimbursement for a portion of its advertising costs from the franchisor, in accordance with a cooperative advertising agreement, accrues the reimbursement under the all-events test (discussed later in this chapter) when the franchisee places the advertising.[32]

SELLING A FRANCHISE

Typically, a business owner ends the relationship with the franchisor by selling the franchise. The buyer may be a third party or the franchising company. Most franchise contracts require that any sale be approved by the company, which may complicate the sale process.

Noncorporate Taxpayers

When a noncorporate owner of a franchise sells the various assets, these assets are subject to different tax treatments. For almost all depreciable assets held long term, the portion of the gain that is attributable to prior depreciation is taxed as ordinary income. However, the portion of the gain on IRC §1250 property attributable to accumulated depreciation allowed or allowable using the straight-line method is taxed at a maximum rate of 25%.

> **Note.** IRC §1250 property includes all depreciable real property that is not subject to IRC §1245. For more information, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 1: Form 4797.

The sale of assets that produce ordinary income in the course of business is also taxed as ordinary income when the assets are sold with the franchise. Assets in this category include accounts receivable and inventory.[33] The proceeds for these assets are reported on the schedule normally used to report the income and expenses of that business, such as Schedule C, *Profit or Loss From Business.*

Any long-term gain from the sale of depreciable assets in excess of the original cost basis is normally taxed at the lower capital gains rates of 0%, 15%, or 20%, depending on the marginal tax bracket of the taxpayer.

> **Note.** For more information on capital gains rates and tax brackets effective beginning on January 1, 2013, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation.

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30. Internal Revenue Service, *Audit Technique Guide for Retail Industry* (Feb. 2009).
31. Ibid.
32. Ibid.
33. IRC §1221(a)(4).

IRC §197 intangibles (e.g., purchased goodwill) are treated as §1245 property. IRC §1245 requires the lesser of the gain realized or the depreciation allowed or allowable to be **recaptured as ordinary income upon the sale** or other transfer of the §1245 property. Sales of purchased goodwill and other intangibles are eligible for capital gains tax rates on the portion of the gain in excess of any prior amortization. When multiple intangibles are disposed of in a single transaction or a series of related transactions, all the intangibles are treated as if they were a single asset for purposes of determining the amount of gain that is ordinary income. However, there is an exception for intangibles whose value is less than the adjusted basis.[34]

Note. For more information about §1245 property, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 1: Form 4797.

IRC §197(c)(2) excludes intangibles **created by the taxpayer** (such as created goodwill) from the definition of amortizable §197 intangibles. However, self-created intangibles qualify as capital assets under IRC §1221.[35]

Income from a noncompete agreement between the seller and the new owner is taxed as ordinary income on Part II of Form 4797, *Sales of Business Property.*[36] The courts have consistently held that payments received for noncompete agreements are compensation for services, "albeit in the negative form of forbearance from future competitive conduct."[37] From the seller's perspective, this makes the noncompete agreement distinct from other intangibles. The seller is not transferring an intangible that they already owned; instead, the seller is being paid in advance to refrain from working in a competitive manner. The buyer, however, is purchasing an intangible asset that may be amortized under §197.

Example 6. Kristen, a sole proprietor, owns a retail cosmetic store. The store has a franchise agreement with a national supplier. She purchased the franchise agreement directly from the supplier in July 2000 for $50,000. In July 2014, she sold the business. In the sales contract, the sales price allocated to intangibles includes the following.

Franchise agreement	$15,000
Goodwill	40,000
Covenant not to compete	50,000

Kristen's adjusted basis and gain on the intangible assets are computed as follows.

	Franchise Agreement		Goodwill		Covenant Not To Compete	
Sales price		$15,000		$40,000		$50,000
Cost	$50,000		$0		$0	
Less: prior amortization	(46,667)		(0)		(0)	
Adjusted basis	$ 3,333	(3,333)	$0	(0)	$0	(0)
Gain		$11,667		$40,000		$50,000

Kristen must report the $50,000 gain from the covenant not to compete as ordinary income on Form 4797, Part II.

34. IRC §1245(b)(8).

35. Ltr. Rul. 200243002 (Jul. 16, 2002).

36. Rev. Rul. 74-29, 1974-1 CB 79; see also *Muskat v. U.S.,* 554 F.3d 183 (1st Cir. 2009).

37. *Davee v. U.S.,* 195 Ct. Cl. 184 (Jun. 11, 1971).

The created goodwill of $40,000 qualifies as a capital asset under §1221. Thus, Kristen has a $40,000 long-term capital gain on the goodwill.

The franchise agreement is a §197 intangible, which is treated as §1245 property. Under §1245, the lesser of the gain realized or the amortization allowed or allowable is recaptured as ordinary income. Accordingly, Kristen has an ordinary gain of $11,667 on the sale of the franchise agreement.

If Kristen's goodwill had been purchased rather than created, she would be required to report the franchise agreement and the goodwill as the sale of a single asset on Form 4797, Part III.

Note. Both the buyer and seller of a group of assets that comprise a trade or business are required to file Form 8594, *Asset Acquisition Statement,* if goodwill or the going concern value attaches (or could attach) to the assets and the purchaser's basis in the assets is determined solely by the amount paid for the assets. This ensures that the assets are classified in the same manner by both parties.

Corporate Taxpayers

When a franchise is owned by a C corporation and it sells the business, the net capital gain realized by the C corporation is generally taxed at the same marginal rate as ordinary income, but the tax on the net capital gain is capped at the 35% rate.[38] However, the characterization of income as ordinary or capital gain is still important because a C corporation cannot deduct capital losses against ordinary income.[39]

Net capital gains realized by S corporations generally pass through to the shareholders and are taxed at the rates applicable to each shareholder.

ACCOUNTING METHODS

All practitioners should have a basic understanding of the accrual method of accounting. Even for practitioners preparing only Forms 1040, knowledge of the distinction between cash and accrual accounting is important, as it may affect the timing of deductions claimed on Schedule A. **For most taxpayers, Schedule A deductions must generally be claimed using the cash method.** Individuals filing Schedule C, or Schedule F, *Profit or Loss From Farming,* for a new business, as well as entities, often have a choice of whether to use the cash or accrual method. It is therefore beneficial to be able to advise clients on the attributes and possible benefits and drawbacks of both methods as they relate to the business in question.

This section explains how to distinguish between the cash and accrual method of accounting. It also explains when, for tax purposes, either cash or accrual accounting must be used. If neither method is **required,** it is important to understand when the cash method, the accrual method, or a hybrid of the two may be desirable.

This section describes the accrual method of accounting only as it is prescribed for tax reporting purposes under the Code, Treasury regulations, and IRS guidance. It does not purport to describe full accrual book accounting conforming to generally accepted accounting principles (GAAP), as may be required by other regulatory agencies.

Note. For additional information on this topic, see IRS Pub. 538, *Accounting Periods and Methods.*

38. IRC §1201(a).

39. IRC §1211(a).

ACCRUAL VERSUS CASH METHOD[40]

A **cash method** taxpayer generally reports income when it is received and deducts expenses when they are paid. As discussed later, most individual nonbusiness taxpayers filing a Form 1040 (without a Schedule C or Schedule F) are cash-method taxpayers.

> **Note.** Even under the cash method, it is important to understand the following rules.[41]
>
> - Income constructively received during the tax year is treated as fully received within that tax year. Generally, income is **constructively received** by a taxpayer when it is available to them without restriction. (For example, a check received December 30, 2014, but not deposited until January 3, 2015, is considered income in 2014.)
> - Restrictions apply to deducting prepayments of expenses.

An **accrual method** taxpayer generally recognizes and reports income in the year or period that it is earned — that is, when all performance of services or delivery of goods has occurred, so as to give the taxpayer a claim of right to payment without substantial risk of forfeiture. In short, income is reported when the work is done or the goods are sold. However, if payment occurs **before** performance, the income is generally recognized when paid for tax reporting purposes. Under the accrual method, income is generally recognized at the **earliest** of the following dates.[42]

- When the taxpayer receives payment
- When the income amount is due to the taxpayer
- When the taxpayer earns the income
- When title to goods sold has passed

In the case of prepayments, however, there are exceptions to the foregoing rule that allow some deferral of prepaid income. These exceptions are cited later in this section.

Similarly, the accrual-method taxpayer deducts **expenses** when they are incurred rather than when they are paid.[43] Accrual-method taxpayers can deduct or capitalize a business expense when both of the following conditions are satisfied.

1. The **all-events test** was met. This occurs when:
   a. All events have occurred that fix the fact of liability, and
   b. The liability can be determined with reasonable accuracy.
2. **Economic performance** occurred. Generally, economic performance occurs when the property or services are provided or used.

> **Note.** For certain types of expenses, such as taxes, economic performance occurs only upon payment. This is discussed later.

40. Accounting methods are sometimes referred to as "cash basis" and "accrual basis." However, because the term "basis" has another very specific meaning under the Code, the term "method" is used in this section when speaking of accounting methods. The cash method is also known as and referred to in the Code as the "cash receipts and disbursements" method.

41. IRS Pub. 538, *Accounting Periods and Methods*.

42. Ibid.

43. Ibid.

Example 7. Burt is a cash-method taxpayer. His wages are reported to him on Form W-2, *Wage and Tax Statement,* each year. Burt performs work in December 2014 but does not receive his paycheck until January 2015. These wages will be reported as income on his 2015 return.

If Burt sees the doctor in 2014 but does not pay the bill until 2016, he cannot take the deduction until he files his 2016 tax return. If he tried to deduct the cost on his 2014 return, he would be using the accrual method, which is not allowed for medical expenses.[44]

Example 8. In August 2014, Joe started a new business as a carpenter. Through word of mouth, he got a small labor-only repair job that paid him $50 when it was completed in September.

In December, Joe decides to promote his business because he has had no customers since he completed the September job. On December 1, he has flyers printed for $100. He pays the print shop for this bill in January 2015. On December 1, he also has a business phone installed at a cost of $35. His monthly rate for the phone is $70. He charges $105 to his credit card on December 31 to pay the phone company for the installation and his first month's usage.

> **Note.** It is important to note that this is done **after** the business is operating. Advertising done before the business has begun may require treatment as a start-up cost and may require capitalization (and sometimes amortization) of the expense.

Joe's advertising pays off. On December 15, he is contracted for a small deck repair, with the customer providing the materials. Joe completes the job immediately and invoices the customer $500 for his labor. The invoice allows 30-day terms, and the customer pays it in January 2015.

The following table shows how these items of income and expenses from Joe's 2014 activity are treated under the cash and accrual methods.

	Tax Year 2014		Tax Year 2015	
Cash method				
Gross income		$ 50		$500
Advertising expense (flyers)	$ 0		$100	
Utilities	105		0	
Total expenses	$105	(105)	$100	(100)
Net income		($ 55)		$400
Accrual method				
Gross income		$550		$ 0
Advertising expense (flyers)	$100		$ 0	
Utilities	105		0	
Total expenses	$205	(205)	$ 0	(0)
Net income		$345		$ 0

44. This is reinforced by Treas. Reg. §1.213-1(a), which provides: "Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only for medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and **regardless of the method of accounting employed by the taxpayer** in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year." (Emphasis added.)

Joe's accountant Holly explains to him that the accrual method tends to match expenses with the income generated. At the end of each period, the accrual method gives a better and generally more accurate picture of a business's financial performance. Holly explains that the accrual method, however, could cause Joe to have taxable income on his December job before he has received payment.

If Joe's "books" are his check register (as it is for many small businesses), then use of the accrual method requires the accountant to ask more questions to find out what Joe's accrual adjustments, receivables, and payables are at the beginning and the end of the taxable year.

Choice of Accounting Methods

Accounting methods that may be used for tax are defined by IRC §§446–448. IRC §446(a) 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." This allows a taxpayer to elect the accrual method, a hybrid method, or any other method permitted by Chapter 1 of the Code.[45] However, IRC §451(a) provides that unless the taxpayer uses a different method, the cash method is the default.[46] This provision is mitigated when the Code (e.g., IRC §448) specifically precludes certain taxpayers from using the cash method. Under §446(b), the IRS may prescribe that a taxpayer use a different method if whatever method is being used by the taxpayer "does not clearly reflect income." IRC §446(e) provides that once a taxpayer establishes a method of accounting by "regularly . . . [computing] . . . his income in keeping his books" by that method, then IRS permission is required to change the accounting method.

Once a taxpayer files a return using a given method (usually cash), they cannot change that method without IRS permission. IRC §446(d), however, provides that if a taxpayer is engaged in more than one trade or business, they may elect and use a different method of accounting for each trade or business.

When income is reported using a given method, IRC §461 generally requires the same method to be used for **deductions** (with few exceptions).[47]

As stated earlier, unless a taxpayer elects otherwise or is precluded by the Code from using it, the cash method is the default. A taxpayer may establish accrual, a hybrid, or another permitted method by electing the method on their **first** Schedule C or Schedule F filed for a particular business or on their initial business entity return. On each of these forms and schedules, a check box is provided to indicate the method of accounting used. The initial return establishes the method for all subsequent returns for that business unless and until the IRS allows the taxpayer to change it.

Example 9. Bob worked as an employee for the last four full weeks of December and then continued working into January. His gross pay is $250 a week. He is paid each Friday for the previous week's work. He had three paydays in December. Although he earned four week's pay, or $1,000, by December 31, his Form W-2 only shows $750 because it reports wages on the cash method.

If Bob uses his Form W-2, without adjustment, to prepare his tax return, he is reporting his income on the cash method. He must then also report his deductions on the cash method. If this is the first return he has filed for this job, he establishes the cash method as his accounting method for reporting wages and deductions from this job for all future returns. If Bob establishes a sideline business, however, he can choose another method for reporting the income and expenses of that business on his Schedule C.

45. IRC §446(c).

46. IRC §451(a) states: "General rule — The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."

47. For example, a cash-method taxpayer must still accrue depreciation and certain prepayments.

Example 10. Steve, a mortician, provides his services for a $20,000 funeral in December 2014. However, the grieving family informs Steve that they cannot pay his bill until late 2015, when the will is expected to be settled. If Steve is on the accrual method, he has to pay taxes on this income on his 2014 tax return even though he has no corresponding cash receipts.

Under the cash method, the tax on this income is due with his 2015 return, which is after he was paid for his services.

Note. Certain professional service providers, even if they use the accrual method, are not required to accrue the amounts due for personal services if the experience of the taxpayer (the professional) indicates that portion will not be collected.[48] This exception applies only if no interest or penalty is charged for late payment; the taxpayer meets the gross receipts test of IRC §448(c) for all prior tax years (generally, 3-year-average gross receipts do not exceed $5 million per year); and the services provided are in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

To summarize, the **cash method may be more appropriate** for the following reasons.

- Having filed their first nonbusiness return on the cash method, most Form 1040 taxpayers are required to continue using the cash method for the same source of income (e.g., wages from the same job) unless a change of accounting method was approved by the IRS.
- For simplicity of bookkeeping and return preparation, the cash method is normally advised, particularly when the taxpayer keeps informal records. In these instances, the additional preparation cost of accrual adjustments for small businesses can easily exceed any tax benefit, as well as being inconvenient and less understandable to the client.
- The cash method allows the business some latitude in deferral of income by delaying billings or extending terms to customers.
- The cash method allows current income to be used to pay the applicable taxes.

The accrual method may be more appropriate for the following reasons.

- It may be required for larger businesses and certain others.
- It may be used to accelerate deductions for expenses when economic performance has occurred (i.e., the goods or services were bought and provided but were not paid for within the taxable year or period).
- The accrual method may be used to defer recognition of prepaid revenues. However, this advantage is limited.[49]
- It may be used to give a more realistic picture of the business's or entity's financial performance over the period, and, generally, a more consistent and balanced financial statement.

48. IRC §448(d)(5).

49. For limitations, see IRS Pub. 538, *Accounting Periods and Methods,* p. 11 (Dec. 2012).

WHEN THE ACCRUAL METHOD IS REQUIRED ON TAX RETURNS

Certain types of income and expense must be reported using the accrual method, even if the taxpayer is otherwise using the cash method and the rest of the return is computed using the cash method. Additionally, certain entities must use the accrual method for tax reporting purposes.

Inventories

For smaller businesses, inventory is one of the most common items for which a form of accrual accounting must be used; however, there are exceptions.[50] Inventory is shown in the "cost of goods sold" section of Schedule C (part III), in which the taxpayer computes their deduction based on only those goods that were actually sold or otherwise disposed of during that year. The sold goods reported in part III of Schedule C are the ones for which economic performance (by being sold and delivered) has occurred. The regulations specifically provide[51] that a taxpayer who otherwise uses the cash method may report purchases and sales (i.e., inventory transactions) on the accrual method. This is a common hybrid method.

Larger Entities

Certain entities are precluded by IRC §448 from using the cash method or any hybrid method that includes the cash method. This applies to the following entity types.

- A C corporation with average annual gross receipts (AAGR) exceeding $5 million
- A partnership that has a C corporation (other than a qualified personal service corporation as defined by IRC §448) as a partner, if the partnership has AAGR exceeding $5 million
- A tax shelter
- A trust subject to tax on unrelated business income with AAGR from its unrelated business exceeding $5 million[52]

AAGR for any year is the average of the gross receipts for the tax year and two preceding tax years. To use the cash method, the entity's AAGR must be $5 million or less for **all** AAGR periods beginning after December 31, 1985.[53]

Example 11. Acme Corporation's gross receipts were $5 million for 1991; $4 million for 1992; and $7 million for 1993. In 1993, Acme's AAGR was $5.33 million (($5 million + $4 million + $7 million) ÷ 3 years). Acme cannot use the cash method for 1993 or any later year. Therefore, unless it meets an exception, Acme cannot use the cash method for 2014.

In 2014, Acme wants to change its accounting method because revenues have decreased. Acme Corporation's revenue is $2 million in 2012, $3 million in 2013, and $3 million in 2014. (($2 million + $3 million +$3 million) ÷ 3 = $2.67 million)). Because this AAGR is less than $5 million, Acme wants to change to the cash method for 2014. ACME needs the IRS's approval to change its accounting method because it exceeded the $5 million AAGR limit in 1993.

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50. IRC §263A; and Treas. Reg. §1.446-1(c)(2)(i).

51. Treas. Reg. §1.446-1(c)(1)(iv) states "A taxpayer using an accrual method of accounting for purchases and sales may use the cash method in computing all other items of income and expense."

52. IRC §448(d)(6).

53. For details of computation and special rules, see IRC §448 and IRS Pub. 538, *Accounting Periods and Methods*.

Exceptions to the Rules Requiring the Accrual Method. The exceptions described in this section do not apply to tax shelters as defined by IRC §448(d)(3).

1. **Exceptions to Rules Regarding Overall Method.** Certain taxpayers may use the cash method of accounting even if the production, purchase, or sale of merchandise is an income-producing factor and they would otherwise have to account for inventory. However, the taxpayer who purchases inventory items for resale may not deduct these items as they are purchased. Even though the taxpayer is not required to account for inventory, these items may only be deducted (as nonincidental materials and supplies) when resold or used by the taxpayer.[54] In this way, even though the taxpayer is permitted to use the cash method, they still must accrue inventory expense (including the costs of producing inventory) as provided in IRC §263A. Taxpayers who may use the cash method include the following.

   - Under Rev. Proc. 2001-10, a qualifying taxpayer that is not a tax shelter, with AAGR of $1 million or less[55]
   - Under Rev. Proc. 2002-28, a qualifying small business taxpayer that meets the following conditions
     - Has average annual gross receipts of $10 million or less
     - Is not prohibited from using the cash method under IRC §448
     - Is an "eligible business" (for definition, see IRS Pub. 538)
     - Has not changed (or has not been required to change) from the cash method because they became ineligible to use the cash method under Rev. Proc. 2002-28[56]
   - A taxpayer engaged in the trade or business of farming, unless the taxpayer is required to use an accrual method under IRC §447 (C corporations and partnerships with one or more C corporation partners) or is prohibited from using the cash method under §448 (tax shelters)[57]
   - A farm corporation that does not have gross receipts in excess of $1 million in any taxable year beginning after December 31, 1975 (For computational purposes, any predecessor entity must also be considered and members of the same controlled group are treated as a single corporation.[58])
   - A family farm corporation that does not have gross receipts in excess of $25 million in any taxable year beginning after December 31, 1985 (For computational purposes, any predecessor entity must also be considered, but members of the same controlled group enjoy the relaxed attribution rules of IRC §447(d).)

2. **Exceptions to Large Entity Rule.** The following businesses are excepted from the rule that requires larger entities to use the accrual method. However, if the production, purchase, or sale of merchandise is an income-producing factor and they do not meet any of the previously mentioned exceptions to the inventory accrual rules, such businesses still must account for inventory and report inventory transactions (purchases and sales) using an accrual method for those items (a hybrid method may be used).

   - Nurseries, sod farms, and tree farms other than fruit and nut tree farms[59]
   - Qualified personal service corporations that meet the criteria of IRC §448(d)(2), substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting

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54. Rev. Proc. 2002-28, 2002-18 IRB 817.
55. For definitions and computation, see IRS Pub. 538, *Accounting Periods and Methods,* pp. 14–15 (Dec. 2012).
56. IRS Pub. 538, *Accounting Periods and Methods,* p. 15 (Dec. 2012).
57. Rev. Proc. 2002-28, 2002-18 IRB 816.
58. IRC §447(d).
59. IRC §447.

As mentioned earlier, there are some exceptions to the general rule that accrual accounting must be used for inventory. However, when inventory is present, the accrual method may still be advisable because it allows the use of the **lower of cost or market** (LCM) method of inventory valuation.[60] The LCM method allows the business taxpayer to downwardly adjust and deduct inventory that has lost value due to obsolescence or damage during the year. The LCM method could be particularly advisable for stores selling computers, high-tech products, and other merchandise that is particularly subject to obsolescence during the period it is offered for sale. However, the LCM method cannot be used if inventory is valued using the last in-first out (LIFO) method. Conversely, if the **cost** method is used, the inventory is carried on the books at its historical cost (yielding no deduction as it loses value) until it is eventually sold or otherwise disposed of.

> **Note.** Due to the flexibility of the LCM method, it may be advisable to accrue inventories using the full computation method provided on Schedule C, Form 1125-A, and so on, even when exceptions to the inventory accrual rule may apply.

> **Note.** Inventory items that cannot be sold at normal prices due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes may be valued at their bona fide selling prices minus the direct cost of disposition, regardless of which method is used to value the rest of the inventory. However, the valuation used may not be less than the scrap value.[61]

CONSTRAINTS ON USE OF THE ACCRUAL METHOD — RELATED PARTIES

In transactions between related parties,[62] one party is generally not allowed a deduction until the other party is required to include the amount in income.[63]

Example 12. Martha used the accrual method for the vineyard and commercial winery that she owns near Temecula, California. Her sister Leslie has a small print shop in town, and she uses the cash method. They are both calendar-year taxpayers. In June 2014, in anticipation of the harvest, Martha orders 100,000 custom wine bottle labels from Leslie, which cost $10,000. The sisters agree that Martha will pay for the label printing after the fall vintage, when the wine is expected to be sold. Leslie prints the labels and Martha accepts delivery in July.

Unexpectedly, the weather changes for the worse and Martha has a much smaller crop than she expected. In addition, the vinted pale Moscato is not nearly as sweet as it should be and does not sell well. In December, Martha pays Leslie $4,000 and tells her that she will pay the rest in 2015.

As it turns out, 2015 is a big year for Moscato in Temecula. Martha has a great vintage, producing a beautiful amber-hued Moscato that is full of flavor. It sells about as fast as she can stomp the grapes, and she pays Leslie the remaining $6,000.

In preparing her 2014 return, Martha would normally accrue the $10,000 label expense in 2014, when the all-events test was met and economic performance occurred. However, Leslie is a related party who uses the cash method. Martha knows that Leslie does not have to include the last $6,000 in income until 2015. Accordingly, Martha can only deduct $4,000 in 2014, which is the amount Leslie included in her 2014 income under the cash method. Martha will deduct the remaining $6,000 in 2015, when Leslie must include that amount in her income.

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60. *How to Calculate Cost of Goods Sold*. Murray, Jean. About.com. [http://biztaxlaw.about.com/od/businessaccountingrecords/ht/cogscalc.htm] Accessed on Feb. 21, 2014. Also see Instructions for Form 1040, p. C-11 (for 2012 returns) and Form 1125-A, *Cost of Goods Sold* (instructions for line 9a): "if you are using the cash method of accounting [for inventory transactions], you are required to use cost."

61. Treas. Reg. §1.471–2(c); and IRS Pub. 538, *Accounting Periods and Methods,* p. 17 (Dec. 2012).

62. Related parties are defined in IRC §267.

63. IRS Pub. 538, *Accounting Periods and Methods,* p. 14 (Dec. 2012); and IRC §267.

ACCRUAL ADJUSTMENTS WHEN RECORDS ARE ON THE CASH METHOD

Many practitioners have clients who want to use the accrual method but have kept informal books using the cash method. In these situations, a balance sheet is usually not available, and the practitioner may have to prepare one. A balance sheet prepared under GAAP always reflects accrual accounting.

Income

To report income under the accrual method, the practitioner essentially calculates all income **earned** (whether or not received) during the taxable year or period. Income also often includes **prepayments** during the period for goods or services to be delivered or performed in a later year or period, but many of these may be subject to permitted exceptions.[64] Generally, an accural-method taxpayer may elect to postpone recognition and reporting of prepaid income from services agreed to be performed in the next tax year until the following tax year; however, it may not be further postponed. Prepaid rent and income received under a guarantee or warranty contract cannot be deferred. For both sales and service revenues, exceptions apply as to what may be deferred, and additional reporting requirements may apply. For further information, see IRS Pub. 538, *Accounting Periods and Methods.*

The practitioner may determine income by inspecting and totaling invoices and other documentation for work performed or goods sold during the year, adding any prepayments that are not subject to an exception. From this amount, prepayments for goods or services provided during the current year should be subtracted if the prepayments were already included in income in a previous year.

In accounting for such items as **interest and rent** income using the accrual method, it is necessary to compute these items on a daily basis, from the time they were last paid to the end of the taxable year or period. The calculated amount is added to the amounts actually received by the taxpayer during the year, and any earnings received that were accrued and recognized in a prior year or period are subtracted. Converting cash-basis income to accrual-basis income is represented by the following formula.

	Income received during year
+	Income earned but not received at yearend
−	Income accrued at end of previous tax year
	Accrual-basis income

Expenses

Expenses and costs directly associated with the revenue of a period are properly allocable to that period.[65] Therefore, all expenses directly associated with the income of the period and the indirect expenses incurred and accrued during the taxable period must be determined. This includes all expenses invoiced to the taxpayer, regardless of whether they are paid. Also included are ongoing indirect expenses (e.g., telephone, utilities, etc.) that have accrued since the last invoice date, through the end of the taxable period or year. It is important to ensure that the final total does not include expenses accrued and deducted in a prior year or period. Converting cash-basis expenses to accrual-basis expenses is represented by the following formula.

	Cash-basis expenses paid during year
+	Expenses incurred but not paid at yearend
−	Expenses accrued at end of previous tax year
	Accrual-basis expenses

64. IRS Pub. 538, *Accounting Periods and Methods,* pp. 11–12 (Dec. 2012).

65. Ibid, p. 14.

Example 13. Bob is a private freelance fireman using a calendar year and the accrual method. Because he only puts out fires for subscribers, his telephone is very important to his business. Accordingly, he has a business-only telephone line, as well as his regular residential telephone line. His business telephone billing period ends on the 15th of each month. On January 20, 2015, he receives his bill for the period of December 16, 2014, through January 15, 2015. It shows his regular monthly charge of $62, and $5 for a long-distance business call made on December 21. Because the bill is for 31 days of service and there were 16 service days in December, Bob must accrue and deduct $32 (($62 ÷ 31 days) × 16 days), as well as the $5 long-distance charge incurred on December 21, for a total of $37.

In preparing Bob's 2014 tax return, his accountant Andrea adds up all of Bob's business telephone invoices dated January 2014 through December 2014; these total $720. She asks him whether all of the long-distance calls shown were for business. Bob says that they were. To that total, Andrea adds $37 for the accrued part of the December 2014 service, as computed from his January 2015 telephone bill. Andrea remembers that she had to do the same thing last year, and part of the January 2014 bill was already deducted on Bob's 2013 tax return. Accordingly, she looks back at her 2013 tax return computation (which is documented in Bob's file) and finds that, of a $38 bill dated January 15, 2014, she deducted $20 in 2013. She subtracts that $20 from her 2014 total. Andrea's computation is shown in the following table.

Bills dated January through December 2014	$720
Portion of bill dated January 15, 2015, for service in December 2014	37
Less: portion of bill dated January 15, 2014, for service in December 2013	(20)
Telephone expense reported on Bob's 2014 tax return	$737

Prepaid Expenses: General Rule. Generally, an expense paid in advance is deductible only in the year to which it applies. The economic performance rule of accrual (discussed earlier) generally prevents the deduction of prepaid expenses.

Note. This constraint upon the deduction of prepaid expenses and the **12-month rule,** described in this section, also apply under the cash method. The **recurring item exception,** however, only applies under the accrual method.

However, there are exceptions that allow certain expenses paid in advance to be deducted even though economic performance (receiving or using the goods or services) has not occurred.[66]

12-Month Rule. Under the 12-month rule, deductions may be allowed for prepaid costs for certain rights or benefits that do not extend beyond the earlier of:

1. 12 months after the right or benefit begins, or
2. The end of the tax year **after** the tax year in which payment is made.

Example 14. Sandra's Sushi, LLC, uses the accrual method and has a calendar yearend. It purchases a 1-year insurance policy June 1, 2014, and pays the full year's premium of $12,000. The policy covers the period from June 1, 2014, through May 31, 2015. Under the **12-month rule,** Sandra's Sushi can deduct the full $12,000 in 2014. This is because the policy does not extend past 12 months after its benefits begin.

If Sandra's Sushi used the **general rule,** it could deduct only $7,000 in 2014 (($12,000 ÷ 12 months) × 7 months policy period in 2014), and the other $5,000 in 2015.

[66] IRS Pub. 538, *Accounting Periods and Methods,* pp. 13–14 (Dec. 2012).

Taxpayers who previously used the general rule and now want to use the 12-month rule, or vice versa, must receive the IRS's approval to change methods. The procedure used to change the taxpayer's accounting method is described later.

Observation. Cash-basis taxpayers who use **credit cards issued by banks** are allowed a deduction when the charge occurs rather than when the credit card bill is paid. However, **credit cards issued by merchants** do not qualify for this treatment.

Recurring Items. Certain recurring expenses paid in advance may be deductible in the year they are paid, as long as the treatment of these and similar items is consistently applied. **This exception also allows the deduction of certain liabilities when,** by the end of the taxable year, the fact of the liability is fixed and its amount is reasonably certain but **economic performance has not occurred.** (For certain types of expense, payment constitutes economic performance. This is discussed later under "Special Items.") The recurring item exception cannot be used by tax shelters.[67] This exception applies if **all** the following conditions are satisfied.

1. The all-events test is met.
2. Economic performance occurs by the earlier of the following dates.
   - **a.** 8½ months after the close of the year
   - **b.** The date a timely return (including extensions) is filed for the year
3. The item is either not material or accruing the item in the year in which the all-events test is met results in a better match against income than accruing the item in the year of economic performance.[68]

Caution. This exception does not apply to liabilities arising from interest, workers' compensation, tort, breach of contract, violation of law, or to certain other liabilities.[69]

Note. If not previously used, **a change to use the recurring item exception constitutes a change of accounting method.** However, **for many recurring item changes, consent is automatic.** For a list of automatic changes, see the IRS instructions for Form 3115, *Application for Change in Accounting Method.*

67. IRC §461(i)(1).

68. IRS Pub. 538, *Accounting Periods and Methods,* p. 13 (Dec. 2012); Treas. Reg. §1.461-5; and IRC §461(h)(3).

69. Treas. Reg. §1.461-5(c).

Special Items. Under Treasury regulations, certain items are subject to particular treatment under the accrual method. Many of these are detailed in Treas. Regs. §§1.461-1, 1.461-4, 1.461-5, 1.461-6, and IRC §461. Some of the more common items follow. **For these items, economic performance is not deemed to occur until actual payment is made;** therefore, for tax purposes, the expense may only be deducted upon payment.[70]

- **Taxes and licensing fees.** Generally, economic performance with respect to taxes and licensing fees payable to or at the direction of a governmental agency occurs as the tax or fee is paid. The following are exceptions to this general rule.
  - **Real estate taxes** for which the taxpayer made **a valid election under IRC §461(c)**
  - Certain **foreign taxes**
  - **Recurring items** under Treas. Reg. §1.461-5 (discussed earlier) (If the recurring item exception is adopted as provided in the regulation, the liability to pay a tax may be accrued in the taxable year before the year of payment.)
- Rebates and refunds
- Awards, prizes, and jackpots
- Liabilities arising under **insurance, warranty, and service contracts**
- Liabilities arising under a **workers' compensation** act or out of **any tort, breach of contract, or violation of law** (For rules regarding **contested liabilities**, see Treas. Reg. §1.461-2.)

Other Expenses. Under IRC §263, the following expenditures are not subject to mandatory capitalization. They may be expensed, but the amount of the expense may be limited by the applicable Code section.

- Expenditures for the development of mines or deposits deductible under IRC §616
- Research and experimental expenditures deductible under IRC §174
- Farmers' soil and water conservation and endangered species recovery expenditures deductible under IRC §175
- Expenditures by farmers for fertilizer, etc., deductible under IRC §180
- Expenditures for removal of architectural and transportation barriers to the handicapped and elderly that the taxpayer elects to deduct under IRC §190
- Expenditures for tertiary injectants for which a deduction is allowed under IRC §193
- Clean fuel vehicles and refueling property placed in service before January 1, 2006, under IRC §179A
- Capital costs incurred in complying with Environmental Protection Agency sulfur regulations under IRC §179B
- Certain refinery property under IRC §179C
- Certain energy efficient commercial building property placed in service after December 31, 2005, and before January 1, 2014, under IRC §179D
- Certain mine safety equipment placed in service after December 20, 2006, and before January 1, 2014, under IRC §179E

70. Treas. Reg. §1.461-4(g).

The Balance Sheet Technique

The **balance sheet technique** may be used as an alternative to the methods presented in the preceding sections or to verify the calculation. This can be used to determine or verify the amount of income and expenses when converting a client's cash records to the accrual method.

This technique of converting income and expenses from the cash to the accrual method relies upon the balance sheet to provide the following amounts.

- Accrued income not yet received (end-of-year accounts receivable (AR)), which must be added to cash income
- Accrued but unpaid expenses (end-of-year accounts payable (AP)), which must be added to cash expenses
- Previously accrued income recognized on the previous year's tax return (beginning-of-year AR), which must be subtracted from cash income
- Previously accrued expenses recognized on the previous year's tax return (beginning-of-year AP), which must be subtracted from cash expenses

Example 15. Use the same facts as **Example 8.** As previously computed using the invoices and receipts reconstruction method, Joe's carpentry net income and expenses follow.

	Tax Year 2014	Tax Year 2015
Cash method		
Gross income	$ 50	$500
Expenses	(105)	(100)
Net income	($ 55)	$400
Accrual method		
Gross income	$550	$ 0
Expenses	(205)	(0)
Net income	$345	$ 0

This comprises all of Joe's business for the year; he had no other investment in the business, and took no distributions.

In January 2015, Joe visits his accountant, Holly, and tells her that he learned a little bit about accounting from the Internet, and he wants to use the accrual method for his tiny little business.

Joe gives Holly his business account check register and tells her that all business income was deposited to that account. The register has only one entry, which was the opening deposit of $50 that he received in September for his first job. He has not withdrawn this amount.

Joe also provides his credit card statement for December, which shows a phone bill charge of $105.

Holly asks Joe whether anyone owed him for work he performed during the year. Joe tells Holly about the December job on which he hopes to be paid $500.

Holly asks Joe whether he owes anything. He explains that he has a $100 invoice for flyers that he plans to pay in January.

Holly asks whether Joe took any distributions or made any contributions to the business's capital, and he tells her that he does not think so. From the documentation at hand and the information provided by Joe, Holly constructs a simple balance sheet and shows it to Joe. He tells her that it looks right.

Because the business is new, Joe does not have a balance sheet for the beginning of the year. His balance sheet at the end of 2014 follows.

Assets	
Cash	$ 50
Accounts receivable (trade)	500
Total assets	$550
Liabilities and equity	
Accounts payable (advertising)	$100
Owner's equity	450
Total liabilities and equity	$550

Holly knows that if she takes the gross income reflected by the cash method ($50), adds the end-of-year trade receivables ($500), and subtracts the beginning-of-year trade receivables that were included in income of a prior year ($0), she generally arrives at a close approximation of (in this case, exactly) the gross income reflected by the accrual method ($550). Holly knows that the cash income, adjusted by the **change** in trade AR over the year or period, generally results in a close approximation of accrual income.

Holly also knows that if she takes the expenses reflected by the cash method ($105), adds the end-of-year AP for direct and indirect costs ($100), and subtracts the beginning-of-year AP for direct and indirect costs that were included in income of a prior year ($0), she generally arrives at a close approximation of (in this case, exactly) the expenses reflected by the accrual method ($205). Holly knows that the cash expenses, adjusted by the **change** in trade AP over the year or period, generally results in a close approximation of expenses under the accrual method.

Using this balance sheet method, Joe's 2014 net income is $345 ($550 − $205), which is the same amount determined using the invoices and receipts reconstruction method (the original 2014 and 2015 net income computations shown in **Example 8.)**

Observation. In this example, the change in owner's equity from the beginning of the year through the end of the year ($450), plus the year's distributions or "draw" ($0), less the year's contributions of capital ($105 business phone bill charged to a personal credit card) equals the year's net income under the accrual method ($450 + $0 – $105 = $345). This is because properly prepared balance sheets always correspond to accrual accounting.

If, however, the balance sheet showed GAAP depreciation or there were nondeductible expenses (such as 50% of travel and entertainment) or nontaxable income, or if the mileage rate was used on the tax return for car expenses, then this equation will not agree with income shown on the tax return unless adjustments are made for those items.

Those adjustments are shown on Schedule M-1 of an entity return, when required. Thus, although the **change in equity + distributions – contributions** formula, without further adjustment, does not always agree with income reported on a tax return, it may often be used to recheck otherwise computed net income under the accrual method. Accordingly, the practitioner may make further inquiry if a discrepancy seems to exist, given all of the facts and circumstances of any individual case.

In using the balance sheet technique, it is important to note that a client's AR may, due to their internal bookkeeping protocols, contain items other than gross receipts from the trade or business. For example, when an entity such as an S corporation has some of its money in a certificate of deposit, interest accrued between payment dates that is included in the AR (at either the beginning or end of the year, or both) must be subtracted and the computed interest for the year reported on the proper line of the tax return. Likewise, AP must be analyzed to ensure that it includes only deductible expenses and that they are categorized by type (advertising, utilities, wages, etc.).

Other adjustments may be required in converting cash records to the accrual method. The practitioner therefore must review the computations, in light of all of the taxpayer's facts and circumstances, make reasonable inquiries, and make sure that the result makes sense economically.

HYBRID METHODS

IRC §446(c)(4), in addition to allowing the cash and accrual methods, also allows the use of "any combination of the foregoing methods permitted under regulations prescribed by the Secretary." A hybrid method, therefore, may be the taxpayer's custom combination of the two major methods. Generally, a hybrid method must be elected and used on the first return filed for a business, with an attachment to the return describing the particular hybrid. A hybrid method may also be adopted later, with the IRS's consent to a change of accounting method (described later).

Why Use a Hybrid Method?

A hybrid method may be useful when the Code requires a particular treatment of certain items of income and deduction but it is more efficient and convenient for the taxpayer to keep their books under a different method. A hybrid method may also be useful when the available documentation and the client's bookkeeping practices are such that consistently using a different method for a particular category of income or expense facilitates the computation of a return that most clearly reflects income. The following examples illustrate situations in which a hybrid method may be advisable.

- The taxpayer desires to use the cash method but maintains an inventory (see earlier discussion on inventory). In this situation, the taxpayer may decide to elect the accrual method for all inventory transactions and use the cash method for everything else.
- The taxpayer is on the cash method, but the state of their books makes it difficult to accurately and reliably determine what they actually paid during the year for payroll taxes. This problem can be exacerbated when a payroll service is used as an intermediary. The payroll tax **accrued** for the year, conversely, may be relatively easy to ascertain from the Forms W-2 or W-3 if the practitioner knows the rates of the various taxes. In this instance, it may be expedient to accrue payroll taxes. If used consistently, this can result in a more accurate tax return with less cost and inconvenience to the client and less exposure (error risk) for the practitioner.

CHANGE OF ACCOUNTING METHOD

For any trade, business, or entity, the taxpayer adopts an accounting method by using that method when they file their first tax return. A depreciation method is similarly established for any asset by use of a particular permissible method on the first return claiming such a deduction. However, if an impermissible depreciation method is used, it is established by using that method on tax returns filed for two consecutive years.[71]

Any change in the accounting method (e.g., an overall change such as accrual to hybrid, a change in method of valuing inventory, or a change in the method of depreciating any asset) generally requires IRS consent. A taxpayer applies for permission to change their accounting method using Form 3115. For some changes, the consent is automatic; other changes require explicit IRS approval. In either case, Form 3115 must be filed and an IRS user fee may have to be paid with the form. This fee, if it applies, can be substantial.[72] It generally does not apply, however, to automatic consent changes.

Note. If the taxpayer used an improper accounting method in prior years and applies for a change of accounting method, limited "audit protection" is afforded for those prior years. Generally, the IRS does not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.[73]

The list of 180 automatic changes is found is the instructions for Form 3115.[74] The automatic changes include, but are not limited to, the following.

- Certain changes in depreciation method from an impermissible method to a permissible one and from one permissible method to another
- Change to an overall cash method for qualifying taxpayers
- Change to an overall accrual method when this is required by the Code
- Accrual method taxpayers deducting payroll tax obligations in the year incurred (However, consent is not automatic for a taxpayer who previously used the cash method and now wants a change in order to accrue payroll taxes under a hybrid method. Accordingly, if this is desirable, it is better to establish the hybrid method from the first return so a change is not required.)
- Certain inventory accounting changes

71. IRS Pub. 946, *How To Depreciate Property*.

72. For a schedule of user fees, see Appendix A of Rev. Proc. 2012-1, 2012-1 IRB 1.

73. Rev. Proc. 2011-14, 2011-4 IRB 330.

74. See also the appendix to Rev. Proc. 2011-14, 2011-4 IRB 330.