Office of Chief Counsel
Internal Revenue Service
memorandum

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(Small Business/Self-Employed)

from: Michael J. Montemurro
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(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated April 8, 2011. This advice may not be used or cited as precedent.

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LEGEND

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
X =

Y =
Z =
Agreement =

ISSUES

You requested advice on the proper method of accounting for Taxpayer. You asked about the following issues:

1. Is Taxpayer's proper method of accounting the cash receipts and disbursements method (cash method) or an accrual method?
2. May Taxpayer use the completed-contract method under § 1.460-4(d) of the Income Tax Regulations?
3. May the Service require an adjustment under § 481 of the Internal Revenue Code for the tax year ending Year 3, relating to the possible impermissible method of accounting for tax years ending Year 1 and Year 2?
4. Is the 6-year statute of limitations open because Taxpayer did not report accrued income on its Form 1120S, *U.S. Income Tax Return for an S Corporation*?
5. Should the Service enter into an agreement on Form 906, *Closing Agreement on Final Determination Covering Specific Matters*, to finalize any determination of liability?

We need further factual information to respond to the above issues. Thus, we are closing the case pending further factual development by your office. Below is a brief summary of the facts as we understand them, followed by the information needed to determine Taxpayer's proper method of accounting.

FACTS

Taxpayer is an S Corporation that currently uses the overall cash method. Taxpayer is engaged in the health field and initially provided medical research assistance to academic clients such as hospitals. For example, it has provided the following type of services: research and development, analysis of clients' needs and objectives, procurement of medical equipment, asset evaluation and planning, construction management, market feasibility studies, site selections and evaluations, analysis of operations and management issues, healthcare facility design and construction supervision, contract negotiations, and other healthcare consulting services. Recently, Taxpayer's business has expanded to providing X. It has identified these goods as Y. Some, if not all, of this Y equipment appears to be in Z of Taxpayer's clients, which are then installed on the premises.

CASE DEVELOPMENT

Issue 1: Is Taxpayer's proper method of accounting the cash method or an accrual method?

To determine whether Taxpayer may use the cash method, two basic questions need to be addressed. The first question is whether § 448 prohibits Taxpayer from using the cash method. Because Taxpayer is an S Corporation, § 448 will not preclude Taxpayer from using the cash method, unless Taxpayer is a tax shelter as defined in § 448(d)(3).

Your office will need to determine whether Taxpayer is barred from using the cash method because it is a tax shelter.

The second question is whether Taxpayer is required to use an accrual accounting method. Taxpayer will normally be required to use an accrual method of accounting if it needs to take an inventory, unless Taxpayer is a qualifying small business taxpayer under Rev. Proc. 2002-28, 2002-1 C.B. 815. A qualifying small business taxpayer is exempt from having to use an accrual method even if it takes an inventory. Your office will need to determine whether Taxpayer is a qualifying small business taxpayer within the meaning of section 5.01 of Rev. Proc. 2002-28.

If Taxpayer is not a qualifying small business taxpayer, then your office will need to determine whether Taxpayer needs to take an inventory. If Taxpayer needs to take an inventory, then Taxpayer will be required to use at least an accrual method for the purchases and sales of its inventory. See § 1.446-1(c)(1)(iv) and (2)(i).

The submitted facts indicate that Taxpayer is producing, purchasing, or selling Y to its clients. Further, the submitted facts indicate that this production, purchase, or sale is an income-producing factor. To verify that Taxpayer's activities involving its Y is an income-producing factor, your office will need to compare Taxpayer's cost of its Y with Taxpayer's gross receipts determined using the cash method.

Issue 2: May Taxpayer use the completed-contract method under § 1.460-4(d)?

Generally, under § 460(a), a taxpayer that enters into a long-term contract for the manufacture, building, installation, or construction of property must report income and expenses from the long-term contract on the percentage-of-completion method (PCM). However, a long-term construction contract is exempt from the PCM if the taxpayer estimates (at the time it enters into the contract) that the contract will be completed within a two-year period beginning on the contract commencement date, but only if the taxpayer's average annual gross receipts for the three taxable years preceding the year in which the contract is entered into do not exceed $10,000,000. See § 460(e)(1) and § 1.460-3(b)(1) and (3).

To determine whether Taxpayer may use the completed-contract method, or if any method under § 460 for long-term contracts applies, this office needs to know the subject matter of Taxpayer's contracts, that is, what is the Y Taxpayer is supplying. From the facts submitted, it is unclear whether the installation of the Y in the customer's facility meets the definition of "installation" as used in § 1.460-3(b), is merely delivery of Taxpayer's inventory under § 471, or constitutes both activities as described in § 1.460-1(d)(1), or should properly be accounted for under some other method of accounting. Thus, your office must furnish this office with Appendix 1 to the Agreement, which describes the Y that Taxpayer will supply under the Agreement.

If Taxpayer's Agreement is a long-term construction contract, Taxpayer must use the PCM unless the contract is an exempt contract as described in § 1.460-3(b)(1) and (3). Under § 1.460-1(e), the Commissioner may treat one agreement as two or more contracts and two or more agreements as one contract, depending on the factors described in that paragraph.

Issue 3: May the Service require a § 481 adjustment for the tax year ending Year 3, relating to the possible impermissible method of accounting for tax years ending Year 1 and Year 2?

Whether the Service may make a § 481 adjustment depends on the answers to Issues 1 and 2. An adjustment under § 481 is necessary whenever amounts are being duplicated or omitted because of a change in method of accounting. Generally, when the Service imposes a change in method of accounting, the change is made in the earliest tax year under examination. Rev. Proc. 2002-18, 2002-1 C.B. 678.

Issue 4: Is the 6-year statute of limitations open because Taxpayer did not report accrued income on its Form 1120S, *U.S. Income Tax Return for an S Corporation*?

Whether Taxpayer is subject to the 6-year statute of limitations depends on the answers to Issues 1 and 2.

Issue 5: Should the Service enter into an agreement on Form 906, *Closing Agreement on Final Determination Covering Specific Matters*, to finalize any determination of liability?

Generally, this office does not consider whether the Service should enter into a closing agreement prior to the time substantive issues have been resolved. Thus, consideration of this issue should be deferred at this time.

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This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call at , or at if you have any further questions.