



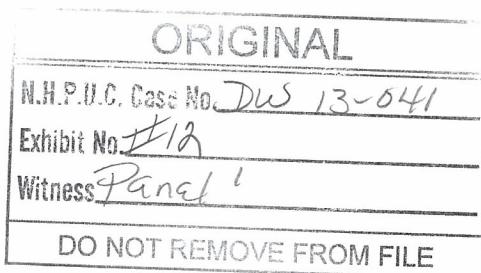
Department of the Treasury  
Internal Revenue Service

## Publication 538

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# Accounting Periods and Methods



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## Introduction

Every taxpayer (individuals, business entities, etc.) must figure taxable income on the basis of an annual accounting period called a tax year. The calendar year is the most common tax year. Other tax years include a fiscal year and a short tax year.

Each taxpayer must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are the cash method and the accrual method.

Under the cash method, you generally report income in the tax year you receive it, and deduct expenses in the tax year in which you pay them.

Under the accrual method, you generally report income in the tax year you earn it, regardless of when payment is received. You deduct expenses in the tax year you incur them, regardless of when payment is made.



*This publication explains some of the rules for accounting periods and accounting methods. In some cases, you may have to refer to other sources for a more in-depth explanation of the topic.*

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## Reminders

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

## Useful Items

You may want to see:

### Publication

- 537** Installment Sales
- 541** Partnerships
- 542** Corporations

### Form (and Instructions)

- 1128** Application To Adopt, Change, or Retain a Tax Year
- 2553** Election by a Small Business Corporation
- 3115** Application for Change in Accounting Method

### **8716** Election To Have a Tax Year Other Than a Required Tax Year

See *Ordering forms and publications*, earlier for information about getting these publications and forms.

## Accounting Periods

You must use a tax year to figure your taxable income. A tax year is an annual accounting period for keeping records and reporting income and expenses. An annual accounting period does not include a short tax year (discussed later). You can use the following tax years:

- A calendar year; or
- A fiscal year (including a 52-53-week tax year).

Unless you have a required tax year, you adopt a tax year by filing your first income tax return using that tax year. A required tax year is a tax year required under the Internal Revenue Code or the Income Tax Regulations. You cannot adopt a tax year by merely:

- Filing an application for an extension of time to file an income tax return;
- Filing an application for an employer identification number (Form SS-4); or
- Paying estimated taxes.

This section discusses:

- A calendar year.
- A fiscal year (including a period of 52 or 53 weeks).
- A short tax year.
- An improper tax year.
- A change in tax year.
- Special situations that apply to individuals.
- Restrictions that apply to the accounting period of a partnership, S corporation, or personal service corporation.
- Special situations that apply to corporations.

## Calendar Year

A calendar year is 12 consecutive months beginning on January 1st and ending on December 31st.

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

If you file your first tax return using the calendar tax year and you later begin business as a sole proprietor, become a partner in a partnership, or become a shareholder in an S corporation, you must continue to use the calendar year unless you obtain approval from the IRS to change it,

or are otherwise allowed to change it without IRS approval. See *Change in Tax Year*, later.

Generally, anyone can adopt the calendar year. However, you must adopt the calendar year if:

- You keep no books or records;
- You have no annual accounting period;
- Your present tax year does not qualify as a fiscal year; or
- You are required to use a calendar year by a provision in the Internal Revenue Code or the Income Tax Regulations.

## Fiscal Year

A fiscal year is 12 consecutive months ending on the last day of any month except December 31st. If you are allowed to adopt a fiscal year, you must consistently maintain your books and records and report your income and expenses using the time period adopted.

## 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 52-53-week tax year must always end on the same day of the week. Your 52-53-week tax year must always end on:

- Whatever date this same day of the week last occurs in a calendar month, or
- Whatever date this same day of the week falls that is nearest to the last day of the calendar month.

For example, if you elect a tax year that always ends on the last Monday in March, your 2012 tax year will end on March 25, 2013.

**Election.** To make the election for the 52-53-week tax year, attach a statement with the following information to your tax return.

1. The month in which the new 52-53-week tax year ends.
2. The day of the week on which the tax year always ends.
3. The date the tax year ends. It can be either of the following dates on which the chosen day:
  - a. Last occurs in the month in (1), above, or
  - b. Occurs nearest to the last day of the month in (1), above.

When you figure depreciation or amortization, a 52-53-week tax year is generally considered a year of 12 calendar months.

To determine an effective date (or apply provisions of any law) 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 tax year is considered to:

- Begin on the first day of the calendar month beginning nearest to the first day of the 52-53-week tax year, and
- End on the last day of the calendar month ending nearest to the last day of the 52-53-week tax year.

**Example.** Assume a tax provision applies to tax years beginning on or after July 1, 2012, which happens to be a Sunday. For this purpose, a 52-53-week tax year that begins on the last Tuesday of June, which falls on June 26, 2012, is treated as beginning on July 1, 2012.

## Short Tax Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when you (as a taxable entity):

- Are not in existence for an entire tax year, or
- Change your accounting period.

Tax on a short period tax return is figured differently for each situation.

## Not in Existence Entire Year

Even if a taxable entity was not in existence for the entire year, a tax return is required for the time it was in existence. Requirements for filing the return and figuring the tax are generally the same as the requirements for a return for a full tax year (12 months) ending on the last day of the short tax year.

**Example 1.** XYZ Corporation was organized on July 1, 2012. It elected the calendar year as its tax year. Therefore, its first tax return was due March 15, 2013. This short period return will cover the period from July 1, 2012, through December 31, 2012.

**Example 2.** A calendar year corporation dissolved on July 23, 2012. Its final return is due by October 15, 2012. It will cover the short period from January 1, 2012, through July 23, 2012.

**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. The decedent's final return will be a short period tax return that begins on January 1st, and ends on the date of death. In the case of a decedent who dies on December 31st, the last day of the regular tax year, a full calendar-year tax return is required.

**Example.** Agnes Green was a single, calendar year taxpayer. She died on March 6, 2012. Her final income tax return must be filed by April 15, 2013. It will cover the short period from January 1, 2012, to March 6, 2012.

## Figuring Tax for Short Year

If the IRS approves a change in your tax year or you are required to change your tax year, you must figure the tax and file your return for the short tax period. The short tax period begins on the first day after the close of your old tax year and ends on the day before the first day of your new tax year.

Figure tax for a short year under the general rule, explained below. You may then be able to use a relief procedure, explained later, and claim a refund of part of the tax you paid.

**General rule.** Income tax for a short tax year must be annualized. However, self-employment tax is figured on the actual self-employment income for the short period.

**Individuals.** An individual must figure income tax for the short tax year as follows.

1. Determine your adjusted gross income (AGI) for the short tax year and then subtract your actual itemized deductions for the short tax year. You must itemize deductions when you file a short period tax return.
2. Multiply the dollar amount of your 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). The result 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. The result is your annualized income.
5. Figure the total tax on your annualized income using the appropriate tax rate schedule.
6. Multiply the total tax by the number of months in the short tax year and divide the result by 12. The result is your tax for the short tax year.

**Relief procedure.** Individuals and corporations can use a relief procedure to figure the tax for the short tax year. It may result in less tax. Under this procedure, the tax is figured by two separate methods. If the tax figured under both methods is less than the tax figured under the general rule, you can file a claim for a refund of part of the tax you paid. For more information, see section 443(b)(2) of the Internal Revenue Code.

**Alternative minimum tax.** To figure the alternative minimum tax (AMT) due for a short tax year:

1. Figure the annualized alternative minimum taxable income (AMTI) for the short tax period by completing the following steps.
  - a. Multiply the AMTI by 12.
  - b. Divide the result by the number of months in the short tax year.
2. Multiply the annualized AMTI by the appropriate rate of tax under section 55(b)(1) of the Internal Revenue Code. The result is the annualized AMT.

3. Multiply the annualized AMT by the number of months in the short tax year and divide the result by 12.

For information on the AMT for individuals, see the Instructions for Form 6251, Alternative Minimum Tax—Individuals. For information on the AMT for corporations, see the Instructions to Form 4626, Alternative Minimum Tax—Corporations.

**Tax withheld from wages.** You can claim a credit against your income tax liability for federal income tax withheld from your wages. Federal income tax is withheld 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.

## Improper Tax Year

Taxpayers that have adopted an improper tax year must change to a proper tax year. For example, if a taxpayer began business on March 15 and adopted a tax year ending on March 14 (a period of exactly 12 months), this would be an improper tax year. See *Accounting Periods*, earlier, for a description of permissible tax years.

To change to a proper tax year, you must do one of the following.

- If you are requesting a change to a calendar tax year, file an amended income tax return based on a calendar tax year that corrects the most recently filed tax return that was filed on the basis of an improper tax year. Attach a completed Form 1128 to the amended tax return. Write "FILED UNDER REV. PROC. 85-15" at the top of Form 1128 and file the forms with the Internal Revenue Service Center where you filed your original return.
- If you are requesting a change to a fiscal tax year, file Form 1128 in accordance with the form instructions to request IRS approval for the change.

## Change in Tax Year

Generally, you must file Form 1128 to request IRS approval to change your tax year. See the Instructions for Form 1128 for exceptions. If you qualify for an automatic approval request, a user fee is not required.

## Individuals

Generally, individuals must adopt the calendar year as their tax year. An individual can adopt a fiscal year provided that the individual maintains his or her books and records on the basis of the adopted fiscal year.

## **Partnerships, S Corporations, and Personal Service Corporations (PSCs)**

Generally, partnerships, S corporations (including electing S corporations), and PSCs must use a required tax year. A required tax year is a tax year that is required under the Internal Revenue Code and Income Tax Regulations. The entity does not have to use the required tax year if it receives IRS approval to use another permitted tax year or makes an election under section 444 of the Internal Revenue Code (discussed later). The following discussions provide the rules for partnerships, S corporations, and PSCs.

### **Partnership**

A partnership must conform its tax year to its partners' tax years unless any of the following apply.

- The partnership makes an election under section 444 of the Internal Revenue Code to have a tax year other than a required tax year by filing Form 8716.
- The partnership elects to use a 52-53-week tax year that ends with reference to either its required tax year or a tax year elected under section 444.
- The partnership can establish a business purpose for a different tax year.

The rules for the required tax year for partnerships are as follows.

- If one or more partners having the same tax year own a majority interest (more than 50%) in partnership profits and capital, the partnership must use the tax year of those partners.
- If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.



*If a partnership changes to a required tax year because of these rules, it can get automatic approval by filing Form 1128.*

**Least aggregate deferral of income.** The tax year that results in the least aggregate deferral of income is determined as follows.

1. Figure 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 that tax year forward to the end of each other partner's tax year.

2. Multiply each partner's months of deferral figured 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 (total) deferral for the tax year used in step (1).
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 the calculation results in more than one tax year qualifying as the tax year with the least aggregate deferral, the partnership can choose any one of those tax years as its tax year. However, if one of the tax years that qualifies is the partnership's existing tax year, the partnership must retain that tax year.

**Example.** A and B each have a 50% interest in partnership P, which uses a fiscal year ending June 30. A uses the calendar year and B uses a fiscal year ending November 30. P must change its tax year to a fiscal year ending November 30 because this results in the least aggregate deferral of income to the partners, as shown in the following table.

Year End 12/31:	Year End 12/31	Profits Interest 0.5	Months of Deferral -0-	Interest x Deferral -0-
A	12/31	0.5	-0-	-0-
B	11/30	0.5	11	5.5
Total Deferral .....				5.5
Year End 11/30:	Year End 12/31	Profits Interest 0.5	Months of Deferral 1	Interest x Deferral 0.5
A	12/31	0.5	1	0.5
B	11/30	0.5	-0-	-0-
Total Deferral .....				0.5

**When determination is made.** The determination of the tax year under the least aggregate deferral rules must generally be made at the beginning of the partnership's current tax year. However, the IRS can require the partnership to use another day or period that will more accurately reflect the ownership of the partnership. This could occur, for example, if a partnership interest was transferred for the purpose of qualifying for a particular tax year.

**Short period return.** When a partnership changes its tax year, a short period return must be filed. The short period return covers the months between the end of the partnership's prior tax year and the beginning of its new tax year.

If a partnership changes to the tax year resulting in the least aggregate deferral, it must file a Form 1128 with the short period return showing the computations used to determine that tax year. The short period return must indicate at the top of page 1, "FILED UNDER SECTION 1.706-1."

**More information.** For more information about changing a partnership's tax year, and information about ruling requests, see the Instructions for Form 1128.

## S Corporation

All S corporations, regardless of when they became an S corporation, must use a permitted tax year. A permitted tax year is any of the following.

- The calendar year.
- A tax year elected under section 444 of the Internal Revenue Code. See *Section 444 Election*, below for details.
- A 52-53-week tax year ending with reference to the calendar year or a tax year elected under section 444.
- Any other tax year for which the corporation establishes a business purpose.

If an electing S corporation wishes to adopt a tax year other than a calendar year, it must request IRS approval using Form 2553, instead of filing Form 1128. For information about changing an S corporation's tax year and information about ruling requests, see the Instructions for Form 1128.

## Personal Service Corporation (PSC)

A PSC must use a calendar tax year unless any of the following apply.

- The corporation makes an election under section 444 of the Internal Revenue Code. See *Section 444 Election*, below for details.
- The corporation elects to use a 52-53-week tax year ending with reference to the calendar year or a tax year elected under section 444.
- The corporation establishes a business purpose for a fiscal year.

See the Instructions for Form 1120 for general information about PSCs. For information on adopting or changing tax years for PSCs and information about ruling requests, see the Instructions for Form 1128.

## Section 444 Election

A partnership, S corporation, electing S corporation, or PSC can elect under section 444 of the Internal Revenue Code to use a tax year other than its required tax year. Certain restrictions apply to the election. A partnership or an S corporation that makes a section 444 election must make certain required payments and a PSC must make certain distributions (discussed later). The section 444 election does not apply to any partnership, S corporation, or PSC that establishes a business purpose for a different period, explained later.

A partnership, S corporation, or PSC can make a section 444 election if it meets all the following requirements.

- It is not a member of a tiered structure (defined in section 1.444-2T of the regulations).
- It has not previously had a section 444 election in effect.

- It elects a year that meets the deferral period requirement.

**Deferral period.** The determination of the deferral period depends on whether the partnership, S corporation, or PSC is retaining its tax year or adopting or changing its tax year with a section 444 election.

**Retaining tax year.** Generally, a partnership, S corporation, or PSC can make a section 444 election to retain its tax year only if the deferral period of the new tax year is 3 months or less. This deferral period is the number of months between the beginning of the retained year and the close of the first required tax year.

**Adopting or changing tax year.** If the partnership, S corporation, or PSC is adopting or changing to a tax year other than its required year, the deferral period is the number of months from the end of the new tax year to the end of the required tax year. The IRS will allow a section 444 election only if the deferral period of the new tax year is less than the shorter of:

- Three months, or
- The deferral period of the tax year being changed. This is the tax year immediately preceding the year for which the partnership, S corporation, or PSC wishes to make the section 444 election.

If the partnership, S corporation, or PSC's tax year is the same as its required tax year, the deferral period is zero.

**Example 1.** BD Partnership uses a calendar year, which is also its required tax year. BD cannot make a section 444 election because the deferral period is zero.

**Example 2.** E, a newly formed partnership, began operations on December 1. 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 is 3 months, the number of months between September 30 and December 31.

**Making the election.** Make a section 444 election by filing Form 8716 with the Internal Revenue Service Center where the entity will file its tax return. Form 8716 must be filed by the earlier of:

- The due date (not including extensions) of the income tax return for the tax year resulting from the section 444 election, or
- 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.

**Note.** If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day.

Attach a copy of Form 8716 to Form 1065, Form 1120S, or Form 1120 for the first tax year for which the election is made.

**Example 1.** AB, a partnership, begins operations on September 13, 2012, and is qualified to make a section

444 election to use a September 30 tax year for its tax year beginning September 13, 2012. AB must file Form 8716 by January 15, 2013, which is the due date of the partnership's tax return for the period from September 13, 2012, to September 30, 2012.

**Example 2.** The facts are the same as in *Example 1* except that AB begins operations on October 21, 2012. AB must file Form 8716 by March 17, 2013.

**Example 3.** B is a corporation that first becomes a PSC for its tax year beginning September 1, 2012. B qualifies to make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 2012. B must file Form 8716 by December 17, 2012, the due date of the income tax return for the short period from September 1, 2012, to September 30, 2012.

**Note.** The due dates in Examples 2 and 3 are adjusted because the dates fall on a Saturday, Sunday or legal holiday.

**Extension of time for filing.** There is an automatic extension of 12 months to make this election. See the Form 8716 instructions for more information.

**Terminating the election.** The section 444 election remains in effect until it is terminated. If the election is terminated, another section 444 election cannot be made for any tax year.

The election ends when any of the following applies to the partnership, S corporation, or PSC.

- The entity changes to its required tax year.
- The entity liquidates.
- The entity becomes a member of a tiered structure.
- The IRS determines that the entity willfully failed to comply with the required payments or distributions.

The election will also end if either of the following events occur.

- An S corporation's S election is terminated. However, if the S corporation immediately becomes a PSC, the PSC can continue the section 444 election of the S corporation.
- A PSC ceases to be a PSC. If the PSC elects to be an S corporation, the S corporation can continue the election of the PSC.

**Required payment for partnership or S corporation.** A partnership or an S corporation must make a required payment for any tax year:

- The section 444 election is in effect.
- The required payment for that year (or any preceding tax year) is more than \$500.

This payment represents the value of the tax deferral the owners receive by using a tax year different from the required tax year.

Form 8752, Required Payment or Refund Under Section 7519, must be filed each year the section 444 election is in effect, even if no payment is due. If the required payment is more than \$500 (or the required payment for any prior year was more than \$500), the payment must be made when Form 8752 is filed. If the required payment is \$500 or less and no payment was required in a prior year, Form 8752 must be filed showing a zero amount.

**Applicable election year.** Any tax year a section 444 election is in effect, including the first year, is called an applicable election year. Form 8752 must be filed and the required payment made (or zero amount reported) by May 15th of the calendar year following the calendar year in which the applicable election year begins.

**Required distribution for PSC.** A PSC with a section 444 election in effect must distribute certain amounts to employee-owners by December 31 of each applicable 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.** A partnership, S corporation, or PSC can file a back-up section 444 election if it requests (or plans to request) permission to use a business purpose tax year, discussed later. If the request is denied, the back-up section 444 election must be activated (if the partnership, S corporation, or PSC otherwise qualifies).

**Making back-up election.** The general rules for making a section 444 election, as discussed earlier, apply. When filing Form 8716, type or print "BACK-UP ELECTION" at the top of the form. However, if Form 8716 is filed on or after the date Form 1128 (or Form 2553) is filed, type or print "FORM 1128 (or FORM 2553) BACK-UP ELECTION" at the top of Form 8716.

**Activating election.** A partnership or S corporation activates its back-up election by filing the return required and making the required payment with Form 8752. The due date for filing Form 8752 and making the payment is the later of the following dates.

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

A PSC 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."

## 52-53-Week Tax Year

A partnership, S corporation, or PSC can use a tax year other than its required tax year if it elects a 52-53-week tax year (discussed earlier) that ends with reference to either its required tax year or a tax year elected under section 444 (discussed earlier).

A newly formed partnership, S corporation, or PSC can adopt a 52-53-week tax year ending with reference to either its required tax year or a tax year elected under section 444 without IRS approval. However, if the entity wishes to change to a 52-53-week tax year or change from a 52-53-week tax year that references a particular month to a non-52-53-week tax year that ends on the last day of that month, it must request IRS approval by filing Form 1128.

## Business Purpose Tax Year

A partnership, S corporation, or PSC establishes the business purpose for a tax year by filing Form 1128. See the Instructions for Form 1128 for details.

## Corporations (Other Than S Corporations and PSCs)

A new corporation establishes its tax year when it files its first tax return. 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. An S corporation or a PSC must use the required tax year rules, discussed earlier, to establish a tax year. Generally, a corporation that wants to change its tax year must obtain approval from the IRS under either the: **(a)** automatic approval procedures; or **(b)** ruling request procedures. See the Instructions for Form 1128 for details.

# Accounting Methods

An accounting method is a set of rules used to determine when income and expenses are reported on your tax return. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item.

You choose an accounting method when you file your first tax return. If you later want to change your accounting method, you must get IRS approval. See *Change in Accounting Method*, later.

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

You must use the same accounting method from year to year. An accounting method clearly reflects income

only if all items of gross income and expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly reflects your income, your income will be refigured under the method that, in the opinion of the IRS, does clearly reflect income.

**Methods you can use.** In general, you can compute your taxable income under any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- A hybrid method which combines elements of two or more of the above accounting methods.

The cash and accrual methods of accounting are explained later.

**Special methods.** This publication does not discuss special methods of accounting for certain items of income or expenses. For information on reporting income using one of the long-term contract methods, see section 460 of the Internal Revenue Code and the related regulations. The following publications also discuss special methods of reporting income or expenses.

- Publication 225, *Farmer's Tax Guide*.
- Publication 535, *Business Expenses*.
- Publication 537, *Installment Sales*.
- Publication 946, *How To Depreciate Property*.

**Hybrid method.** Generally, you can use any combination of cash, accrual, and special methods of accounting if the combination clearly reflects your income and you use it consistently. However, the following restrictions apply.

- If an inventory is necessary to account for your income, you must use an accrual method for purchases and sales. See *Exceptions under Inventories*, later. Generally, you can use the cash method for all other items of income and expenses. See *Inventories*, later.
- If you use the cash method for reporting your income, you must use the cash method for reporting your expenses.
- 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 for purposes of section 448 of the Internal Revenue Code.

**Business and personal items.** You can account for business and personal items using different accounting methods. For example, you can determine your business

income and expenses under an accrual method, even if you use the cash method to figure personal items.

**Two or more businesses.** If you operate two or more separate and distinct businesses, you can use a different accounting method for each business. No business is separate and distinct, unless a complete and separate set of books and records is maintained for each business.

**Note.** If you use different accounting methods to create or shift profits or losses between businesses (for example, through inventory adjustments, sales, purchases, or expenses) so that income is not clearly reflected, the businesses will not be considered separate and distinct.

## Cash Method

Most individuals and many small businesses use the cash method of accounting. Generally, if you produce, purchase, or sell merchandise, you must keep an inventory and use an accrual method for sales and purchases of merchandise. See *Inventories*, later, for exceptions to this rule.

### Income

Under the cash method, you include in your gross income all items of income you actually or constructively receive during the tax year. If you receive property and services, you must include their fair market value (FMV) in income.

**Constructive receipt.** Income is constructively received when an amount is credited to your account or made available to you without restriction. You need not have possession of it. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations.

**Example.** You are a calendar year taxpayer. Your bank credited, and made available, interest to your bank account in December 2012. You did not withdraw it or enter it into your books until 2013. You must include the amount in gross income for 2012, the year you constructively received it.

**TIP** *You cannot hold checks or postpone taking possession of similar property from one tax year to another to postpone 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

Under the cash method, generally, you deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance. Instead, you may be required to capitalize certain costs, as explained later under *Uniform Capitalization Rules*.

**Expense paid in advance.** An expense you pay in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule.

Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following.

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

If you have not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses you paid in advance, you must obtain approval from the IRS before using the general rule and/or the 12-month rule. See *Change in Accounting Method*, later.

**Example 1.** You are a calendar year taxpayer and pay \$3,000 in 2012 for a business insurance policy that is effective for three years (36 months), beginning on July 1, 2012. The general rule that an expense paid in advance is deductible only in the year to which it applies is applicable to this payment because the payment does not qualify for the 12-month rule. Therefore, only \$500 ( $6/36 \times \$3,000$ ) is deductible in 2012, \$1,000 ( $12/36 \times \$3,000$ ) is deductible in 2013, \$1,000 ( $12/36 \times \$3,000$ ) is deductible in 2014, and the remaining \$500 is deductible in 2015.

**Example 2.** You are a calendar year taxpayer and pay \$10,000 on July 1, 2012, for a business insurance policy that is effective for only one year beginning on July 1, 2012. The 12-month rule applies. Therefore, the full \$10,000 is deductible in 2012.

### Excluded Entities

The following entities cannot use the cash method, including any combination of methods that includes the cash method. (See *Special rules for farming businesses*, later.)

- A corporation (other than an S corporation) with average annual gross receipts exceeding \$5 million. See *Gross receipts test*, below.
- A partnership with a corporation (other than an S corporation) as a partner, and with the partnership having average annual gross receipts exceeding \$5 million. See *Gross receipts test*, below.
- A tax shelter.

### Exceptions

The following entities are not prohibited from using the cash method of accounting.

- Any corporation or partnership, other than a tax shelter, that meets the gross receipts test for all tax years after 1985.
- A qualified personal service corporation (PSC).

**Gross receipts test.** A corporation or partnership, other than a tax shelter, that meets the gross receipts test can generally use the cash method. A corporation or a partnership meets the test if, for each prior tax year beginning after 1985, its average annual gross receipts are \$5 million or less.

An entity's average annual gross receipts for a prior tax year is determined by:

1. Adding the gross receipts for that tax year and the 2 preceding tax years; and
2. Dividing the total by 3.

See *Gross receipts test for qualifying taxpayers*, for more information. Generally, a partnership applies the test at the partnership level. Gross receipts for a short tax year are annualized.

**Aggregation rules.** Organizations that are members of an affiliated service group or a controlled group of corporations treated as a single employer for tax purposes are required to aggregate their gross receipts to determine whether the gross receipts test is met.

**Change to accrual method.** A corporation or partnership that fails to meet the gross receipts test for any tax year is prohibited from using the cash method and must change to an accrual method of accounting, effective for the tax year in which the entity fails to meet this test.

**Special rules for farming businesses.** Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain corporations (other than S corporations) and partnerships that have a partner that is a corporation must use an accrual method for their farming business. For this purpose, farming does not include the operation of a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees).

There is an exception to the requirement to use an accrual method for corporations with gross receipts of \$1 million or less for each prior tax year after 1975. For family corporations engaged in farming, the exception applies if gross receipts were \$25 million or less for each prior tax year after 1985. See chapter 2 of Publication 225, *Farmer's Tax Guide*, for more information.

**Qualified PSC.** A PSC that meets the following function and ownership tests can use the cash method.

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

**Ownership test.** A corporation meets the ownership test if at least 95% of its stock is owned, directly or indirectly, at all times during the year by one or more of the following.

1. Employees performing services for the corporation in a field qualifying under the function test.

2. Retired employees who had performed services in those fields.
3. The estate of an employee described in (1) or (2).
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 PSCs. Stock owned by one of these entities 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 when determining if the ownership test is met.

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

**Change to accrual method.** A corporation that fails to meet the function test for any tax year; or fails to meet the ownership test at any time during any tax year must change to an accrual method of accounting, effective for the year in which the corporation fails to meet either test. A corporation that fails to meet the function test or the ownership test is not treated as a qualified PSC for any part of that tax year.

## Accrual Method

Under the accrual method of accounting, generally you report income in the year it is earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

### Income

Generally, you include an amount in gross income for the tax year in which all events that fix your right to receive the income have occurred and you can determine the amount with reasonable accuracy. Under this rule, you report an amount in your gross income on the earliest of the following dates.

- When you receive payment.
- When the income amount is due to you.
- When you earn the income.
- When title has passed.

**Estimated income.** If you include a reasonably estimated amount in gross income and later determine the exact amount is different, take the difference into account in the tax year you make that determination.

**Change in payment schedule.** If you perform services for a basic rate specified in a contract, you must accrue the income at the basic rate, even if you agree to receive

payments at a reduced rate. Continue this procedure until you complete the services, then account for the difference.

## Advance Payment for Services

Generally, you report an advance payment for services to be performed in a later tax year as income in the year you receive the payment. However, if you receive an advance payment for services you agree to perform by the end of the next tax year, you can elect to postpone including the advance payment in income until the next tax year. However, you cannot postpone including any payment beyond that tax year.

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

**Postponement not allowed.** Generally, one cannot postpone including an advance payment in income for services if either of the following applies.

- You are to perform any part of the service after the end of the tax year immediately following the year you receive the advance payment.
- You are to perform any part of the service at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payment.

**Examples.** In each of the following examples, assume the tax year is a calendar year and that the accrual method of accounting is used.

**Example 1.** You manufacture, sell, and service computers. You received payment in 2012 for a one-year contingent service contract on a computer you sold. You can postpone including in income the part of the payment you did not earn in 2012 if, in the normal course of your business, you offer computers for sale without a contingent service contract.

**Example 2.** You are in the television repair business. You received payments in 2012 for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets manufactured and sold by unrelated parties. You include the payments in gross income as you earn them.

**Example 3.** You own a dance studio. On October 1, 2012, you receive payment for a one-year contract for 48 one-hour lessons beginning on that date. You give eight lessons in 2012. Under this method of including advance payments, you must include one-sixth (8/48) of the payment in income for 2012, and five-sixths (40/48) of the payment in 2013, even if you do not give all the lessons by the end of 2013.

**Example 4.** Assume the same facts as in *Example 3*, except the payment is for a two-year contract for 96 lessons. You must include the entire payment in income in 2012 since part of the services may be performed after the following year.

**Guarantee or warranty.** Generally, you cannot postpone reporting income you receive under a guarantee or warranty contract.

**Prepaid rent.** You cannot postpone reporting income from prepaid rent. Prepaid rent does not include payment for the use of a room or other space when significant service is also provided for the occupant. You provide significant service when you supply space in a hotel, boarding house, tourist home, motor court, motel, or apartment house that furnishes hotel services.

**Books and records.** Any advance payment you include in gross receipts on your tax return for the year you receive payment must not be less than the payment you include in income for financial reports under the method of accounting used for those reports. Financial reports include reports to shareholders, partners, beneficiaries, and other proprietors for credit purposes and consolidated financial statements.

**IRS approval.** You must file Form 3115 to obtain IRS approval to change your method of accounting for advance payment for services.

## Advance Payment for Sales

Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods held primarily for sale to customers in the ordinary course of your trade or business. However, the rules do not apply to a payment (or part of a payment) for services that are not an integral part of the main activities covered under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts due and payable are considered received.

**How to report payments.** Generally, include an advance payment in income in the year in which you receive it. However, you can use the alternative method, discussed next.

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

- Include advance payments in gross receipts under the method of accounting you use for tax purposes, or
- Include any part of advance payments in income for financial reports under the method of accounting used for those reports. Financial reports include reports to shareholders, partners, beneficiaries, and other proprietors for credit purposes and consolidated financial statements.

**Example 1.** You are a retailer. You use an accrual method of accounting and account for the sale of goods

when you ship the goods. You use this method for both tax and financial reporting purposes. You can include advance payments in gross receipts for tax purposes in either: (a) the tax year in which you receive the payments; or (b) the tax year in which you ship the goods. However, see *Exception for inventory goods*, later.

**Example 2.** You are a calendar year taxpayer. You manufacture household furniture and use an accrual method of accounting. Under this method, 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 2012, you received an advance payment of \$8,000 for an order of furniture to be manufactured for a total price of \$20,000. You shipped the furniture to the customer in December 2012, but it was not delivered and accepted until January 2013. For tax purposes, you include the \$8,000 advance payment in gross income for 2012; and include the remaining \$12,000 of the contract price in gross income for 2013.

**Information schedule.** If you use the alternative method of reporting advance payments, you must attach a statement with the following information to your tax return each year.

- Total advance payments received in the current tax year.
- Total advance payments received in earlier tax years and not included in income before the current tax year.
- Total payments received in earlier tax years included in income for the current tax year.

**Exception for inventory goods.** If you have an agreement to sell goods properly included in inventory, you can postpone including the advance payment in income until the end of the second tax year following the year you receive an advance payment if, on the last day of the tax year, you meet the following requirements.

- You account for the advance payment under the alternative method (discussed earlier).
- You have received a substantial advance payment on the agreement (discussed next).
- You have enough substantially similar goods on hand, or available through your normal source of supply, to satisfy the agreement.

These rules also apply to an agreement, such as a gift certificate, that can be satisfied with goods that cannot be identified in the tax year you receive an advance payment.

If you meet these conditions, all advance payments you receive by the end of the second tax year, including payments received in prior years but not reported, must be included in income by the second tax year following the tax year of receipt of substantial advance payments. You must also deduct in that second year all actual or estimated costs for the goods required to satisfy the agreement. If you estimated the cost, you must take into account any

difference between the estimate and the actual cost when the goods are delivered.

**Note.** You must report any advance payments you receive after the second year in the year received. No further deferral is allowed.

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

**Example.** You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In 2008, you entered into a contract for the sale of goods properly includable 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 receive the following advance payments under the contract.

2009 .....	\$17,500
2010 .....	10,000
2011 .....	7,500
2012 .....	5,000
2013 .....	5,000
2014 .....	5,000
<b>Total contract price .....</b>	<b>\$50,000</b>

Your customer asked you to deliver the goods in 2015. In your 2010 closing inventory, you had on hand enough of the type of goods specified in the contract to satisfy the contract. Since the advance payments you had received by the end of 2010 were more than the costs you estimated, the payments are substantial advance payments.

For 2012, include in income all payments you received by the end of 2012, the second tax year following the tax year in which you received substantial advance payments. You must include \$40,000 in sales for 2012 (the total amounts received from 2009 through 2012) and include in inventory the cost of the goods (or similar goods) on hand. If no such goods are on hand, then estimate the cost necessary to satisfy the contract.

No further deferral is allowed. You must include in gross income the advance payment you receive each remaining year of the contract. Take into account the difference between any estimated cost of goods sold and the actual cost when you deliver the goods in 2015.

**IRS approval.** You must file Form 3115 to obtain IRS approval to change your method of accounting for advance payments for sales.

## Expenses

Under an accrual method of accounting, you generally deduct or capitalize a business expense when both the following apply.

1. The all-events test has been met. The test is met when:
  - a. All events have occurred that fix the fact of liability, and
  - b. The liability can be determined with reasonable accuracy.
2. Economic performance has occurred.

## Economic Performance

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

**Example.** You are a calendar year taxpayer. You buy office supplies in December 2012. You receive the supplies and the bill in December, but you pay the bill in January 2013. You can deduct the expense in 2012 because all events have occurred to fix the liability, the amount of the liability can be determined, and economic performance occurred in 2012.

Your office supplies may qualify as a recurring item, discussed later. If so, you can deduct them in 2012, even if the supplies are not delivered until 2013 (when economic performance occurs).

**Workers' compensation and tort liability.** If you are required to make payments under workers' compensation laws or in satisfaction of any tort liability, economic performance occurs as you make the payments. If you are required to make payments to a special designated settlement fund established by court order for a tort liability, economic performance occurs as you make the payments.

**Taxes.** Economic performance generally occurs as estimated income tax, property taxes, employment taxes, etc. are paid. However, you can elect to treat taxes as a recurring item, discussed later. You can also elect to ratably accrue real estate taxes. See chapter 5 of Publication 535 for information about real estate taxes.

**Other liabilities.** Other liabilities for which economic performance occurs as you make payments include liabilities for breach of contract (to the extent of incidental, consequential, and liquidated damages), violation of law, rebates and refunds, awards, prizes, jackpots, insurance, and warranty and service contracts.

**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.

**Compensation for services.** Generally, economic performance occurs as an employee renders service to the

employer. However, deductions for compensation or other benefits paid to an employee in a year subsequent to economic performance are subject to the rules governing deferred compensation, deferred benefits, and funded welfare benefit plans. For information on employee benefit programs, see Publication 15-B, Employer's Tax Guide to Fringe Benefits.

**Vacation pay.** You can take a current deduction for vacation pay earned by your employees if you pay it during the year or, if the amount is vested, within 2½ months after the end of the year. If you pay it later than this, you must deduct it in the year actually paid. An amount is vested if your right to it cannot be nullified or cancelled.

**Exception for recurring items.** An exception to the economic performance rule allows certain recurring items to be treated as incurred during the tax year even though economic performance has not occurred. The exception applies if all the following requirements are met.

1. The all-events test, discussed earlier, is met.
2. Economic performance occurs by the earlier of the following dates.
  - a. 8½ months after the close of the year.
  - b. The date you file a timely return (including extensions) for the year.
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.
4. Either:
  - a. The item is not material, or
  - b. Accruing the item in the year in which the all-events test is met results in a better match against income than accruing the item in the year of economic performance.

This exception does not apply to workers' compensation or tort liabilities.

**Amended return.** You may be able to file an amended return and treat a liability as incurred under the recurring item exception. You can do so if economic performance for the liability occurs after you file your tax return for the year, but within 8½ months after the close of the tax year.

**Recurrence and consistency.** To determine whether an item is recurring and consistently reported, consider the frequency with which the item and similar items are incurred (or expected to be incurred) and how you report these items for tax purposes. A new expense or an expense not incurred every year can be treated as recurring if it is reasonable to expect that it will be incurred 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. However, in certain situations an immaterial item for financial accounting purposes is treated as material for purposes of economic performance.

**Matching expenses with income.** Costs directly associated with the revenue of a period are properly allocable to that period. To determine whether the accrual of an expense in a particular year results in a better match with the income to which it relates, generally accepted accounting principles (GAAP; visit [www.fasab.gov/accepted.html](http://www.fasab.gov/accepted.html)) are an important factor.

For example, if you report sales income in the year of sale, but you do not ship the goods until the following year, the shipping costs are more properly matched to income in the year of sale than the year the goods are shipped. Expenses that cannot be practically associated with income of a particular period, such as advertising costs, should be assigned to the period the costs are incurred. However, the matching requirement is considered met for certain types of expenses. These expenses include taxes, payments under insurance, warranty, and service contracts, rebates, refunds, awards, prizes, and jackpots.

## Expenses Paid in Advance

An expense you pay in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following.

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

If you have not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses you paid in advance, you must get IRS approval before using the general rule and/or the 12-month rule. See *Change in Accounting Method*, later, for information on how to get IRS approval. See *Expense paid in advance under Cash Method*, earlier, for examples illustrating the application of the general and 12-month rules.

## Related Persons

Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until you make the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. See section 267 of the Internal Revenue Code and Publication 542, Corporations, for the definition of related person.

## Inventories

An inventory is necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If you must account for an inventory in your business, you must use an accrual method of accounting for your purchases and sales. However, see *Exceptions*, next. See also *Accrual Method*, earlier.

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

The rules for valuing inventory are not the same for all businesses. The method you use must conform to generally accepted accounting principles for similar businesses and must clearly reflect income. Your inventory practices must be consistent from year to year.



*The rules discussed here apply only if they do not conflict with the uniform capitalization rules of section 263A and the mark-to-market rules of section 475.*

## Exceptions

The following taxpayers can use the cash method of accounting even if they produce, purchase, or sell merchandise. These taxpayers can also account for inventoriable items as materials and supplies that are not incidental (discussed later).

- A qualifying taxpayer under Revenue Procedure 2001-10 on page 272 of Internal Revenue Bulletin 2001-2, available at [www.irs.gov/pub/irs-irbs/irb01-02.pdf](http://www.irs.gov/pub/irs-irbs/irb01-02.pdf).
- A qualifying small business taxpayer under Revenue Procedure 2002-28, on page 815 of Internal Revenue Bulletin 2002-18, available at [www.irs.gov/pub/irs-irbs/irb02-18.pdf](http://www.irs.gov/pub/irs-irbs/irb02-18.pdf).



*In addition to the information provided in this publication, you should see the revenue procedures referenced in the list, above, and the instructions for Form 3115 for information you will need to adopt or change to these accounting methods (see *Changing methods*, later).*

**Qualifying taxpayer.** You are a qualifying taxpayer under Revenue Procedure 2001-10 only if:

- You satisfy the gross receipts test for each prior tax year ending on or after December 17, 1998 (see *Gross receipts test for qualifying taxpayers*, next). Your average annual gross receipts for each test year (explained in Step 1, listed next) must be \$1 million or less.
- You are not a tax shelter as defined under section 448(d)(3) of the Internal Revenue Code.