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Legal Alert: Sometimes Smaller Is Better—How H.R. 1 Offers Small Businesses Welcome Flexibility

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Through the sea of commentary generated by the provisions in the Tax Cuts and Jobs Act (H.R. 1 or the Act) and its 429 pages of legislative text, there may be a gold lining for small businesses. As discussed in a previous legal alert and in the Eversheds Sutherland Tax Reform Blog, the effects of this bill are both far-reaching and narrowly targeted. The provisions in the Act provide numerous opportunities that increase the flexibility small businesses have to reduce the administrative burden of certain tax compliance measures. Specifically, this legal alert focuses on the following provisions in the Act that impact small businesses: expansion of section 179 expensing, greater availability of the cash method of accounting, increased flexibility in accounting for inventories and long-term contracts, larger exemption from the UNICAP rules, and an exemption from the limitation on deductions for business interest.

Expansion of Section 179 Expensing

Congress enacted section 179 to provide small businesses a current-year deduction for the full purchase price of financed or leased equipment and qualifying off-the-shelf software. Intended for small businesses, section 179 placed a cap on the possible total amount written off—$500,000 for 2017—and limits for the total amount of equipment purchased—$2 million in 2017. The deduction begins to phase out dollar-for-dollar after a given business spends $2 million, thereby making it a true small- and medium-sized business deduction. Although the immediate expensing provision (discussed in a previous legal alert) captured a significant amount of the benefit provided for in section 179, for property outside the scope of the full expensing provision, the changes to section 179 may offer a great opportunity.

Section 3201 of the Act increases the section 179 expensing limitation to $5 million and the phase-out amount to $20 million, with both caps indexed for inflation. Similar to the aforementioned five-year period for full expensing, the expansion of section 179 would be available for tax years 2018–2022. In addition to increasing the section 179 caps on expensing and the correlating phase-out, section 3201 of the Act also modifies the definition of section 179 property. It adds to the historic definition, which included tangible personal property with a MACRS recovery period of 20 years or less, qualified energy-efficient heating and air-conditioning property, certain off-the-shelf computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Greater Availability to Adopt the Cash Method of Accounting

Section 3202 of the Act provides small business taxpayers with a welcome simplification to their accounting methods practice by expanding the universe of taxpayers that may use the cash method of accounting. Currently, sole proprietorships, partnerships (without a corporate partner), S corporations, and corporations and partnerships with corporate partners with average gross receipts less than $5 million may use the cash method of accounting to recognize income and deduct expenses. The Act increases the gross receipts threshold for corporations and partnerships with a corporate partner from $5 million to $25 million in order to qualify to use the cash method of accounting and repeals the requirement that these small businesses satisfy this requirement for all prior years. The new gross receipts test further allows taxpayers with average annual gross receipts that do not exceed $25 million for the three prior taxable-year periods to use the cash method.

Similar to the caps on section 179 expensing, the Act indexes the gross receipts test for inflation. The increased threshold extends to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations—all of which have significantly more restrictive thresholds currently that prevent them from using the cash method of accounting.

<u>Increased Flexibility in Accounting for Inventories</u>

In addition to increasing the qualification thresholds for corporations and partnerships with corporate partners to use the cash method of accounting, section 3202 of the Act allows businesses with average gross receipts less than $25 million that maintain inventories to use the cash method of accounting. If choosing to use the cash method of accounting, qualifying taxpayers may account for inventory as non-incidental materials and supplies. Currently, businesses are required to use an inventory method if maintaining inventory is a material income-producing factor to the business, and these taxpayers are required to use the accrual method of accounting for tax purposes. There is an existing exception for small businesses and businesses in certain identified industries with annual gross receipts of less than $1 million and $10 million, respectively. But the new legislation clearly raises the thresholds for all, providing administrative relief to a number of taxpayers currently maintaining inventories as part of their businesses.

This provision allows small businesses to choose between (1) treating inventories as non-incidental materials and supplies or (2) following their current accounting method reflected on their applicable financial statements or books and records. This option will certainly be beneficial in circumstances where the treatments differ.

Section 3202 of the Act also increases the threshold for taxpayers with long-term contracts to qualify for the exemption from the requirement to use the percentage-of-completion method of accounting. With respect to taxpayers with long-term contracts, in order to be exempt from the requirement to use the percentage-of-completion method (as opposed to the completed contract method), taxpayers now must have average annual gross receipts of less than $25 million, as opposed to the current, more restrictive $10 million threshold. Businesses meeting this exception are permitted to use the completed-contract method (or any other permissible exempt contract method).

Enlarged Exemption from the UNICAP Rules

Lastly, section 3202 of the Act raises the average annual gross receipts threshold for taxpayers exempt from the uniform capitalization (UNICAP) rules from $10 million to $25 million. Currently, a business with less than $10 million of average annual gross receipts is not subject to the UNICAP rules with respect to personal property acquired for resale, but the legislation raises that threshold to $25 million and expands the exemption to personal and real property acquired or manufactured by such business, in addition to personal property acquired for resale.

It is important to remember that the rules for inventory valuation and identification remain largely unchanged, leaving small business taxpayers with multiple options for valuation and identification methods. For example, taxpayers not currently using the last in, first out method should consider whether electing to adopt this method makes sense for their 2017 tax year; such an election could yield permanent tax benefits.

Exemption from the Limitation on Deduction of Business Interest

Section 3301 of the Act subjects all businesses, regardless of form, to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. Section 3203 of the Act, however, exempts from this general rule businesses with average gross receipts of $25 million or less. This exemption effectively preserves for small businesses the existing deduction for business interest expenses.

Eversheds Sutherland Perspective

These provisions of the Act provide welcome opportunities to a greater number of small businesses. These businesses will benefit from larger deductions on an expanded definition of section 179 property; they will be able to use the cash method of accounting; and they will be able to choose how to account for inventory and long-term contracts. Small businesses will also be exempt from the UNICAP rules and the limitation on deductions of business interest. The threshold standard for each of these conventions is aligned to the same dollar amount, $25 million, to facilitate easier compliance.

Although there are countless opportunities for small businesses to maximize the available benefits through tax accounting adjustments, it is important to remember that application of many of these rules will result in a change in the taxpayer's method of accounting for that item and will require the filing of either an automatic or non-automatic accounting method change. Small businesses should review Rev. Proc. 2017-30 to determine whether such change is available automatically; if so, the deadline for filing the change is not until the taxpayer timely files its return for the 2017 tax year, which is October 15, 2018, for most calendar year taxpayers. If a change is not available automatically under Rev. Proc. 2017-30, any non-automatic change for the 2017 tax year must be filed by year end.

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If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.