CARROLL J SAVAGE
ERIC R FOX
LESLIE JAY SCHNEIDER
LAWRENCE M AXELROD
KEVIN P O'BRIEN
PATRICK J SMITH
LAURIE E KEENAN
JEFFREY E MOELLER
STEVEN H WITMER
WILLIAM L SOLLEE JR
JODI H EPSTEIN
ROBIN M SOLOMON
H CARTER HOOD
HELENA M KLUMPP
BRENDA JACKSON-COOPER
DOUGLAS M ANDRE
JAMES E BROWN
KASEY A PLACE
SPENCER F WALTERS
BENJAMIN L GROSZ

PERCY LEE
JONATHAN L HOLBROOK

IVINS, PHILLIPS & BARKER
CHARTERED

1700 PENNSYLVANIA AVENUE, N.W., SUITE 600
WASHINGTON, D.C. 20006-4723

TELEPHONE (202) 393-7600
FACSIMILE (202) 393-7601
IPB@IPBTAX.COM
WWW.IPBTAX.COM

JAMES S Y. IVINS (1885-1960)
PERCY W. PHILLIPS (1892-1969)
RICHARD B. BARKER (1906-1988)

OF COUNSEL
HARRY L. GUTMAN
MINDY HERZFELD*
CLIFTON B. CATES III
JEANNIE LEAHY*
LISA MILOT
LINDA L. KOTIS

1875 CENTURY PARK EAST, SUITE 600
LOS ANGELES, CA 90067
(310) 551-6633

*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

September 12, 2018

Courier's Desk
Commissioner of Internal Revenue
Internal Revenue Service
Attn: CC:PA:LPD:PR
(Rev. Proc. 2018-40)
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Comments with Respect to Rev. Proc. 2018-40
Application of New Accounting Method Provisions for Small Business Taxpayers

Dear Sir:

On August 3, 2018, the Internal Revenue Service ("IRS") issued Revenue Procedure 2018-40 ("Rev. Proc. 2018-40") to provide procedural guidance to "small business taxpayers" (taxpayers with average annual gross receipts not in excess of $25 million) for purposes of applying the accounting method provisions relating to such taxpayers in the Tax Cut and Jobs Act ("TCJA"). These provisions permit small business taxpayers (1) to use the cash method of accounting for activities that would otherwise require the use of the accrual method of accounting, (2) to avoid the application of sections 471 and 263A, and (3) to avoid the requirement to use the percentage of completion method for certain long-term construction contracts.

Rev. Proc. 2018-40 provides automatic consent to small business taxpayers seeking to implement the foregoing TCJA accounting method provisions. We believe this is a positive first step in facilitating application of these TCJA provisions.

However, Rev. Proc. 2018-40 does not provide any guidance to small business taxpayers as to the substantive income tax consequences that flow from implementing the various accounting method provisions in the TCJA. Instead, section 5 of Rev. Proc. 2018-40 asks for comments regarding the application of the accounting method provisions in TCJA to small business taxpayers. While the specific areas in which comments are requested in Rev. Proc. 2018-40 relate to certain procedural aspects of the TCJA provisions, nevertheless, in our view, a more pressing issue is the need for the IRS to provide an explanation of the substantive tax consequences that

flow from applying the various accounting method provisions in the TCJA that relate to small business taxpayers. In many cases, these tax consequences are not self-evident and as a result may be unclear to many small business taxpayers.

Accordingly, the purpose of this letter is to respond to the general request in Rev. Proc. 2018-40 for comments with respect to the new accounting method provisions in the TCJA relating to small business taxpayers. However, for the reasons discussed above, these comments are not directed at the procedural aspects of compliance with the various accounting method provisions in the TCJA, but instead focus on the particular substantive tax consequences that we believe should flow from applying the various tax accounting provisions in the TCJA that relate to small business taxpayers. It is our hope that these suggestions will be adopted by the IRS and will be incorporated into formal guidance, such as a notice of proposed rulemaking.

Without such substantive guidance, small business taxpayers may not be able to evaluate the substantive tax consequences of the accounting provisions relating to small business taxpayers that are contained in the TCJA. In addition, clarification as to the substantive tax consequences that result from the various accounting method provisions will avoid confusion and unnecessary issues arising in subsequent examinations of affected taxpayers.

Background

As Rev. Proc. 2018-40 makes clear, the recently-enacted TCJA makes changes with respect to the accounting methods of small business taxpayers in four basic areas:

1. The TCJA extends the availability of the cash method of accounting to taxpayers with average annual gross receipts that do not exceed $25 million ("small business taxpayers"), an increase from the previous threshold of $5 million.

2. The TCJA eliminates for small business taxpayers the requirement in section 471 of the Code to account for goods held for sale to customers as inventory and, instead permits such taxpayers to treat such goods as non-incidental materials and supplies within the meaning of Treas. Reg. § 1.162-3.

3. The TCJA eliminates for small business taxpayers the requirement in section 263A of the Code to capitalize certain direct and indirect costs to goods that are either held for sale to customers or held for use in the taxpayer's trade or business.

4. The TCJA makes the gross receipts test in the exception in section 460(e)(1)(B) of the Code from the requirement to account for certain long-term real estate construction contracts under the percentage of completion method consistent with the gross receipts test under the other provisions of the Code described above.

Our comments are directed at the tax consequences that flow from electing each of these provisions.

Legal Analysis

1. Cash Method of Accounting

As noted above, the TCJA permits taxpayers with annual average gross receipts that do not exceed $25 million to use the cash method of accounting, even though such taxpayers would otherwise be required to use the accrual method as a result of being engaged in a trade or business in which the purchase or production of goods held for sale to customers is an income-producing factor.

The tax consequences that flow from the use of the cash method of accounting rather than the accrual method of accounting are relatively straightforward. If a taxpayer uses the cash method of accounting rather than the accrual method, income is not recognized until the income is actually or constructively received by the taxpayer. Likewise, expenses are not deductible by the taxpayer until the expenses are paid. Accordingly, no further explanation of the rules governing the timing of revenue or expense recognition for taxpayers using the cash method of accounting is necessary.

2. Tax Impact of the Exclusion from the Inventory Provisions in Section 471

A second effect for a small business taxpayer under the TCJA is the ability to treat goods that would otherwise be characterized as inventory, because the goods are held for sale to customers in the ordinary course of business, as non-incidental materials and supplies, within the meaning of Treas. Reg. § 1.162-3. However, Treas. Reg. § 1.162-3(a)(1) makes clear that the cost of non-incidental materials and supplies is deductible at the time when the materials and supplies are used or consumed, rather than at the time these items are purchased. Moreover, the legislative history of the TCJA makes clear that Congress understood that the tax consequence of treating goods as non-incidental materials and supplies, rather than as inventory, means that the cost of those goods is deductible at the time they are used or consumed, rather than when such goods are initially purchased by a taxpayer. H.R. Rep. No. 115-466, at 378, n.640.

If Congress had intended for these costs to be deductible at the time they are incurred to purchase the materials and supplies, Congress would have needed to characterize goods that are subject to this exemption from section 471 as *incidental* materials and supplies, rather than as non-incidental materials and supplies, and further, Congress would have needed to exempt small business taxpayers from the requirements in the regulations that determine when taxpayers are permitted to deduct the cost of incidental materials and supplies at the time they are purchased. These requirements include the requirement that no records be kept of the amount or nature of the incidental materials and supplies on hand, the requirement that no physical inventory be taken of such items, and the requirement that immediate expensing of incidental materials and supplies must not violate the clear reflection of income requirement. Treas. Reg. § 1.162-3(a)(2).

As a result of the fact that the cost of non-incidental materials and supplies is deductible at the time the items are used or consumed, rather than when the items are purchased, it might superficially appear that the provision excluding inventory of small business taxpayers from section 471 would have no effect on the timing of the deduction of costs that would be included in cost of goods sold with respect to that inventory. However, that conclusion would overlook two important consequences of the treatment of inventory as non-incidental materials and supplies.

First, and most significantly, the deduction for the costs of non-incidental materials and supplies is not deferred until the materials and supplies are sold; instead the costs are deductible when the materials and supplies are used or consumed. In contrast, the cost of goods that are treated as inventory does not reduce taxable income until the goods are sold. Treas. Reg. § 1.471-1. As a result, while the cost of raw materials that are purchased by a small business taxpayer engaged in a manufacturing business and that are treated as non-incidental materials and supplies must be deferred at the time the raw materials are purchased, nevertheless, those deferred costs should be deductible when the raw materials are used or consumed in the production of finished goods, rather than being deferred until the time when the finished goods that are produced using the raw materials are sold to a customer.

It might be argued that this conclusion is limited by the provision in Treas. Reg. § 1.162-3(b) that nothing in section 162 changes the application of provisions in other sections of the regulations, such as the requirement in section 263A that the cost of materials and supplies consumed in the production of goods must be included in the cost of those goods or the provisions in Treas. Reg. § 1.471-1 that certain materials and supplies must be included in inventory. However, neither of those sections is applicable to a small business taxpayer because of the provisions discussed above that exempt small business taxpayers from both section 263A and section 471. Accordingly, these provisions should not alter the conclusion that a small business taxpayer is permitted to deduct the cost of raw materials at the time those materials are used or consumed in the production of finished goods, rather than being required to defer those costs until the finished goods produced using the raw materials are sold to customers.

While this conclusion would not affect the timing of the deduction for the cost of goods that are purchased for resale by a small business taxpayer that is engaged in a wholesaling or retailing business, nevertheless, this conclusion unquestionably accelerates the timing of deductions for raw materials for a small business taxpayer that is a manufacturer of goods. However, we are not aware of any commentary that has pointed out this distinction. Accordingly, to avoid uncertainty on this point, when regulations are issued addressing the small business taxpayer provisions in the TCJA, we think this conclusion should be confirmed.

Second, while taxpayers accounting for goods as non-incidental materials and supplies must *ordinarily* defer the cost of the materials and supplies until the materials and supplies are used or consumed, there is a de minimis exception in the regulations under section 162 that parallels the de minimis exception in section 263(a) for capital expenditures. Treas. Reg. § 1.162-

3(f) provides that if a taxpayer makes the de minimis election in Treas. Reg. § 1.263(a)-1(f) for purchases of property that would otherwise be regarded as a capital expenditure, such election must also apply to materials and supplies that otherwise meet the requirements in Treas. Reg. § 1.263(a)-1(f).

Pursuant to Treas. Reg. § 1.263(a)-1(f), the cost of property purchased by a taxpayer for use in a trade or business may be immediately expensed if certain requirements are satisfied and the expenditure does not exceed $500 for a taxpayer without an applicable financial statement. While this threshold potentially increases to $5,000 per unit of property purchased, if the taxpayer has an applicable financial statement, we doubt that most small business taxpayers would be able to satisfy the requirements necessary to use this higher threshold. Nevertheless, in any event, a small business taxpayer ought to be permitted to deduct the cost of raw materials purchased, in the case of a manufacturer, or purchases of goods held for resale, in the case of a wholesaler or retailer, to the extent those purchases otherwise satisfies the requirements in Treas. Reg. § 1.263(a)-1(f).

Some commentators have pointed to the exclusion in Treas. Reg. § 1.263(a)-1(f)(2)(i) for property that is intended to be included in inventory as a reason for excluding inventory of a small business taxpayer from the de minimis exception in Treas. Reg. § 1.263(a)-1(f). However, the exclusion from section 471 in the TCJA for certain e goods held by a small business taxpayer should likewise exempt such a taxpayer from the exclusion in Treas. Reg. § 1.263(a)-1(f)(2)(i). Accordingly, when regulations are issued implementing the small business taxpayer provisions in the TCJA, the conclusion that the cost of purchases of raw materials or goods held for resale by an electing small business taxpayer is eligible for the de minimis election in Treas. Reg. § 1.263(a)-1(f) should be confirmed.

3. Tax Impact of the Exclusion of Small Business Taxpayers from the UNICAP Provisions in Section 263A

As noted above, a third aspect of the small business taxpayer provisions in the TCJA is the exclusion of such taxpayers from the provisions in section 263A, which are ordinarily referred to as the UNICAP rules. Section 263A would normally require a taxpayer producing goods that are held for sale to customers to defer in inventory the direct and indirect costs of producing the goods. These rules would also apply to taxpayers purchasing goods for resale to customer. Finally, section 263A would require a taxpayer producing depreciable property for use in a trade or business carried on by the taxpayer to capitalize into the cost basis of the property the direct and indirect costs of producing the property.

However, under the TCJA, a small business taxpayer is entitled to avoid the application of the UNICAP rules to the costing of any property (either inventory or fixed assets) that the taxpayer produces. This provision raises the issue of how the cost of each of those asset classes is determined if section 263A is inapplicable to such property.

Turning first to the determination of the cost of inventories that are produced by a small business taxpayer, if these inventories are treated as non-incidental materials and supplies pursuant to the provisions of the TCJA, we submit that *all* of the direct labor and overhead costs incurred in producing the goods are deductible as incurred. The reason for this conclusion is that when the section 263A provisions are made inapplicable to non-incidental materials and supplies, this treatment should have the effect of subjecting the materials and supplies to the costing regime that was in effect for materials and supplies prior to the enactment of section 263A.

In this regard, the requirement to capitalize direct labor and overhead costs in the cost of materials and supplies that are produced by a taxpayer originated with the UNICAP rules in section 263A. Treas. Reg. § 1.263A-1(b)(11). This treatment is confirmed in Treas. Reg. § 1.162-3(b). Thus, taxpayers that are subject to section 263A are required to include the costs of direct labor and overhead in the cost of any non-incidental materials and supplies that are produced by the taxpayer.

In contrast, prior to the enactment of section 263A in 1986, the costing rules for different asset classes were not uniform. Hence the name "uniform capitalization rules" in section 263A, which derives from the fact that a principal purpose of section 263A was to make uniform the rules governing the costing of different asset classes. Gen. Explanation of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100th Cong., 1st Sess. 504, 509 (1987).

Prior to the enactment of section 263A, the costing rules for inventoriable goods produced by a taxpayer were governed by the full absorption method of inventory costing in Treas. Reg.§ 1.471-11. These rules required the capitalization of the costs of direct labor and certain, but not all, types of overhead costs to the cost of goods produced by a taxpayer for sale to its customers. However, these rules were limited in their application to the costing of inventories and did not apply to the costing of non-incidental materials and supplies. *Id.* at 505.

To ascertain what rules governed the determination of the cost of non-incidental materials and supplies prior to the enactment of section 263A, Notice 88-86, 1988-2 C,B, 401, provides some helpful guidance. Notice 88-86 explained the scope of section 263A prior to the issuance of any regulations. In section D of Notice 88-86, there is a discussion of the intended application of section 263A to non-incidental materials and supplies. In fact, section D of Notice 88-86 indicates that section 263A was intended to apply to non-incidental materials and supplies held by taxpayers that were not engaged in a business that involved the sale of inventory. In this regard, the Notice provided that section 263A was intended to apply to materials and supplies held by a taxpayer operating a non-inventory business only if the materials and supplies were significant in amount. This rule was later incorporated into Treas. Reg. § 1.263A-1(b)(11).

To explain this provision, section D of Notice 88-86 contains an example of a situation where section 263A would not be applicable to non-incidental materials and supplies because the materials and supplies were not significant in amount. This example addresses the treatment of an architect that is providing design services. The Notice concludes that the blueprints and drawings

that the architect supplies to its clients are not subject to section 263A. While the example does not spell out precisely what tax consequences flow from this conclusion, it seems apparent that the IRS intended that the architect need not capitalize into the cost of the blueprints and drawings a share of the salaries of employees that worked on the blueprints and drawings, nor would any of the architectural firm's overhead costs be allocated to the cost of the blueprints and drawings. Any other conclusion would leave the architect in essentially the same place as if section 263A were applicable.

By analogy, this same treatment should apply if a small business taxpayer that produces inventory is permitted to treat its inventory as non-incidental materials and supplies and is also exempt from the application of section 263A pursuant to the TCJA. Such a taxpayer should be permitted to deduct the labor and overhead costs associated with the production the goods that are treated as non-incidental materials and supplies.

With respect to the determination of the cost of self-constructed fixed assets, the costing rules under the TCJA provisions should be based on the costing rules that existed prior to the enactment of section 263A. Unfortunately, as explained in the legislative history under section 263A, the law governing the costing of self-constructed property used in a taxpayer's trade or business prior to the enactment of section 263A was unclear. Conflicting precedents took varying approaches to this issue. Gen. Explanation of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100th Cong., 1st Sess. 504-05 (1987).

Accordingly, the regulations that are issued under the TCJA should provide guidance on the determination of the proper cost of depreciable property produced by a small business taxpayer for use in its trade or business and that is excluded from the application of section 263A. This guidance should make clear which overhead costs, if any, are required to be capitalized, along with the treatment of the cost of direct materials and direct labor that are incident to the production of depreciable property.

4. Exclusion from PCM for Certain Construction Contracts

Under section 460(a), taxpayers engaged in the construction of real property pursuant to a long-term contract, as that term is defined in section 460(f)(1), must use the percentage of completion method ("PCM") in accounting for the revenue and costs incurred in performing the long-term contract. However, prior to the TCJA, an exception from the requirement to use PCM was provided for certain real estate construction contracts performed by a taxpayer with average gross receipts of $10 million or less. IRC § 460(e)(1)(B) and (e)(4).

Under the TCJA, the foregoing exception from the requirement to use PCM was expanded to taxpayers with average annual gross receipts not in excess of $25 million, consistent with the gross receipts threshold for small business taxpayers in the other provisions described above. Apart from the increase in the gross receipts threshold, the rules in section 460 under the TCJA are the same as under prior law.

Presumably, small business taxpayers that are exempt from section 460(a) would ordinarily elect to use the completed contract method ("CCM"), as provided in Treas. Reg. § 1.451-4(c), since this method would be the most favorable alternative for most small business taxpayers. Under that method, no revenue is reported until the contract is completed. Costs that are allocable to a long-term construction contract reported on CCM would presumably be governed by the rules in Treas. Reg. § 1.460-5(d). These rules are relatively straightforward and should be cross-referenced in any regulations that are issued under the TCJA.

Conclusion

In conclusion, we submit that it is desirable for the IRS to provide specific guidance to small business taxpayers that are covered by the new provisions in the TCJA as to the precise substantive tax consequences that result from applying the various accounting provisions in the TCJA that relate to small business taxpayers. Taxpayers that are eligible to take advantage of these provisions are likely to be relatively unsophisticated with respect to tax matters and accordingly would benefit from very specific guidance issued by the IRS. While we recognize that, in some cases, the TCJA provisions are merely an expansion of existing rules for taxpayers that have a greater amount of gross receipts than the threshold under prior law, nevertheless, the absence of guidance with respect to the existing small business taxpayer provisions under prior law has led to confusion and uncertainty about the effect of the TCJA provisions. Accordingly, certainty on this important subject would be desirable.

Respectfully submitted,

Leslie J. Schneider

Patrick J. Smith