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Accounting Periods and Methods

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Introduction

This publication explains rules for accounting periods and accounting methods. Every taxpayer (business or individual) must figure taxable income on the basis of an annual accounting period, called a tax year. Every taxpayer must also use a consistent accounting method. This is a set of rules used to determine when and how income and expenses are reported.

This publication does not provide complete coverage of the rules and procedures discussed. Nor is it intended to serve as a guide to general business and tax accounting. In many cases, you will need to refer to the original sources cited for a fuller explanation of the subject.

The most common accounting period is the calendar year. You may also be able to use a fiscal year. Under certain conditions, a short tax year is permitted.

The two most commonly used accounting methods are the cash method and an accrual method. Under the cash method, you generally report income in the tax year you receive it, and you deduct expenses in the tax year you pay them. Generally, under an accrual method, you report income in the tax year you earn it, regardless of when payment is received, and you deduct expenses in the tax year you incur them, regardless of when payment is made.

Useful Items

You may want to see:

Publication

- ☐ **541** Tax Information on Partnerships
- ☐ **542** Tax Information on Corporations
- ☐ **589** Tax Information on S Corporations

Form (and Instructions)

- ☐ **1128** Application To Adopt, Change, or Retain a Tax Year
- ☐ **3115** Application for Change in Accounting Method

Ordering publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You may also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms and Publications* in your income tax package for details.

Telephone help. You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call 1–800–829–1040.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call 1–800–829–4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

Accounting Periods

You must figure taxable income on the basis of a tax year. Your ''tax year'' is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

- A calendar year, or
- A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individual and partnership returns is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors, partners, and S corporation shareholders. The due date for filing returns for corporations and S corporations is the 15th day of the 3rd month after the end of the tax year. If the 15th day of the month falls on a Saturday, Sunday, or legal holiday, the due date is the next day that is not a Saturday, Sunday, or legal holiday.

This section discusses:

- The calendar tax year;
- The fiscal tax year (including a period of 52 or 53 weeks);
- The short tax year;
- Change in accounting periods;
- Improper tax years;
- Accounting period restrictions that apply to partnerships, S corporations, and personal service corporations; and
- Special situations that apply to corporations.

Calendar Tax Year

If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, or become a partner in a partnership or a shareholder in an S corporation, you must continue to use the calendar tax year unless you get permission to change. See *Change in Accounting Period,* later.

You must adopt the calendar tax year if:

1) You do not keep adequate records,
2) You have no annual accounting period, or
3) Your present tax year does not qualify as a fiscal year.

Fiscal Tax Year

A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52–53 week year is a fiscal tax year that varies from 52 to 53 weeks. See *52–53 Week Tax Year,* discussed next.

If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

52–53 Week Tax Year

You can elect to use a 52–53 week tax year if you keep your books and records and report your income and expenses on that basis. If you make this election, your tax year will always be either 52 or 53 weeks long, and will always end on the same day of the week. You may choose to have your year always end on either:

1) The date a specified day of the week last occurs in a particular month, or
2) The date that day of the week occurs nearest to the last day of a particular calendar month.

For example, if you elect a tax year that always ends on the last Monday in March, then for the tax year ending in 1996, your tax year will end on March 25, 1996. If you elect a tax year ending on the Monday nearest to the end of January, then for the tax year ending in 1996, your tax year will end on January 29, 1996.

Election. You make the election by filing your tax return for the 52–53 week year and attaching to it a statement showing:

1) The day of the week on which the tax year will always end,
2) Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month, and
3) The month in which or with reference to which the tax year will end.

When you figure depreciation or amortization, a 52–53 week year is considered a year of 12 full months, unless you have consistently used some other practice in the past.

To apply provisions of the law that are expressed in terms of tax years beginning, including, or ending on the first or last day of a specified calendar month, a 52–53 week year is considered to begin on the first day of the calendar month beginning nearest to the first day of the 52–53 week year. The 52–53 week year is considered to end on the last day of the calendar month ending nearest to the last day of the 52–53 week year.

Example. Assume a tax provision applies to tax years beginning on or after July 1, 1996. For this purpose, a tax year beginning on June 24, 1996, is treated as beginning on July 1, 1996.

Change to a 52–53 week tax year. You may change to a 52–53 week year that ends with reference to the end of the same month with which your present tax year ends, without first getting the permission of the IRS. You must attach the statement, discussed earlier under *Election,* to the tax return for the year for which the election is made.

Example. If you now use a calendar year and want to change to a 52–53 week year ending on the Friday closest to December 31, prior approval is not needed. You make the election to change by filing the statement with your return.

Approval required. If you want to change to a 52–53 week tax year that ends with reference to the end of a month that is not the same month in which your old tax year ended, you must first get approval from the IRS, as explained later in *Change in Accounting Period.*

For example, if you use a calendar year and want to change to a 52–53 week year ending on the Saturday nearest the end of November, you must first get approval from the IRS.

Change from a 52–53 week tax year. To change from a 52–53 week year to any other tax year, including another 52–53 week year, you must first get the approval of the IRS.

Short Tax Year

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when you (as a taxable entity) are not in existence for an entire tax year. The second occurs when you change your accounting period.

Each situation results in a different way of figuring tax for the short tax year.

Not in Existence Entire Year

A tax return is required for the short period during which you were in existence. Requirements for filing the return and figuring the tax generally are the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

Example 1. Corporation X came into existence on July 1, 1995. It elected the calendar year as its tax year. Corporation X must file its return by March 15, 1996. The return covers the period July 1, 1995, to December 31, 1995.

Example 2. A calendar year corporation dissolved on July 23, 1996. It must file its final return by October 15, 1996, for the period January 1, 1996, to July 23, 1996.

Example 3. Partnership YZ formed on September 4, 1995, and elected to use a fiscal year ending November 30. Partnership YZ must file its return by March 15, 1996.

Death of individual. When an individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year.

Example. Agnes Jones was a single, calendar year taxpayer. She died on March 6, 1995. Her last tax return for the period January 1, 1995, to March 6, 1995, must be filed by April 15, 1996.

Change in Accounting Period

You must, with certain exceptions, get approval from the IRS to change your tax year. To get this approval, you must file a current Form 1128 and pay the correct user fee, if any. This is explained later. This form must be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins on the first day after the end of your present tax year and ends on the day before the first day of your new tax year.

Example. John Adams, a sole proprietor, filed his return using a calendar tax year. For business purposes, he wanted to change to a fiscal tax year ending June 30. John will have a short tax year for the period January 1 to June 30. John must file Form 1128 by August 15, the 15th day of the 2nd calendar month after the close of the short tax year.

Extension. If you file Form 1128 after the due date, it is late and will be considered only if you can show good cause for filing late. However, applications received within 90 days of the date required may qualify for an automatic extension. See Revenue Procedure 92–85, C.B. 1992–2, p. 490, and the later discussion, *Extension of time to file application,* under *Change in Accounting Method,* for more information. Your application must contain all of the information requested. Do not change your tax year until the IRS has approved your request.

If your application is approved, you must file an income tax return for the short tax year. There are special rules for figuring the tax for a short tax year caused by a change in your accounting period. See *Tax for short tax year,* later.

Net operating loss. If the short period required to effect the change is a tax year in which you have a net operating loss (NOL), you must deduct the NOL ratably over a 6-year period starting with the first tax year after the short period unless you meet one of the exceptions discussed later in item 5 of *Expeditious approval,* under *Corporations* (these exceptions are the same as the exceptions for other taxpayers).

Husband and wife. A husband and wife who have different tax years may not file a joint return. There is an exception to this rule if their tax years began on the same date and end on different dates because of the death of either or both. If the husband and wife want the same tax year so they can file a joint return, the method of changing a tax year depends on whether they are newly married.

Newlyweds. A newly married husband or wife may want to change his or her accounting period to that of the other spouse so they can file a joint tax return. The husband or wife can adopt the accounting period of the other spouse without first getting approval. They can file a joint return for the first or second tax year ending after the date of marriage if:

1) The due date for filing the required separate short tax year return of the spouse wishing to change (the 15th day of the 4th month following the end of the short tax year) falls on or after the date of the marriage, and
2) The return for the short tax year is timely filed. The return for the short tax year must include a statement that the accounting period is being changed under authority of section 1.442–1(e) of the Income Tax Regulations.

If, on the date of the marriage, the due date for filing the required short-year return has passed, the couple cannot file a joint return until the second tax year ending after the date of the marriage, and then only if the spouse who is changing the tax year files a timely short tax year return.

Example. John and Jane were married on July 30, 1995. John filed his return for the fiscal year ending June 30, 1995. Jane used the calendar year, but wants to change to John's fiscal year so they may file a joint return. If Jane files a separate return by October 16, 1995, for the short period January 1, 1995, through June 30, 1995, she will have changed her accounting period to a fiscal year ending June 30. Then she and John can file a joint return for their tax year ending June 30, 1996.

Other spouses. Any husband or wife not meeting the above conditions, but wishing to change to the accounting period of the other spouse so that they can file a joint return must first get the permission of the IRS. In some cases, permission may be granted even if there is no substantial business purpose for requesting the change.

Tax for short tax year. If the IRS approves the change in your tax year, or you have to change your tax year, you must figure the tax and file your return for the short tax year that begins with the first day after the end of your old tax year and ends on the day before the first day of your new tax year.

You figure the tax for your short tax year under a general rule. Then, after one year from the beginning of the short tax year, you can use a relief procedure under which you may be able to claim a refund of some of the tax you paid under the general rule. The general rule and the relief procedure are explained next.

General rule. Figure the income tax for the short tax year by placing your taxable income on an annual basis. Self-employment tax is figured on actual self-employment income and is not annualized.

Individuals. Individuals must figure their income tax for the short tax year under the general rule as follows:

1) Determine the adjusted gross income for the short tax year and subtract the actual amount of itemized deductions for the short tax year. You must itemize your deductions when you file a short tax year return.
2) Multiply the total dollar amount of exemptions by the number of months in the short tax year and divide the result by 12.
3) Subtract the amount in (2) from the amount in (1). This is your modified taxable income.
4) Multiply the modified taxable income in (3) by 12, then divide the result by the number of months in the short tax year. This is your annualized income.
5) Figure the total tax on your annualized income using the Tax Rate Schedules.
6) Multiply the total tax by the number of months in the short tax year and divide by 12. The result is your tax for the short tax year.

Example. Frank Jones has an adjusted gross income of $28,800. His itemized deductions total $6,800, and he can claim exemptions for himself, his wife, and two children. Each exemption is $2,500 for 1995. The income and the itemized deductions are for the 9-month period January 1 through September 30, 1995. He will figure his tax on a joint return for that period as follows:

1) $28,800 − $6,800 = $22,000
2) $2,500 × 4 × 9/12 = $7,500
3) $22,000 − $7,500 = $14,500 (modified taxable income)
4) $14,500 × 12/9 = $19,333 (annualized income)
5) Tax on $19,333 = $2,900 (from Tax Rate Schedule)
6) $2,900 × 9/12 = $2,175 (tax for short tax year)

Corporations. Corporations figure the tax for the short tax year under the general rule described above for individuals. There is no adjustment for personal exemptions.

Example. A corporation files a tax return, because of a change in its accounting period, for the 6-month short tax year ending June 30, 1995. It had taxable income of $40,000 during the short tax year. Its annualized taxable income is $80,000 ($40,000 × 12/6). Its total tax (as annualized) is $15,450. The tax for the short tax year is $7,725 ($15,450 × 6/12).

52–53 week year. If you must first get approval because you change the month with reference to which your tax year ends, you must file a return for the short tax year if it covers more than 6 but less than 359 days. If you use a calendar year and the IRS approves your election to change to a 52–53 week year ending on the Monday closest to September 30, you must file a return for the short tax year from January 1, to September 30.

If the short period created by the change is 359 days or more, treat it as a full tax year. If the short period created is 6 days or less, it is not a separate tax year. Treat it as part of the following year.

Figure the tax for the short tax year as shown previously, except that you annualize on a daily rather than a monthly basis. You use 365 instead of 12, and you use the number of days in the short tax year instead of the number of months. Use 365 days regardless of the number of days in the calendar year.

Exception. You may use a relief procedure for figuring the tax for the short tax year. It may result in less tax. Under the relief procedure, the tax is figured by two methods. If both methods yield a tax amount that is less than the amount of tax that you figured for the short tax year under the general rule, you may file a claim for refund of some of the tax you paid under the general rule. Both individuals and corporations may use the relief procedure. For information on this relief procedure, see section 443(b)(2) of the Internal Revenue Code.

Alternative minimum tax for tax preferences. An alternative minimum tax imposed for the short tax year is figured by first annualizing the alternative minimum taxable income for the short tax year. Do this by multiplying that amount by 12 and dividing by the number of months in the short tax year. Then apply the appropriate rate of tax under section 55(a)(1) of the Internal Revenue Code to this annualized income to arrive at the annualized alternative minimum tax. This annualized tax is then prorated by multiplying the tax by the number of months in the short tax year and dividing that amount by 12. The result is the alternative minimum tax due for the short tax year.

For information on the alternative minimum tax for individuals, see the *Instructions for Form 6251.* For information on the alternative minimum tax for corporations, see Publication 542.

Tax withheld on wages. You can claim a credit against your tax liability for federal income taxes withheld from your wages. This withholding is always on a calendar year basis. The amount withheld in any calendar year is allowed as a credit for the tax year beginning in the calendar year.

If you had more than one tax year begin in the same calendar year, the total amount withheld must be taken as a credit against the tax for the last tax year beginning in the calendar year.

Improper Tax Year

If you begin your business on a date other than the first day of a calendar month and end it exactly 12 months from the date it began and this ending date is other than the last day of the month, you have not satisfied the requirements for establishing a calendar year or a fiscal year. Nor does the adoption of an accounting period ending exactly 12 months from the date your business began satisfy the requirements for a 52–53 week tax year. Because you have not satisfied the requirements for either a calendar or a fiscal year, you have adopted an improper tax year. You must either file an amended income tax return on the basis of a calendar year, or if you want to use a tax year other than the calendar year, you must get approval from the IRS to change your tax year. See *Change in Accounting Period,* earlier.

If you want to adopt a calendar year to correct an improper tax year, you must attach a completed Form 1128 to your amended income tax return that is filed on a calendar year basis. Write "FILED UNDER REV. PROC. 85–15," at the top of your Form 1128. The form and your amended return should be filed with the Internal Revenue Service Center where you filed your original return.

User Fees

User fees are charged by the Internal Revenue Service for requests for changes in accounting periods and methods, and for certain tax rulings and determination letters. For more information and a schedule of fees for employee plans and exempt organizations, see Publication 1375.

If substantially identical rulings are requested for related entities, a reduced fee schedule may apply. See Revenue Procedure 92–90, C.B. 1992–2, p. 501, for more information.

Partnerships, S Corporations, and Personal Service Corporations

Generally, partnerships, S corporations, and personal service corporations must use "required tax years." The required tax year does not have to be used if the partnership, S corporation, or personal service corporation establishes a business purpose for a different period (explained later), or makes a ***section 444 election*** (explained later).

Partnerships

A partnership must conform its tax year to its partners' tax years, unless the partnership can establish a business purpose for a different period or makes a section 444 election. The rules for the required tax year for partnerships are as follows:

1) If a majority interest (aggregate interest of more than 50%) in partnership capital and profits is held by one partner, or by more than one partner with the same tax year, the partnership must adopt that tax year.
2) If there are no partners who own a majority interest, or if the partners who do own a majority interest do not have the same tax year, the partnership is required to change to the tax year of its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
3) If no tax year is established by either the majority partners or the principal partners, the partnership must adopt a tax year that results in the least aggregate deferral of income to the partners.

Least aggregate deferral of income. To figure the least aggregate deferral of income, compare the deferrals that all partners would get if the partnership used the tax year of each one of its partners. A computation must be made for each partner whose tax year is different from the other partners as follows:

1) Determine the number of months of deferral for each partner using one partner's tax year. Find the months of deferral by counting the months from the end of the one partner's tax year forward to the end of each other partner's tax year.
2) Multiply each other partner's deferral period found in step (1) by that partner's share of interest in the partnership profits for the year used in step (1).
3) Add the amounts in step (2) to get the aggregate (the total) deferral for that partner's tax year.
4) Repeat steps (1) through (3) for each partner's tax year that is different from the other partners' years.

The partner's tax year that results in the lowest aggregate (total) number is the tax year that must be used by the partnership. If more than one year qualifies as the tax year that has the "least aggregate deferral of income," the partnership may choose any year that qualifies. However, if one of the tax years that qualifies is already the partnership's existing year, the partnership must retain that year.

Example. Partnership P is on a fiscal year ending June 30. Partner A reports income on the calendar year and Partner B reports income on the fiscal year ending November 30. A and B each have a 50% interest in P's profit. For P's tax year beginning July 1, 1994, P must change to a fiscal tax year ending November 30 because this results in the least aggregate deferral of income (B, .5 interest × 0 deferral

= 0; A, .5 interest × 1 month deferral = .5). The calendar year would result in a much higher aggregate deferral (A, .5 interest × 0 deferral = 0; B, .5 interest × 11 month deferral = 5.5).

When determination is made. The determination of this tax year must generally be made at the beginning of the partnership's current tax year. However, the IRS may require the use of some other day or period that will more accurately reflect the ownership of the partnership. This could occur, for example, if a partnership interest has been transferred for the purpose of qualifying for a particular tax year.

More than one tax year. If more than one tax year qualifies, the partnership may select any one of those tax years as its tax year. However, if one of the qualifying tax years is also the partnership's existing tax year, the partnership must maintain its existing tax year.

Change initiated by partnership. The change to this required tax year is treated as initiated by the partnership with approval from the IRS. The partnership must attach a statement showing the computations to the income tax return for the short period and must put at the top of page 1 of the return, "FILED UNDER SECTION 1.706–1T."

Information on partnerships. For general information on partnerships, see Publication 541.

S Corporations

A small business corporation can elect to be an S corporation. All S corporations, regardless of when they became S corporations, must use a permitted tax year. A permitted tax year is a calendar year, or any other tax year for which the corporation establishes a business purpose. A business purpose exists if the requested year is a natural business year, or if the ownership tax year test is met. See *Business Purpose Tax Year,* later. An S Corporation may also elect under section 444 to have a tax year other than a permitted year. See *Section 444 Election,* later. For information on S corporations, see Publication 589.

Personal Service Corporations

Personal service corporations must use a calendar tax year unless they can establish a business purpose for a different period, or make a section 444 election, discussed later. For this purpose, a personal service corporation is a corporation in which the principal activity, during the testing period, discussed below, is the performance of personal services that are substantially performed by employee-owners. Employee-owners must own more than 10% of the fair market value of the corporation's stock on the last day of the testing period.

Testing period. Generally, the testing period for a tax year is the prior tax year.

Example. Corporation A has been in existence since 1980. It has always used a January 31 fiscal year for its accounting period. To determine whether A is a personal service corporation for its tax year beginning February 1, 1995, the testing period is A's tax year ending January 31, 1995.

New corporations. The testing period for a new corporation for its first tax year starts with the first day of the tax year and ends on the earlier of:

1) The last day of its tax year, or
2) The last day of the calendar year in which the tax year begins.

Example. B Corporation's first tax year begins June 1, 1995. B wants to use a September 30 fiscal year for its accounting period. B's testing period for its first tax year is June 1, 1995, through September 30, 1995. If B wants to use a March 31 fiscal year, the testing period is June 1, 1995, through December 31, 1995.

Performance of personal services. For this purpose, any activity that involves the performance of services in the fields of health, veterinary services, law, engineering, architecture, accounting, actuarial science, performing arts, or certain consulting services, is considered to be the performance of personal services.

Principal activity. The principal activity of a corporation is considered to be the performance of personal services if, during the testing period, the corporation's compensation costs for personal service activities is more than 50% of its total compensation costs.

Employee-owner. A person is an employee-owner of a corporation for a testing period if the person:

1) Is an employee of the corporation on any day of the testing period, and
2) Owns any outstanding stock of the corporation on any day of the testing period.

Independent contractor. For purposes of the employee-owner definition, a person who owns any outstanding stock of the corporation and who performs personal services for or on behalf of the corporation is treated as an employee of the corporation. This rule applies even if the legal form of the person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

More information. For more information on the tax year of a personal service corporation, see section 1.441-4T of the Income Tax Regulations.

Section 444 Election

Partnerships, S corporations, and personal service corporations may elect under section 444 to use a tax year that is different from the permitted tax year. Certain restrictions apply to this election. In addition, the electing partnership or S corporation may have to make a payment for the deferral. See *Required payment for partnerships and S corporations,* later. This election does not apply to any partnership, S corporation, or personal service corporation that establishes a business purpose for a different period, explained later.

A partnership, S corporation, or personal service corporation may make a section 444 election if:

1) It is not a member of a tiered structure (see section 1.444–2T of the Income Tax Regulations),
2) It has not previously had a section 444 election in effect, and
3) It elects a year that meets the deferral period requirement.

Deferral period. Generally, a partnership, S corporation, or personal service corporation may make a section 444 election only if the tax year it wants to use results in a deferral period of 3 months or less.

However, an election to change a tax year from its required year will be allowed only if the deferral period of the tax year it wants to use is not longer than the shorter of:

1) Three months, or
2) The deferral period of the tax year being changed.

For a partnership, S corporation, or personal service corporation that wants to ***adopt or change*** its tax year by making a section 444 election, the deferral period is the number of months between the end of the tax year it wants to use and the close of the required tax year. If the current tax year is the required tax year, the deferral period is zero.

Example 1. BD Partnership uses a calendar tax year which is also its required tax year. Because BD's deferral period is zero, BD is not able to make a section 444 election.

Example 2. E, a newly formed partnership, began operations on December 1, 1995. E is owned by calendar year partners. E wants to make a section 444 election to adopt a September 30 tax year. E's deferral period for the tax year beginning December 1, 1995, is 3 months, the number of months between September 30 and December 31, 1996.

Making the election. You make a section 444 election by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The due date (without regard to extensions) of the income tax return resulting from the section 444 election, or
2) The 15th day of the 6th month of the tax year for which the election will be effective. For this purpose, count the month in which the tax year begins even if it begins after the first day of that month.

In addition, you must attach a copy of Form 8716 to your Form 1065 or appropriate Form 1120 for the first tax year for which the election is made.

Example 1. AB, a partnership, began operations on September 11, 1995, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 11, 1995. AB must file Form 8716 by January 16, 1996, which is the due date of the partnership's tax return for the period September 11, 1995, to September 30, 1995.

Example 2. The facts are the same as in Example (1) except that AB began operations on October 21, 1995. AB must file Form 8716 by March 15, 1996, the 15th day of the 6th month of the tax year for which the election will first be effective.

Example 3. B is a corporation that first becomes a personal service corporation for its tax year beginning September 1, 1995. B qualifies to make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 1995. B must file Form 8716 by December 15, 1995, the due date of the income tax return for the short period September 1, 1995, to September 30, 1995.

Extension of time for filing. You may qualify for an automatic extension of 12 months to make this election. See Revenue Procedure 92–85 for more information.

Effect of election. Partnerships and S corporations that make a section 444 election must make certain required payments. An electing personal service corporation must make certain distributions. These required payments and distributions are discussed later.

Ending the election. The section 444 election remains in effect until it is terminated. The election ends when the partnership, S corporation, or personal service corporation:

1) Changes to its required tax year,
2) Liquidates,
3) Willfully fails to comply with the required payments or distributions, or
4) Becomes a member of a tiered structure.

The election will also end if an S corporation's S election is terminated, or a personal service corporation ceases to be a personal service corporation. However, if a personal service corporation that has a section 444 election in effect elects to be an S corporation, the S corporation may continue the election of the personal service corporation. Or, if an S corporation terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation.

If the election is terminated, another section 444 election cannot be made for any tax year.

Required payment for partnerships and S corporations. Partnerships and S corporations must make a "required payment" for any tax year that the section 444 election is in effect and the required payment amount is more than $500. You also must pay if you had a required payment for any prior tax year that was more than $500 and you have a liability of any amount for that applicable year.

Any tax year that a section 444 election is in effect, including the first year, is called an "applicable election year." This required payment represents the value of the tax deferral that the owners receive through the use of a tax year different from the required tax year.

Report the required payment on Form 8752, *Required Payment or Refund Under Section 7519.* If the required payment is more than $500 (or the required payment for any prior year was more than $500), pay it when Form 8752 is filed. If the required payment is $500 or less, and no payment was required in a prior year, no payment is required, but Form 8752 must be filed showing a zero amount.

When to file. Form 8752 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins. For example, if a partnership's applicable election year begins July 1, 1995, Form 8752 must be filed by May 15, 1996.

Required distribution for personal service corporations. If a personal service corporation makes a section 444 election, it must distribute certain amounts to employee-owners by December 31 of each applicable election year. If it fails to make these distributions, it may be required to defer certain deductions for amounts paid to owner-employees. The amount deferred is treated as paid or incurred in the following tax year.

For information on the minimum distribution, see the instructions for Part I of Schedule H (Form 1120) *Section 280H Limitations for a Personal Service Corporation (PSC).*

Back-up election. If you have requested, or plan to request, permission to use a tax year that has a business purpose, you can file a section 444 election (if you otherwise qualify) as a backup to your requested business year. If you are denied your request for a business purpose tax year, you must then activate your back-up section 444 election.

Making back-up election. Follow the general rules for making a section 444 election, as discussed earlier. In addition, type or print "BACK-UP ELECTION" at the top of Form 8716. However, if you file Form 8716 on or after the date you file Form 1128, for your requested business purpose year, type or print at the top of Form 8716 "FORM 1128 BACK-UP ELECTION."

Activating election. Partnerships and S corporations activate their back-up election by filing the return required and making the required payment with Form 8752 and printing at the top of the form, "ACTIVATING BACK-UP ELECTION." The due date for filing Form 8752 and the payment is the later of:

1) May 15 of the calendar year following the calendar year in which the applicable election year begins, or
2) 60 days after the partnership or S corporation has been notified by the IRS that the business year request has been denied.

A personal service corporation activates its back-up election by filing Form 8716 with its original or amended income tax return for the tax year in which the election is first effective, and printing on the top of the income tax return, "ACTIVATING BACK-UP ELECTION."

Business Purpose Tax Year

A business purpose tax year is an accounting period that has a substantial business purpose for its existence. Both tax and nontax factors must be considered in determining if there is a substantial business purpose for a requested tax year.

Natural Business Year. One nontax factor that may be sufficient to establish a business purpose for a tax year is the annual cycle of business activity, called a "natural business year." The accounting period of a natural business year includes all related income and expenses. A natural business year exists when a business has a peak period and a nonpeak period. The natural business year is considered to end at or soon after the end of the peak period. In the absence of substantial distortion of income, or other factors showing that the change is requested for purposes of tax advantage, the showing of a natural business year will ordinarily be accepted as a substantial business purpose for approval of a change in accounting period. A business whose income is steady from month to month, year-round, would not have a natural business year as such.

In considering whether there is a business purpose for a tax year, significant weight is given to tax factors. A prime consideration is whether the change would create a substantial distortion of income. Examples of distortion of income are:

1) The deferral of a substantial portion of income, or the shifting of a substantial portion of deductions, from one year to another so as to reduce tax liability,
2) Causing a similar deferral or shifting for any other person, such as a partner or shareholder, and
3) Creating a short period in which there is a substantial net operating loss.

Nontax factors. Other nontax factors, based on the convenience of the taxpayer, usually will not be sufficient to establish that a business purpose exists for a particular tax year. These factors are:

1) The use of a particular year for regulatory or financial accounting purposes,
2) The hiring patterns of a particular business, such as the fact that a firm typically hires staff during certain times of the year,
3) The use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders, and
4) The fact that a particular business involves the use of price lists, a model year,

or other items that change on an annual basis.

A deferral of income to partners or shareholders is not a business purpose. For examples of situations in which a business purpose is not shown and examples in which a substantial business purpose has been established, see Revenue Ruling 87–57, C.B. 1987–2, p. 117.

Expeditious approval. The Internal Revenue Service has provided an ''expeditious approval'' procedure for a partnership, an S corporation, or a personal service corporation to retain or change to a natural business year as determined by the 25% test, discussed next. It also enables an S corporation to adopt, retain, or change to a fiscal year that satisfies the ''ownership tax year test,'' discussed later. For more information, see Revenue Procedure 87-32, C.B. 1987–2, p. 396.

25% test. The natural business year is determined by the 25% test using the method of accounting used for the tax returns for each year involved. To figure the 25% test—

1) Total the gross sales and services receipts for the most recent 12-month period that includes the last month of the requested fiscal year. Figure this for the 12-month period that ends before the filing of the request. Also figure the total of the gross sales and services receipts for the last 2 months of that 12-month period.

2) Determine the percentage of the receipts for the 2-month period by dividing the total of the last 2-month period by the total for the 12-month period. Carry the percentage to two decimal places, and

3) Figure a percentage following steps 1 and 2 for the two 12-month periods just preceding the 12-month period used in (1).

   If the percentage determined for each of the three years equals or exceeds 25%, the requested fiscal year is the natural business year.

If the partnership, S corporation, or personal service corporation qualifies for more than one natural business year, the fiscal year producing the highest average of the three percentages is the natural business year.

If the partnership, S corporation, or personal service corporation does not have at least 47 months of gross receipts (which may include a predecessor organization's gross receipts), it cannot use this expeditious procedure to obtain permission to use a fiscal year.

If the requested tax year is a 52–53 week tax year, the calendar month ending nearest to the last day of the 52–53 week tax year is treated as the last month of the requested tax year for purposes of computing the 25% test.

Ownership tax year test. An S corporation or corporation electing to be an S corporation qualifies for expeditious approval if it meets an ownership tax year test. The test is met if the corporation is adopting, retaining, or changing to a tax year and shareholders holding more than 50% of its issued and outstanding shares of stock have, or are all changing to, the same tax year. These shareholders must hold the stock on the first day of the requested tax year. Shareholders that desire to change to the same tax year should follow section 1.442–1(b)(1) of the Income Tax Regulations in requesting permission. If, on the first day of any tax year, the S corporation no longer meets the ownership tax year test, the corporation must change its tax year to a permitted year.

Filing information. To get expeditious approval, a partnership, S corporation, or corporation electing to be an S corporation must file a tax return for the short period. The short tax year return must be filed by the due date, including extensions.

Form 1128 must be filed by the 15th day of the second calendar month following the close of the short period. Form 1128 must be filed with the Director of the Internal Revenue Service Center where the taxpayer normally files tax returns. The envelope should be marked ''Attention: ENTITY CONTROL.'' In addition, the first page of Form 1128 should have typed or printed at the top of the statement, ''FILED UNDER REV. PROC. 87–32.''

In some cases, a late filing of Form 1128 may be accepted. However, applications received by the IRS 90 days after the due date will not be approved, except in very unusual and compelling circumstances.

A corporation electing to be an S corporation and requesting to adopt, retain, or change its tax year, must file Form 2553, *Election by a Small Business Corporation.* The form must be filed at the time the election request is made. No extension of time can be granted for filing Form 2553. Do not pay the user fee when filing Form 2553. The IRS will notify you when the fee is due. See *User Fees,* earlier.

For more information on these tax year requirements, see Revenue Procedure 87–32 and Revenue Ruling 87–57.

Corporations

A new corporation establishes its tax year when it files its first tax return. An S corporation or a personal service corporation must use the required tax year rules, discussed earlier, to establish its tax year. A newly reactivated corporation that has been inactive for a number of years is treated as a new taxpayer for the purpose of adopting a tax year.

Change in Tax Year

A corporation (other than an S corporation, a personal service corporation, or an interest charge domestic international sales corporation (IC-DISC)) may change its tax year under section 1.442–1(c) of the Regulations without first getting the approval of the IRS if the following conditions are met:

1) It must not have changed its tax year within the 10 calendar years ending with the calendar year in which the short tax year resulting from the change begins,

2) Its short tax year must not be a tax year in which it has a net operating loss,

3) Its taxable income for the short tax year, if figured on an annual basis (annualized), is 80% or more of its taxable income for the tax year before the short tax year,

4) If it is a personal holding company, foreign personal holding company, an exempt organization, foreign corporation not engaged in a trade or business within the United States, a Western Hemisphere trade corporation, or a China Trade Act corporation, ***either*** for the short tax year or for the tax year before the short tax year, it must have the same status for ***both*** the short tax year and the tax year before, and

5) It must not apply to become an S corporation for the tax year that would immediately follow the short tax year required to effect the change.

A statement on behalf of the corporation must be filed with the IRS office where the corporation files its tax returns by the time (including extensions) for filing its return for the short tax year required by the change.

The statement must indicate that the corporation is changing its annual accounting period under section 1.442–1(c) of the Income Tax Regulations and must show that all the preceding conditions have been met. If, on examination, the corporation does not meet all the conditions because of later adjustments in establishing tax liability, the statement will be considered a timely application for permission to change the corporation's annual accounting period to the tax year indicated in the statement.

If the corporation's records are not adequate or the corporation has an accounting period that does not qualify as a fiscal year, the tax year is the calendar year. In this case, if a fiscal year is adopted, it will be treated as a change in the annual accounting period, and the corporation will have to first get approval from the IRS.

Expeditious approval. A procedure is provided whereby certain corporations may expeditiously obtain approval to change their tax year. The procedure applies to a corporation that:

1) Cannot meet the five conditions listed above,

2) Has not changed its annual accounting period within 6 calendar years (or within any of the calendar years the taxpayer has been in existence, if less than 6 years) ending with the calendar year that includes the beginning of the short period required to effect the change of annual accounting period, and

3) Is not any of the following:

   a) A member of a partnership,

   b) A beneficiary of a trust or an estate,

   c) An S corporation (and the corporation does not attempt to make an S corporation election for the tax year immediately following the short period),

   d) A personal service corporation,

e) An interest-charge DISC or Foreign Sales Corporation (FSC), or a shareholder in either of these,

f) A controlled foreign corporation or a foreign personal holding company, or a minority shareholder in either of these,

g) A tax-exempt organization, except those exempt under IRC 521, 526, 527, or 528,

h) Certain passive foreign investment companies (PFICs) and their shareholders making an election under IRC 1295,

i) A cooperative association with a loss in the short period required to effect the change of annual accounting period, or

j) A corporation with an IRC 936 election in effect.

Corporations that qualify and want to change their tax year using this expeditious procedure must comply with the following conditions:

1) The short period required to effect the change in annual accounting period must begin with the day following the close of the old tax year and must end with the day preceding the first day of the new tax year.

2) The corporation must file a tax return for the short period by the due date, including extensions.

3) The books of the corporation must be closed as of the last day of the new tax year. Returns for later years must be made on the basis of a full 12 months or 52–53 weeks ending on the last day of the new tax year. The corporation must figure its income and keep its books and records, including financial reports and statements for credit purposes, on the basis of the new tax year.

4) Taxable income of the corporation (except for a real estate investment trust or a regulated investment company) for the short period must be figured on an annual basis (annualized) and the tax figured as described under *Short Tax Year,* earlier.

5) If the short period required to effect the change of annual accounting period is a tax year in which the corporation has a net operating loss, the loss is to be deducted ratably over a 6-year period beginning with the first tax year after the short period, unless the corporation meets one of the following exceptions:

a) If the net operating loss resulting from the short period is $10,000 or less, the net operating loss can generally be carried back to each of the 3 tax years before the tax year of loss, or carried forward to each of the 15 tax years following the tax year of such loss, or

b) If the net operating loss resulting from a short period of 9 months or longer is greater than $10,000 and is less than the net operating loss for a full 12-month period beginning with the first day of the short period, the net operating loss can be carried back or carried over in the same way referred to in (a) above.

6) If there is any unused credit for the short period, the corporation must carry the unused credit(s) forward. Unused credit(s) from the short period may not be carried back.

7) If the taxpayer ceases to exist, any remaining short period net operating loss must be taken into account on the final return.

See Revenue Procedure 92–13, C.B. 1992–1 p. 665, for more information.

A corporation making this change must file Form 1128 with the Director, Internal Revenue Service Center, where the corporation files its income tax return. The envelope should be marked ''Attention: ENTITY CONTROL.'' The corporation must file the form by the time (including extensions) required for filing the short period return for this change. At the top of Form 1128 should be typed or printed: ''FILED UNDER REV. PROC. 92–13.''

The request will only be denied if Form 1128 is not filed on time, or if the corporation fails to meet the above requirements. Any change of accounting period under this procedure without meeting all of the conditions will be considered to be without the consent of the IRS.

If the request is denied, the service center will return Form 1128. An explanation of the denial will be provided. If the request is approved, the service center will return a copy of Form 1128 stamped ''Approved.'' The corporation must attach the approved Form 1128 to its tax return for the short period. At the top of Form 1128 should be typed or printed: ''FILED UNDER REV. PROC. 92–13.''

Excise Tax Periods

You must account for most federal excise taxes quarterly. The quarters covered, in most cases, are:

Calendar quarter	Calendar months
First	January, February, March
Second	April, May, June
Third	July, August, September
Fourth	October, November, December

Information on excise taxes (including due dates for filing and paying the taxes) is available in the following publications: Publication 510, Publication 349, Publication 378, and Publication 509.

Employment Tax Periods

You must use the calendar quarter for withheld income taxes and social security taxes. You must use the calendar year for federal unemployment taxes. For information on employment taxes, see Publication 15, *Employer's Tax Guide.*

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term ''accounting method'' includes not only the overall method of accounting you use, but also the accounting treatment you use for any material item. You choose your method of accounting when you file your first tax return. After that, if you want to change your accounting method, you must first get consent from the IRS. See *Change in Accounting Method,* later.

No single accounting method is required of all taxpayers. You must use a system that clearly shows your income and expenses, and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same method from year to year. Any accounting method that shows the consistent use of generally accepted accounting principles for your trade or business generally is considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Methods you may use. Subject to the preceding rules, you may figure your taxable income under any of the following accounting methods:

1) Cash method,

2) Accrual method,

3) Special methods of accounting for certain items of income and expenses, and

4) Combination (hybrid) method using elements of two or more of the above.

The cash and accrual methods of accounting are explained later.

If you produce, purchase, or sell merchandise to produce income, you must use an accrual method for purchases and sales because you must take inventories into account in figuring taxable income. See *Inventories,* later.

Special methods. There are special methods of accounting for certain items of income or expenses that are not discussed in this publication. For information on reporting income using one of the long-term contract methods, see section 460 of the Internal Revenue Code and the regulations thereunder, and section 1.451–3 of the Income Tax Regulations. Methods for deducting amortization and depletion are discussed in Publication 535, *Business Expenses.* Other special methods for reporting income or expenses are discussed in the following publications:

Publication 225, *Farmer's Tax Guide*

Publication 537, *Installment Sales*

Publication 946, *How To Depreciate Property*

Combination (hybrid) method. Generally, you may use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply:

1) If inventories are necessary to account for your income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expenses. See *Inventories,* later.
2) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
3) If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to that method. See *Limits on Use of Cash Method,* later.

Business and personal items. You may account for business and personal items under different accounting methods. For example, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

Two or more businesses. If you operate more than one business, you generally may use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. For each trade or business, the method you first use on your tax return for that business must be used in later years. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business, but you must use an accrual method for the manufacturing business.

If you create or shift profits or losses between the businesses so that your income is not clearly shown, your businesses will not be treated as separate and distinct.

No business will be considered separate and distinct if you do not keep a complete and separable set of books and records for that business.

Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. However, if inventories are necessary in accounting for your income, you must use an accrual method for your sales and purchases. If you do not have to keep inventories, the cash method is the method you usually will use. However, see *Limits on Use of Cash Method,* later.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent receives it.

Example 1. You have interest credited to your bank account in December 1995. You must include it in your gross income for 1995 and not in 1996 when you withdraw or enter it in your passbook.

Example 2. You have interest coupons that mature and are payable in 1995, but you do not cash them until 1996. You must include them in income for 1995. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

Expenses

Usually, you must deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may have to postpone the deduction for expenses you pay in advance. In addition, you may have to capitalize certain costs, explained later.

Expenses paid in advance. Expenses you pay in advance can be deducted only in the year to which they apply.

Example. You are a calendar year taxpayer and you pay $1,000 for a business insurance policy that is effective on July 1, 1995, for a one-year period. You may deduct $500 in 1995, and $500 in 1996.

Limits on Use of Cash Method

The cash method, including any combination of methods that includes the cash method, cannot be used by the following entities:

1) Corporations (other than S corporations),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters.

Exceptions

An exception allows a farming business (with gross receipts of $25 million or less), a qualified personal service corporation, and an entity with average annual gross receipts of $5 million or less to continue using the cash method. However, these exceptions do not apply to tax shelters. For information on the exception for farming businesses, see Publication 225, *Farmer's Tax Guide.*

Qualified personal service corporations. A qualified personal service corporation is a corporation that meets both a function test and an ownership test.

Function test. The function test is met if at least 95% of the activities of the corporation are the performance of service in the fields of health, veterinary services, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.

Ownership test. The ownership test is met if at least 95% of the stock of the corporation is owned, directly or indirectly, by:

1) Employees performing services for the corporation in a field qualifying under the function test,
2) Retired employees who had performed services in such fields,
3) The estate of an employee described in (1) or (2), or
4) Any other person who acquired the stock by reason of the death of an employee referred to in (1) or (2), but only for the 2–year period beginning on the date of death.

Indirect ownership is generally taken into account if the stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Stock owned by such an entity is considered owned by the entity's owners in proportion to their ownership interest in that entity. Other forms of indirect stock ownership, such as stock owned by family members, are generally not considered in determining if the ownership test is met.

For purposes of the ownership test, a person is not considered an employee of a corporation unless the services performed by that person for the corporation are more than minimal services.

A corporation that fails the function test for any tax year or fails the ownership test at any time during any tax year must change from the cash method of accounting, effective for the year in which the corporation fails to meet either test. A corporation that fails the function test or the ownership test is not treated as a qualified personal service corporation for any part of that tax year.

$5 million gross receipts test. Any corporation or partnership (other than a tax shelter) may use the cash method, if, for all its tax years after 1985, the corporation or partnership meets the $5 million gross receipts test. A corporation or a partnership meets the test if

its average annual gross receipts for the 3-tax-year period (or, if shorter, the period of existence) ending with the prior tax year are $5 million or less. Generally, a partnership applies the test at the partnership level. For these rules, gross receipts for a short tax year are annualized.

Failure to meet exceptions. If you fail to meet any of the exceptions for limits on use of the cash method in any tax year, you must change to an accrual method of accounting. See *Automatic Change to Accrual Method* under *Change in Accounting Method,* later.

Accrual Method

Under an accrual method of accounting, income generally is reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of an accrual method of accounting is to match your income and your expenses in the correct year.

Income

Generally, you report an item of income in the tax year when all events have happened that fix your right to receive the income and you can determine the amount with reasonable accuracy.

Example. You are a calendar year accrual basis taxpayer. You sold a computer on December 28, 1995. You billed the customer in the first week of January 1996, but did not receive payment until February 1996. You must include the amount of the sale in your income for 1995.

Estimating income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, the difference, if any, is taken into account in the tax year in which the determination is made.

Change in payment schedule for services. If you contract to perform services for a basic rate, you must include the basic rate in your income as it accrues. You must accrue the basic rate even if, as a matter of convenience, you agree to receive payments at a lower rate until you complete your services, at which time you will receive the difference between the basic rate and the amount actually paid to you.

Accounts receivable for services. You may not have to accrue all of your accounts receivable if, based on your experience, you will not collect all of these accounts. This is called the *nonaccrual-experience method,* and is explained in section 1.448–2T(b) of the Income Tax Regulations.

Discounting notes receivable. Discounting notes receivable is a common practice in some businesses. Many dealers receive the notes of customers as part payment for articles sold. These notes are payable over a fixed period. The dealer then sells the notes to a finance company at a discount. The dealer and the finance company often agree that a part of the discount price will be held by the finance company in a ***dealer's reserve*** or similar account until collections are made or the reserve reaches a specified total, at which time it will be paid over or credited to the dealer. In these cases, amounts held in the reserve are treated as income to the dealer. Under an accrual method of accounting the full amount of the ***discount price,*** not reduced by the reserve held by the finance company, is included in income when the notes are sold. This practice is often followed by automobile dealers.

The amount of the reserve is included in the income of the dealer. The dealer has a deductible expense when claims against the reserve become fixed.

Advance Income for Services

Generally, if you receive advance payments for services to be performed in a later tax year, you report the income in the year you receive the payments. However, if under an agreement, you receive advance payments for services to be performed by the end of the next tax year, you can make an election to postpone including the advance payments in income until you earn them. However, you may not postpone including the payments beyond the following tax year.

Service agreements. You may postpone reporting income from advance payments you receive for service agreements on property you sell, lease, build, install, or construct. This includes agreements providing for incidental replacement of parts or materials. However, this applies only if you offer the property without service agreements in the normal course of business.

Guarantees and warranties. You generally may not postpone reporting income you receive for guarantee or warranty contracts.

Prepaid rent or prepaid interest. You cannot postpone reporting income from prepaid rent or prepaid interest. Prepaid rent does not include payments for use of rooms or other space when significant services are also provided for the occupant. You provide significant services when you supply space in hotels, boarding houses, tourist homes, motor courts, motels, or apartment houses that furnish hotel services.

Postponement not allowed. Usually you may not postpone including in income advance payments for services if, under the agreement:

1) You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or

2) You are to perform any part of the services at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payments.

Any advance payment that you include in gross receipts on your tax return in the tax year you receive the payment must not be less than the amount of the payment you include as gross receipts in gross income for your books and records and all your reports. This includes reports (including consolidated financial statements) to shareholders, partners, other proprietors or beneficiaries, and for credit purposes.

If you want to change your method of reporting advance payments for services to postpone income as previously described, you must first get consent from the IRS as discussed later under *Change in Accounting Method.*

In each of the examples that follow, assume you use the calendar year and an accrual method of accounting.

Example 1. You manufacture, sell, and service computers. In 1995, you received payment for a one-year contingent service contract on a computer you sold. You may postpone including the part of the payment you did not earn in 1995 in income if, in the normal course of your business, you offer the computers for sale without the contingent service contracts.

Example 2. You are in the television repair business. In 1995, you received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were manufactured and sold by unrelated parties. You include the payments in gross income as you earn them by performing the services.

In these examples, if for any reason you do not perform part of the services by the end of the following tax year (1996), you must include in gross income for 1996 the amount of the advance payments that are for the unperformed services.

Example 3. You own a dance studio. On November 2, 1995, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons in 1995. Under this method of including advance payments, you must include one-sixth (8/48) of the payment in income for 1995, and five-sixths (40/48) of the payment in 1996, even if you cannot give all the lessons by the end of 1996.

Example 4. Assume the same facts as in Example 3, except that the payment received is for a two-year contract for 96 lessons, beginning November 1, 1995. You must include the entire payment in income in 1995 since a portion of the services may be performed after the following year, in 1997

Advance Income From Sales

Any advance payments you receive for future sales or other dispositions of goods are included in your income under special rules. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your trade or business.

The special rules may not apply to that part of any advance payment you receive for services that are not an integral part of your main

activities under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts that are due and payable are considered received.

Inclusion in income. You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them, or under an alternative method.

Alternative method. Under an alternative method, you generally include advance payments in income in the ***earlier*** tax year in which:

1) You include the advance payments in gross receipts under the method of accounting that you use for tax purposes, or
2) You include any part of the advance payments in income for any of your financial reports under the method of accounting used for those reports.

Your financial reports include your reports to shareholders, partners, beneficiaries, other proprietors, for credit purposes, and for consolidated financial statements.

Example 1. You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this accounting method for both tax and reporting purposes. You must include advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods. But see *Exception for inventory goods,* below.

Example 2. You are a calendar year taxpayer who manufactures household furniture. You use an accrual method of accounting. Under your method of accounting you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In 1995 you received an advance payment of $8,000 from a customer for an order of furniture to be manufactured for a total price of $20,000. You shipped the furniture to your customer in December 1995, but it was not delivered and accepted until January 1996. You must include the entire $8,000 advance payment in your gross income for tax purposes in 1995. You include the remaining $12,000 of the contract price in your gross income, for tax purposes, in 1996.

Exception for inventory goods. If you receive advance payments under an agreement for the sale of goods that are properly included in your inventory, or under an agreement such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of receipt, you may be able to postpone including the advance payments in income in the year of receipt. The postponement period for these advance payments may extend only until the end of the second tax year following the year in which you received substantial advance payments (discussed later) and met the following conditions:

1) You must account for advance payments under the alternative method as discussed earlier,
2) You must have received substantial advance payments on the agreement, and
3) You must have on hand, or available to you, through your normal source of supply in the year of receipt, enough substantially similar goods to satisfy the agreement.

If you meet these conditions at the end of a tax year, all advance payments (not included in income under your accrual accounting method) that you receive by the end of the second tax year following the tax year in which you received substantial advance payments, must be included in income for that second year. Also at the end of this second year you must deduct all actual or estimated costs of goods necessary to satisfy the contract.

Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account when the goods are delivered. Any more advance payments received on this contract after the second year are reported in income in the year received because no further deferral is allowable on this contract.

Substantial advance payments. Under an agreement for a future sale, you have substantial advance payments if, by the end of a tax year, the total advance payments received during that year and preceding tax years are equal to or more than the total costs and expenditures reasonably estimated to be includible in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method discussed earlier. In 1992 you entered into a contract for the sale of goods that are properly includible in your inventory. The total contract price is $50,000 and you estimate that your total inventoriable costs for the goods will be $25,000. You received the following advance payments under the contract:

1992	$17,500
1993	10,000
1994	7,500
1995	5,000
1996	5,000
1997	5,000
Total contract price	$50,000

Your customer asked you to deliver the goods in 1998. In your 1993 closing inventory you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of 1993 were more than the costs you estimated you would have, the payments are substantial advance payments.

Include all payments you receive by the end of 1995, the second tax year following the tax year in which you receive substantial advance payments, in income for 1995. You must include $40,000 in sales for 1995, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated costs necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payment you receive that year. Any difference between the estimated costs and the costs you actually have in satisfying the contract is to be taken into account in 1998, when you deliver the goods.

Information schedule. If you use this alternative method of treating advance payments for future sales of goods, you must attach to your income tax return for each tax year a statement that shows:

1) Total advance payments you received in the current tax year,
2) Total advance payments you received in earlier tax years that you have not included in income before the current tax year, and
3) Total payments you received in earlier tax years that you have included in income for the current tax year.

To change to the alternative method, you must first get consent from the IRS.

Expenses

Generally, you deduct or capitalize business expenses when you become liable for them, whether or not you pay them in the same year.

All events test. Before you can deduct or capitalize the expenses, all events that set the amount of the liability for them must have happened, and you must be able to figure the amount with reasonable accuracy.

Economic Performance Rule

Generally, you cannot deduct or capitalize business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services.

Example. You are a calendar year taxpayer and in December 1995 you buy office supplies. You receive the supplies and the bill for them in December, but you pay for the supplies in January 1996. You can deduct the expense in 1995 because all events that set the amount of liability and economic performance occurred in that year. Your office supplies may qualify as a recurring expense, discussed later, permitting you to deduct them in 1995 even if the delivery of the supplies (economic performance) does not occur until 1996.

Workers' compensation and tort liabilities. A special rule is provided for workers' compensation and tort liabilities. If you must make payments under workers' compensation laws, or in satisfaction of any tort, economic performance occurs as you make the payments.

Settlement fund. Economic performance occurs as qualified payments are made to a court-established designated settlement fund.

Interest. Economic performance occurs with the passage of time (as the borrower uses, and the lender forgoes use of, the lender's money) rather than as payments are made. Interest accruing on debt obligations incurred after June 8, 1984, and not incurred under a written contract binding on March 1, 1984, and at all times thereafter, is deductible only by using a constant interest method that corresponds to the actual economic accrual of interest.

Compensation for services. Generally, economic performance occurs as an employee renders his or her services to the employer. However, an employer's deduction for compensation or other benefits paid to an employee in a year subsequent to economic performance is subject to the rules governing deferred compensation, deferred benefits, and funded welfare benefit plans. For more information on employee benefit plans, see Publication 535, *Business Expenses.*

Vacation pay. You can deduct in the current year vacation pay earned by your employees only if you pay it during the year or, within 2 ½ months after the close of the year. If paid later, it is considered deferred compensation and you can deduct it in the year actually paid.

Recurring items. An exception allows you to treat certain recurring items as incurred during a tax year even though economic performance has not occurred. In this case, you may be able to deduct an expense in 1995, even though economic performance does not occur until 1996. The exception applies if all the following conditions are met:

1) By the end of the year, all events that establish the liability have happened, and you can determine the amount of the liability with reasonable accuracy,
2) Economic performance occurs by the earlier of: 8½ months, or the date you actually file a timely return (including extensions),
3) The item is recurring in nature and you consistently treat similar items as incurred in the tax year in which the all-events test is met, and
4) Either (a) the item is not material or (b) accrual of the item in the year in which the all-events test is met results in a better match against income than would result from accruing the item in the year of economic performance.

The exception for recurring items does not apply to workers' compensation or tort liabilities.

Amended return. If economic performance for a liability occurs after you file a return but within 8½ months after the close of the tax year, you may file an amended return and treat the liability as incurred under the recurring item exception.

Recurrence and consistency. To determine whether an item is recurring and is consistently reported, consider the frequency with which the item and similar items are incurred (or expected to be incurred) and the way in which you report these items for tax purposes. The exception is intended to be available if you are either starting up a trade or business or you are already in a trade or business. In addition, a new type of expense or an expense that does not recur every year may be treated as recurring if it is reasonable to expect that it will recur regularly in the future.

Materiality. Factors to consider in determining the materiality of a recurring item include the size of the item (both in absolute terms and in relation to your income and other expenses) and the treatment of the item on your financial statements. An item considered material for financial statement purposes is also considered material for tax purposes.

For example, you are a calendar year taxpayer and you enter into a one-year maintenance contract on July 1, 1995. If you prorate your expenses between 1995 and 1996 for financial statement purposes, you should do the same for tax purposes. However, if you deduct the full amount in 1995 for financial statement purposes because of its immateriality under generally accepted accounting principles, that expense is not necessarily immaterial for purposes of the recurring item exception.

In some situations, an item that is not material for financial accounting purposes is treated as material for purposes of economic performance. If an item is directly related to an activity, the materiality of the item will be separately determined for that activity. The materiality of overhead expenses that relate to several of your activities is measured against those collective activities.

Matching. To determine whether an accrual of an item in a particular year results in a better matching of the item with the income to which it relates, generally accepted accounting principles are an important factor. Costs directly associated with the revenue of a period are properly allocable to that period.

For example, a sales commission agreement may require certain payments to be made in a year subsequent to when sales income is reported. In this situation, economic performance for part of the commission expense may not occur until the following year. Nevertheless, if you deduct the expense in the year the sales income is reported it will result in a better matching of the commission expense with the sales income. In addition, if sales income is recognized in one year, but the goods are not shipped until the following year, the shipping costs are more properly matched to income in the year the goods are sold than in the year the goods are shipped.

Expenses such as insurance or rent are generally allocable to a period of time. If you are a calendar year taxpayer and enter into a 12-month insurance contract on July 1, 1995, allocate half of your expense to 1995 and half to 1996. In some situations, however, an expense may be immaterial and entirely accruable in 1995. Expenses such as advertising costs that cannot be practically associated with income of a particular period should be assigned to the period in which the costs are incurred. The matching requirement is satisfied for advertising expenses if the period to which the expenses are assigned is the same for tax and financial reporting purposes.

Amortization of multi-year insurance costs. If you are a manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods, you generally must amortize the costs of intangible assets (including insurance policies) over the period of business use. You generally cannot deduct the full amount in the year you pay it. See Revenue Procedure 92–97, C.B. 1992–2, p. 510 for more information.

Special Rules for Related Persons

You cannot deduct business expenses and interest owed to a related cash basis person ***until*** you make the payment and the corresponding amount is includible in the gross income of the related person. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ends before the expense or interest is includible in the gross income of that person.

Related persons. For the purpose of this rule, the following are related persons:

1) Members of the immediate family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
2) Two corporations that are members of the same controlled group.
3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts if the same person is the grantor of both trusts.
4) Certain educational and charitable organizations and a person (if an individual, including the members of the individual's family) who, directly or indirectly, controls the organization.
5) An individual and a corporation of which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for that individual.
6) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust.
7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
8) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
10) A corporation and a partnership if the same persons own more than 50% in

value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

11) A personal service corporation and any employee-owner, regardless of the amount of stock owned by the employee-owner.

Indirect ownership of stock. To decide whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family (as defined in item (1) under *Related persons).*
3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.
4) Stock constructively owned by a person under rule (1), shall, to apply rule (1), (2), or (3), be treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) will not be treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Contested Liabilities

You may deduct certain contested liabilities, such as taxes (except foreign or U.S. possession income, war profits, and excess profits taxes), in the tax year in which you pay them, or transfer money or other property to satisfy the obligation, rather than in the tax year in which the contest is settled. However, to be able to take the deduction in the year of payment or transfer, you must satisfy each of the following rules.

Liability must be contested. You do not have to start a suit in a court of law to contest an asserted liability. However, you must deny its validity or accuracy by a positive act. A written protest included with payment of an asserted liability is enough to start a contest. Lodging a protest in accordance with local law is enough to contest an asserted liability for taxes. You do not have to deny the validity or accuracy of an asserted liability in writing if you can show by all the facts and circumstances that you have asserted and contested the liability.

Transfer to creditor. You must transfer to the creditor or other person enough money or other property to cover the payment of the asserted liability. The money or other property transferred must be beyond your control. If you transfer it to an escrow agent, you have met this requirement if you give up all authority over the money or other property. However, buying a bond to guarantee payment of the asserted liability, making an entry on your books of account, or transferring funds to an account within your control will ***not*** meet this requirement.

Contest must exist. The contest for the asserted liability must exist after the time of the transfer. If you do not make payment until after the contest is settled, you must accrue the liability in the year in which the contest is settled.

Example. You are a calendar year taxpayer using an accrual method of accounting. In 1993 you had a $500 liability asserted against you for repair work completed in that year. You contested this asserted liability and finally settled in 1995 for the full $500. You pay the $500 in January 1996. Even though you did not make the payment until after the contest was settled, the liability accrues and can only be deducted in 1995.

Liability deduction. The liability must have been allowable as a deduction in the year of payment, or in an earlier year when it would have accrued, if there had been no contest.

Economic performance rule. You generally cannot deduct contested liabilities until economic performance occurs. For workers' compensation or tort liabilities, economic performance occurs as payments are made to the person. The payment or transfer of money or other property into escrow to contest an asserted liability is not a payment to the claimant that discharges the liability. Such payment does not satisfy the economic performance test discussed earlier.

Recovered amounts. An adjustment is usually necessary when you recover any part of a contested liability. This occurs when you deduct the liability in the year of payment and recover any part of it in a later tax year when the contest is settled. You do this by including in gross income in the year of final settlement the part of the recovered amount that, when deducted, decreased your tax for any tax year.

Foreign taxes and taxes of U.S. possessions. The rule allowing the deduction of contested liabilities in the tax year of payment does not apply to the ***deduction*** for income, war profits, and excess profits taxes imposed by any foreign government or U.S. possession. This means that an accrual method taxpayer deducts these liabilities in the tax year in which the contested foreign tax or U.S. possession tax is finally determined. Contested foreign taxes accrued for ***foreign tax credit*** are not covered under this provision but relate back to and are credited in the tax year in which they would have been accrued if they had not been contested.

Inventories

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If you must account for inventories in your business, you must use an accrual method of accounting for your purchases and sales. See *Accrual Method,* discussed earlier.

The most common kinds of inventories are:

1) Merchandise or stock in trade,
2) Raw materials,
3) Work in process,
4) Finished products, and
5) Supplies that physically become a part of the item intended for sale.

To figure your taxable income, you must value your inventories at the beginning and end of each tax year. To determine the value of your inventory, you need a method for ***identifying*** the items in your inventory and a method for ***valuing*** these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting practices used for similar businesses, and it must clearly show income. To clearly show income, you must consistently use the same inventory method from year to year.

The value of your inventory includes transportation or other necessary charges incurred in acquiring possession of the goods and may include certain capitalized costs. See *Uniform Capitalization Rules,* later.

The rules discussed here only apply if they do not conflict with the uniform capitalization rules under the Internal Revenue Code section 263A.

Items included in inventory. Include in your inventory all your finished or partly finished goods and raw materials and supplies that become a part of the merchandise you intend to sell.

Merchandise. You include merchandise in your inventory only if you have title to it. Include merchandise you purchase in inventory if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory also includes the following:

1) Goods under contract for sale that you have not yet segregated and applied to the contract,
2) Goods out on consignment, and
3) Goods that are in display rooms, merchandise mart rooms, or booths that are located away from your place of business.

In figuring gross income, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. Do not include the goods you sold in your inventory.

Containers. Containers such as kegs, bottles, and cases, whether or not on hand and whether or not returnable, should be included in your inventory if title to them has not passed to a buyer of the contents. If title has passed to a buyer, you should exclude the containers from your inventory. Under certain circumstances, some containers may be depreciated. See Publication 946, *How To Depreciate Property*

C.O.D. mail sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Include the merchandise in your closing inventory until the buyer pays for it.

Items excluded from inventory. Exclude from your inventory all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future delivery if you do not yet have title to them.

Assets. Assets such as land, buildings, and equipment used in your business, as well as notes and accounts receivable, and similar assets, are not included in inventory. Also, real estate held for sale by a real estate dealer in the ordinary course of business is not included in inventory.

Special rules apply to the cost of inventory or property imported from a related person. See the regulations under section 1059A of the Internal Revenue Code.

Cost Identification

There are three methods of identifying items in inventory—specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific Identification Method

The specific identification method is used when you can identify and match the actual cost of the items in inventory.

If there is no specific identification of items with their costs, you must make an assumption to decide which items were sold and which remain in inventory. Make this identification by either the FIFO method, or the LIFO method.

FIFO and LIFO Methods

The ***first-in first-out (FIFO) method*** assumes that the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of.

The items in inventory at the end of the tax year are matched with the costs of items of the same type that you most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that they cannot be identified with specific invoices, you must use the FIFO method to identify the cost of these items, unless you elect to use the last-in first-out (LIFO) method.

The ***last-in first-out (LIFO) method*** assumes that the items of inventory that you purchased or produced last are sold or removed from inventory first. Items included in your closing inventory are considered to be those from the opening inventory in order of acquisition and to the extent thereof, those items acquired in that tax year.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO generally will produce a smaller cost of goods sold and a higher closing inventory. Under FIFO the reverse will be true.

Adopting LIFO method. To adopt the LIFO method, you must file Form 970, *Application To Use LIFO Inventory Method,* or a statement that has all the information required in Form 970. You must file the form (or the statement) with your timely filed tax return for the year in which you first use LIFO.

Extension of time for filing. You may qualify for an automatic extension of 12 months to make this election. See Revenue Procedure 92–85 for more information.

There are very complex rules involved in using the LIFO method. Only two are briefly discussed here; for more information, see sections 472 through 474 of the Internal Revenue Code and the corresponding Income Tax Regulations.

Dollar-value method. Under the dollar-value method of pricing LIFO inventories, goods and products have to be grouped into one or more pools (classes of items), depending on the kinds of goods or products in the inventories. For more information, see section 1.472–8 of the Income Tax Regulations.

Simplified dollar-value method. An eligible small business may elect the simplified dollar-value LIFO method. An eligible business is one with average annual gross receipts of $5 million or less for the 3 preceding tax years. This method establishes multiple inventory pools in accordance with general categories of inventory items set forth in the appropriate government price indexes and uses the change in those published indexes to estimate the annual changes in prices for inventory items in the pools. For more information, see section 474 of the Internal Revenue Code. Taxpayers not eligible under section 474 should see section 1.472–8(e)(3) of the Income Tax Regulations for a similar simplified dollar-value method.

Valuing Inventory

Since valuing the items in your inventory is a major factor in figuring your taxable income, the method you use to value your inventory is very important. The two common methods to value non-LIFO inventory are the ***cost method*** and the ***lower of cost or market method.***

For a new business not using LIFO, you may select either method to value your inventory. You must use the same method to value your entire inventory, and you may not change to another method without consent from the IRS.

Cost method. To properly value your inventory at cost, you must include all direct and indirect costs that are associated with it. Apply the following rules:

1) For merchandise on hand at the beginning of the tax year, cost means the inventory price of the goods.
2) For merchandise purchased during the year, cost means the invoice price less appropriate discounts plus transportation or other charges you incur in acquiring the goods. It may include other costs that have to be capitalized under the uniform capitalization rules.
3) For merchandise produced during the year, cost means all direct and indirect costs that have to be capitalized under the uniform capitalization rules.

Discounts. You must reduce the cost of your inventory by trade (or quantity) discounts. Generally, these discounts are for volume or quantity purchases. If a discount is allowed regardless of time of payment, it is a trade discount.

A cash discount is a reduction in invoice or purchase price for paying within a prescribed time period. You may choose whether or not you will deduct cash discounts, but you must treat them the same way from year to year. If you do not deduct the cash discounts from your inventory costs, you must include them in your business income.

Lower of cost or market method. Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. For example, if at the end of your tax year you had the following items on hand, the value of closing inventory would be $600.

Items	Cost	Market	Whichever is lower
R	$300	$500	$300
S	200	100	100
T	450	200	200
Totals	$950	$800	$600

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost ($950) and at market ($800) and use the lower of the two figures. If you use the cost method, the value of your closing inventory would be $950.

Market value. Under ordinary circumstances and for normal goods, market value means the usual bid price at the date of your inventory. This price is based on the volume of

merchandise you usually buy. For example, if you buy items in small lots at $10 an item and a competitor buys identical items in larger lots at $8.50 an item, your usual market price will be higher than your competitor's.

The lower of cost or market rule applies to goods purchased and on hand, and to basic elements of cost (direct materials, direct labor, and an allocable share of indirect costs) of goods in process of manufacture and finished goods on hand. It does not apply to goods on hand or in process of manufacture for delivery at fixed prices on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer). These goods must be inventoried at cost.

Lower than market. When, in the regular course of business, you have offered merchandise for sale at prices lower than market, the inventory may be valued at these prices, less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable as reflecting the market.

No market exists. If no market exists, or if quotations are given without reference to actual conditions because of an inactive market, you must use whatever evidence of a fair market price is available, at the dates nearest your inventory date. This evidence could include specific purchases or sales you or others made in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments.

Unsalable goods. Unsalable goods are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You should value these goods at selling prices minus direct costs of disposition, no matter what method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they must be valued on a reasonable basis, considering the usability and condition of the goods. Do not value them for less than scrap value.

Retail method. Resellers who use the retail method of pricing inventories may figure their tax on that basis.

To use this method on your income tax return you must:

1) State that you are using the method on the return,
2) Keep accurate accounts, and
3) Use this method from year to year unless the IRS allows you to change to another method.

You must keep records for each separate department or class of goods carrying different percentages of gross profit. Purchase records should show the firm name, date of invoice, invoice cost, and your retail selling price. You should also keep records of the respective departmental or class accumulation of all purchases, markdowns, sales, stock, etc.

Closing inventory cost. Under the retail method, the total of the retail selling prices of goods on hand at the end of the tax year in each department or class of goods is reduced to approximate cost using the average markup expressed as a percentage of the total retail selling prices.

To figure the average markup percentage, do the following:

1) Add the total of the retail selling prices of the goods in the opening inventory and the retail selling prices of the goods you bought during the year (adjusted for all markups and markdowns), then
2) Subtract from that total, the cost of goods included in the opening inventory plus the cost of goods you bought during the year, and, then
3) Divide the balance from item 2 by the total selling price from item 1.

You can figure approximate cost in two steps. First, find the markup in the items in the closing inventory by multiplying the total retail selling prices by the average markup percentage. Then, subtract the markup from the total retail selling prices. The result is the approximate cost.

If you do not use LIFO and have been figuring your inventory under the retail method except that, to approximate the lower of cost or market, you have followed the consistent practice of adjusting the retail selling prices of goods for markups but not markdowns, you can continue that practice. The adjustments must be bona fide and uniform and markups made to cancel or correct markdowns must also be excluded. The markups included must be reduced by markdowns made to cancel or correct the markups.

If you do not use LIFO and previously figured inventories without eliminating markdowns in making adjustments to retail selling prices, you can use this practice, provided you first get permission to do so from the IRS. In the first tax return you file for your business, you can use this practice subject to approval by the IRS on examination of your tax return.

If you use LIFO with the retail method, you must adjust your retail selling prices for markdowns as well as markups.

Example. Your records show the following information on the last day of your tax year:

Item	Cost	Retail Value
Opening inventory	$52,000	$60,000
Purchases during year	53,000	78,500
Sales		98,000
Markups		2,000
Markdowns		500

Using the retail method you can figure your closing inventory from this information as follows:

Item	Cost	Markups/ Markdowns	Retail Value
Opening inventory	$ 52,000		$ 60,000
Plus: Purchases during year	53,000		78,500
Markups		$ 2,000	
Markdowns		(500)	1,500
Totals (markup percentage 25%)	$105,000		$140,000
Minus: Sales			98,000
Closing inventory at retail			$ 42,000
Minus: Markup percentage (25%)			10,500
Closing inventory at cost			$ 31,500

Markup percentage. In the preceding example, the markup ($35,000) is equal to the difference between cost ($105,000), which includes inventory at the beginning of the period, and purchases at cost plus transportation, and the retail value ($140,000), which included the inventory at sales prices and purchases at sales prices. The total markup divided by the total retail value will give you the percentage (25%) of markup, expressed as a percentage of the retail selling price. Do not use arbitrary standard percentages of purchase markup. The percentage must be the markup percentage figured as accurately as possible from your department records for the period for which you file your return.

Markdowns. Markdowns not based on actual reduction of retail sales prices (such as markdowns based on depreciation and obsolescence) are not allowed in figuring retail selling prices of the goods on hand at the end of the tax year. Markdowns are recognized only if you offered the goods to the public at the reduced prices.

Used with other methods. The retail method may be used with the FIFO method. Subject to special rules, you may use the retail method in conjunction with the LIFO inventory method. In this case, you must adjust the inventory value at the end of the year to the extent of price changes that have taken place since the close of the preceding year. You must make this adjustment based on price indexes acceptable to the IRS.

Price indexes. Generally, you must develop your own retail price index based on analysis of your own data under methods acceptable to the IRS. However, department stores using LIFO that offer a full line of merchandise for sale may use inventory price indexes provided by the Bureau of Labor Statistics. Other sellers may use these indexes if they can demonstrate that they are accurate and suitable for their use. For more information, see Revenue Ruling 75–181, C.B. 1975–1, p. 150.

Perpetual or book inventories. You can figure the costs of goods on hand by perpetual or book inventories if they are kept by following

sound accounting practices. Inventory accounts, however, must be charged with the actual cost of goods purchased or produced, and credited with the value of goods used, transferred, or sold. Credits must be figured on the basis of the actual cost of goods acquired during the year and the inventory value at the beginning of the year.

Physical inventories. You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Practices not approved. The following are some of the inventory practices that are not recognized for tax purposes:

1) Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory,
2) Taking work in process or other parts of your inventory at a nominal price or less than its full value,
3) Omitting part of your stock on hand,
4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock,
5) Including stock in transit, shipped either to or by you, the title to which you do not hold,
6) Separating indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method), or
7) Treating all or substantially all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

Loss of inventory. A casualty or theft loss of inventory, including items you hold for sale to customers, is automatically claimed through the increase in the cost of goods sold by properly reporting your opening and closing inventories. This loss should not be claimed again as a casualty or theft loss. If you take the loss automatically through the increase in the cost of goods sold, any insurance or other reimbursement you receive for the loss must be included in gross income.

You can choose to take the loss separately. If you take the loss separately, you must eliminate the items from inventory by making a downward adjustment to opening inventory or to purchases.

If you take the loss separately, you should reduce the loss by the amount of the reimbursement you received or expect to receive. If you do not receive the reimbursement by the end of the year, you may not claim a loss to the extent that you have a reasonable prospect of recovery.

Reimbursement from creditors or suppliers. If your creditors forgive part of what you owe them because of your inventory loss, this amount is treated as a reimbursement. The amount forgiven is included in gross income.

Disaster loss to inventory. If your inventory loss is due to a disaster in an area determined by the President of the United States to be eligible for federal assistance, you may choose to deduct your loss on your return for the immediately preceding year. However, you must decrease your opening inventory for the year of the loss so that the loss will not show up again in inventories.

Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses you have during the year will be included in the basis of property you produce or in your inventory costs, rather than claimed as a current deduction. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

You are subject to the uniform capitalization rules if, in the course of a trade or business or an activity carried on for profit, you:

1) Produce real or tangible personal property for use in the business or activity,
2) Produce real or tangible personal property for sale to customers, or
3) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are not more than $10 million.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property.

Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property, containing words, ideas, concepts, images, or sounds. However, free-lance authors, photographers, and artists are exempt from the uniform capitalization rules if they qualify as explained next under *Exceptions.*

Exceptions. The uniform capitalization rules do not apply to:

1) Resellers of personal property with average annual gross receipts for the 3 prior tax years of not more than $10 million;
2) Property you use for personal or nonbusiness purposes, or for purposes not connected with a trade or business or an activity conducted for profit;
3) Research and experimental expenditures deductible under section 174;
4) Intangible drilling and development costs of oil and gas or geothermal wells, or any amortization deduction allowable under section 59(e) of the Internal Revenue Code for intangible drilling, development, or mining exploration expenditures;
5) Property you produce under a long-term contract, except for certain home construction contracts described in section 460(e)(1) of the Internal Revenue Code;
6) Timber and certain ornamental trees you raise, harvest, or grow, and the underlying land;
7) Qualified creative expenses you incur as a free-lance writer, photographer, or artist;
8) Costs allocable to natural gas acquired for resale, to the extent these costs would otherwise be allocable to ''cushion gas'' stored underground;
9) Property produced if substantial construction occurred before March 1, 1986;
10) Property provided to customers incident to the provision of services, if it is de minimis in amount and not inventory in the hands of the service provider; and
11) The origination of loans.

De minimis exception. The costs of certain producers using a simplified production method are not subject to the uniform capitalization rules if their total indirect costs are $200,000 or less. See section 1.263A–2(b)(3)(iv) of the Income Tax Regulations for more information.

Special uniform capitalization rules apply to farming businesses. See *Uniform Capitalization Rules* in Publication 225, *Farmer's Tax Guide.*

Free-lance writers, photographers, and artists. A free-lance writer, photographer, or artist is a self-employed individual whose personal efforts create (or may reasonably be expected to create) certain properties.

This exception does not include expenses related to printing, photographic plates, motion picture films, video tapes, or similar items.

A writer is an individual who creates a literary manuscript, a musical composition (including any accompanying words), or a dance score.

A photographer is an individual who creates a photograph or photographic negative or transparency.

An artist is an individual who creates a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The originality and uniqueness of the item created and the predominance of aesthetic value over utilitarian value of the item created is taken into account. This generally excludes the production of jewelry, silverware, pottery, furniture, and other similar household items.

Personal service corporations. This exemption for writers, photographers, and artists also applies to the expense of a personal service corporation which directly relates to the activities of the qualified employee-owner. A ''qualified employee-owner'' is an individual who is a writer, photographer, or artist, and who owns (including ownership by members of his or her family) substantially all of the stock of the corporation.

Further information. The procedures for applying the uniform capitalization rules are complex and beyond the scope of this publication. See section 1.263A of the Income Tax Regulations.

Change in Accounting Method

When you file your first return, you can, without consent from the IRS, choose any permitted accounting method. The method you choose must be used consistently from year to year and clearly show your income. See *Accounting Methods,* earlier.

After your first return is filed, if you want to change your accounting method, you must first get consent from the IRS. This is necessary to notify the IRS that a change is being made and to prevent you from gaining an unlawful tax advantage. The IRS will consider the need for consistency in the accounting area against your reason for wanting to change your accounting method when the method from which you are changing clearly shows your income.

If you request a change in accounting method (such as from an improper to a proper method), the absence of IRS consent to the change does not prevent the IRS from imposing any penalty or addition to tax, nor diminish the amount of the penalty or the addition to tax.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. Although an accounting method may exist without having a pattern of treating an item the same way all the time, in most cases, an accounting method is not established for an item unless the item is treated the same way every time.

Some examples of changes that ***require*** consent are:

1) A change from the cash method to an accrual method or vice versa (unless you must change to an accrual method and you make the change automatically),
2) A change in the method or basis used to value inventories, and
3) A change in the method of figuring depreciation (except certain permitted changes to the straight-line method for property placed in service before 1981, as explained in Publication 534).

Some changes that are not changes in accounting methods and ***do not require*** consent are:

1) A correction of mathematical or posting errors,
2) A correction of errors in computing tax liability (such as errors in computing credits),
3) An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it, and
4) An adjustment in the useful life of a depreciable asset. You cannot change the recovery period for ACRS or MACRS property (depreciable property placed in service after 1980).

Certain accounting method changes are required by law. These are automatic changes that do not need consent.

Consent To Change

In general, to request a change that requires consent, you must file a current Form 3115. You must attach the applicable user fee. You generally must file the application within the first 180 days of the tax year for which you are requesting the change. If the 180th day falls on a Saturday, Sunday, or legal holiday, the filing date is extended to the next working day. For example, a calendar year taxpayer wanting to change accounting methods for 1995 must file by June 29, 1995.

However, if you are requesting a change under an expeditious procedure rule (discussed later) a user fee is not required and the filing date may be extended.

Unless otherwise specifically provided, IRS consent to change for a particular year will be set forth in a ruling letter from the National Office. If you agree to the terms and conditions contained in the letter, you must sign and date the agreement copy of the ruling letter in the space provided (Consent Agreement) and return it to the Office within 45 days from the date of the letter.

The following rules apply to taxpayers who have not been contacted by the IRS for an examination of tax returns. For rules applying to taxpayers who have been contacted for this purpose, see *Taxpayers Under Examination,* later.

An application on Form 3115, filed after the 180-day period but within 9 months after the beginning of the tax year for which the change is requested, can be treated as filed on time if you show reasonable cause for filing it late. See *Extension of time to file application,* later.

If you file your application on Form 3115 after the 180-day period and the IRS does not grant you an extension of time to secure consent, you can treat your application as a timely application for the next tax year. To make this choice, you must notify the IRS of your intention within 30 days after being denied the extension by filing a current Form 3115 for the subsequent tax year. To have your application qualify as a timely application for the next tax year, you must also meet the requirements described under *Early applications,* below.

Extension of time to file application. If you have good reason for filing late, the IRS may grant you an extension. Applications received within 90 days after the due date may qualify for an automatic extension. See Revenue Procedures 92–20 (C.B. 1992–1, p. 685) and 92–85 for more information. However, if you file your request later than 9 months after the beginning of your tax year, the reasons must be unusual and compelling.

Early applications. You can file an application for a change in accounting method within a 6-month period before the beginning of the year you want the change to take effect. These applications are known as "early applications." For an early application to qualify, the following requirements must be met:

1) The application must be on a current Form 3115 and it must be complete in all respects, except for the amount of the net section 481(a) adjustment as of the beginning of the year of change, and the gross receipts and taxable income amounts for the year immediately preceding the year of change.
2) You must furnish these amounts within the first 90 days after the beginning of the year of change.
3) The user fee must be attached to Form 3115.

If you have not furnished all information, including the amount of the adjustment under section 481(a), within the first 90 days after the beginning of the year of change, the IRS will notify you. Then you have 120 days after the beginning of the year of change to complete your application or your case will be closed and the IRS will not process your Form 3115. In order to assist in the processing of these early applications, type or print "FILED UNDER PARAGRAPH 5.01(3) of REV. PROC. 92–20" at the top of Form 3115.

If your early application is not perfected within 120 days, or if your Consent Agreement, discussed earlier, is not signed and returned to the IRS, and you file another early application for a later tax year requesting the same accounting method change requested in the first application, you must attach a copy of the first Form 3115 you filed and any related correspondence. Also, you must attach an explanation as to why the application was not perfected or why the change was not made.

Conferences. At the time you file your Form 3115, you should indicate whether or not you request a conference if the IRS considers an unfavorable response to your request. If you do not request a conference, the IRS presumes that you do not want one.

If you specifically request a conference, the National Office will arrange one before the IRS formally replies to your Form 3115.

Two or more businesses. If you operate two or more separate and distinct trades or businesses, you can use a different accounting method for each, provided the method used clearly reflects the income of each trade or business. A business is separate and distinct if books and records are maintained for each trade or business.

However, if the use of different accounting methods creates or shifts profits or losses between your trades or businesses (for example, through inventory adjustments, sales, purchases, or expenses) so that income is not clearly reflected, your businesses will not be considered separate and distinct. If you request a change in accounting method for any

of these businesses, your request will not be processed and the IRS will return your Form 3115 unless the proposed change in method corrects the defect, resulting in a clear reflection of income. In addition to filing a completed current Form 3115, you must also identify all of your other trades or businesses by name and employer identification number and the method of accounting used by each.

Incomplete Form 3115. If your application is not properly completed according to the instructions for a current Form 3115, you will be notified and given 45 days from the date of the notification letter to furnish the necessary information. The IRS will not process an incomplete application. However, the IRS may grant an additional 15 days to furnish the information in very unusual and compelling circumstances. Your written request for the 15-day extension must be submitted within the 45-day period.

Taxpayers under examination. If you have been contacted by the IRS to schedule an examination of any of your returns, you may only request consent to change your accounting method (without the consent of the District Director) during limited time periods, as provided in section 6 of Revenue Procedure 92–20. For example, you may request a change of your method of accounting during a 90-day period beginning on the date you are contacted by the IRS to schedule an examination. If the examination continues for 18 months, you may request consent to change your accounting method during the first 30 days of your next tax year.

Alternatively, you may request consent to change your accounting method after receiving the consent of the District Director to file Form 3115. However, Rev. Proc. 92–20 does not apply in certain cases. For example, it does not apply to cases under examination by the IRS in which the year or years under examination include the tax year in which you started the practice or method that is at issue.

Expeditious Procedure Rules

There are expeditious procedures under which certain taxpayers may presume to have IRS consent to change their method of accounting. The consent is granted for the tax year for which the taxpayer requests a change (year of change) provided that the taxpayer complies with the provisions of the applicable revenue procedure. No user fee is required for an application filed under any of these procedures.

Some of these rules that apply to businesses generally are listed below. You will need Form 3115 to request a change under any of these procedures.

Overall Change to an Accrual Method

Revenue Procedure 92–74. This procedure applies if you are required to use inventories to determine income, and use the cash method of accounting as your overall method, and you want to change to an overall accrual method, or to an accrual method in conjunction with a request to change to a special method, such as long-term contract accounting. See Rev. Proc. 92–74, C.B. 1992–2, p. 442, for more information.

Revenue Procedure 92–75. This procedure applies if you do not have to use inventories to determine income, and you use the cash method of accounting as your overall method and you want to change to an overall accrual method, or to an accrual method in conjunction with a request to change to a special method, such as long-term contract accounting. See Rev. Proc. 92–75, C.B. 1992–2, p. 448, for more information.

Excluded taxpayers. Certain categories of taxpayers are excluded from using these procedures. In addition, other taxpayers are excluded under certain circumstances. For example, both revenue procedures exclude taxpayers who are under examination or who have been contacted by the IRS.

If you want to change to an accrual method and are eligible to use one of the expeditious procedures described above, file a copy of Form 3115 with the National Office of the IRS when the return is filed for the year of change. The original should be attached to your return for the year of change. These procedures do not apply to taxpayers who must discontinue use of the cash method. See *Automatic Change to Accrual Method,* discussed later.

Discontinuing the LIFO Inventory Method

Revenue Procedure 88–15. This procedure applies if you want to discontinue the use of the LIFO inventory method for all of your LIFO inventory and change to one of the methods specifically permitted. However, certain taxpayers are prohibited from using this revenue procedure.

For this procedure, a permitted method is a method under which:

1) The identification method is either the FIFO method or the specific identification method, and

2) The valuation method is cost; cost or market, whichever is lower; market; the "farm-price method" or the "unit-livestock-price method"; or the retail method, as long as you are eligible to use the method selected.

The inventory method you select, if you are discontinuing the use of the LIFO inventory method, must be in accordance with section 1.472–6 of the Income Tax Regulations. See Rev. Proc. 88–15, C.B. 1988–1, p. 683, for more information.

Change of Method of Depreciation

Revenue Procedure 74–11. Use this procedure to get expeditious consent to change certain methods of depreciation accounting to certain other methods under section 167 of the Internal Revenue Code. This procedure does not apply to property depreciated under ACRS or MACRS.

Any change from one method of depreciation to another method under this procedure must result in a reasonable allowance for depreciation in accordance with the provisions, conditions, and limitations of section 167 and the Income Tax Regulations thereunder.

See Rev. Proc. 74–11, C.B. 1974–1, p. 420, for more information.

Automatic Changes

Some changes are required by law and do not require consent from the IRS. Two of these are discussed below. See Revenue Procedure 95–1 for a list of other automatic change procedures relating to changes in accounting methods.

Automatic Change to Accrual Method

If you must change from the cash method to an accrual method, discussed earlier under *Limits on Use of Cash Method,* you do not have to have prior approval from the IRS to make this change. However, if you do not make this change by the due date (including extensions) of the income tax return for the first tax year affected, you must get prior approval from the IRS as explained earlier under *Consent To Change.* In this case, you will generally be subject to terms and conditions that would place you in a position no more favorable than a taxpayer who made a timely change.

Any adjustment required by section 481(a) of the Internal Revenue Code must be included in income over the lesser of:

1) The number of tax years you used the cash method, or

2) 4 tax years (10 years for a hospital).

If you go out of business before the end of the section 481(a) adjustment period, you must take into account, in the year you end your business, the balance of the section 481(a) adjustment not previously taken into account in computing taxable income.

Form 3115. Although this change to the overall accrual method is regarded as automatic, you must complete and file Form 3115 by the due date (including extensions) for filing your income tax return. Attach Form 3115 with the applicable user fee to your income tax return. In addition, you must attach a statement to your income tax return indicating the period over which the section 481(a) adjustment is to be taken into account and your basis for making this conclusion. At the top of Form 3115, you should have the statement, "AUTOMATIC CHANGE TO ACCRUAL METHOD—SECTION 448."

Change to Special Method

If you wish to use a special method, such as a long-term contract method, in addition to an overall accrual method, you must follow the requirements discussed above under *Consent To Change* for obtaining IRS consent to use the special method. You must type or print at the top of Form 3115: ''CHANGE TO A SPECIAL METHOD OF ACCOUNTING—SECTION 448.''

If your application for change to a special method is approved, include your section 481(a) adjustment in income as explained in the preceding discussion. However, if the application is not approved, you must make an automatic change to an overall accrual method of accounting as explained in that preceding discussion. If the application is not timely filed, you must get prior approval from the IRS. In this case, you will generally be subject to terms and conditions that would place you in a position no more favorable than a taxpayer who filed a timely application. See Income Tax Regulation 1.446–1(e) for more information.

Inventories

If you must adopt the uniform capitalization rules, the accounting method change is made by revaluing the items or costs included in your beginning inventory for the year of change as if the capitalization rules had been in effect in all prior periods. In revaluing inventory costs, the capitalization rules apply to all inventory costs accumulated in prior periods. The difference between the inventory as originally valued and the inventory as revalued is equal to the amount of the adjustment required under section 481(a).

If you are required to make this change, and do so timely, that is, for the first tax year that you are subject to the uniform capitalization rules, it is automatic and you do not need prior approval from the IRS. Otherwise, prior approval is required.

A change is required under the capitalization rules if the change is necessary for you to properly allocate and capitalize costs for production and resale activities.