PacificCPE

COURSE

33253A

S Corporation Accounting Methods, Tax Years, and Income

Getting the accounting and income reporting right is fundamental to S corporation compliance. This course examines the accounting methods and tax year options available to S corporations, then dives into how income and loss are recognized and reported. Whether you're preparing Form 1120-S or advising clients on tax planning, a solid grasp of these rules helps you navigate the pass-through reporting process with confidence and keep your clients on solid ground with the IRS.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- To recognize types of accounting methods and tax year elections offered to S corporations.
- To recognize the proper accounting treatment of items of income and loss of S corporations.

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Chapter 1: ACCOUNTING METHODS AND TAX YEARS OF S CORPORATIONS

Chapter Objective

After completing this chapter, you should be able to:

- To recognize types of accounting methods and tax year elections offered to S corporations.

501 ACCOUNTING METHOD CHOICES

S corporations can adopt any permissible method of accounting (i.e., cash, accrual, or any other method prescribed by the Code). If an S corporation is engaged in more than one trade or business, it can use a different method of accounting for each trade or business. If the S corporation is deemed a tax shelter, however, the accrual method must be used. Unlike a partnership, the S corporation is not bound by the accounting method of its shareholders.

.01 Deductibility of Expenses and Interest

Even if the S corporation elects the accrual method to report income and expense, it must still use the cash method for deducting business expenses and interest owed to certain related-party, cash-method taxpayers. The certain related-party, cash-method taxpayers are:

- Any shareholder who owns stock in the corporation and
- Any person related to a shareholder as defined in Code Sec. 267(b) or Code Sec. 707(b) (1).

As a result, the S corporation will receive the deduction for the expense items when the payment is includible in the recipient’s income.

Tax Pointer

There is no time limit when these accrued items must be paid. Prior law required payment within 2-1/2 months from the end of the tax year; otherwise, the deduction was lost.

Example 5-1

Alpha Corporation, an S corporation, is owned by two unrelated individuals, Ann West and Betty Meade, who report their income on the cash basis. Meade owns one share, and West owns 99 shares of Alpha Corporation. Alpha Corporation adopts the accrual method of accounting and the calendar year for reporting income. Alpha Corporation, on January 1, 2026, signs a lease with West. As of December 31, 2026, Alpha Corporation has accrued rent of $6,000 owed to West. Because West has not received the $6,000 rent by December 31, 2026, Alpha Corporation cannot deduct the $6,000 for rent in 2023 on its Form 1120S.

Example 5-2

Assume the same facts as in Example 5-1, except that on January 1 of the next year (2027), Alpha Corporation delivers a $6,000 check to West who deposits the check and reports it as income. Alpha Corporation will be able to deduct the $6,000 for rent in 2027 on its Form 1120S.

Example 5-3

Assume the same facts as in Example 5-1, except that Alpha Corporation delivers a $6,000 rent check to West on December 31, 2026, and West deposits the check that day. Alpha Corporation will be able to deduct the $6,000 for rent in 2026 on its Form 1120S.

.02 Change of Accounting Method When Converting to S Corporation

An S corporation may not adopt a method of accounting that is different from the method it used as a C corporation without obtaining the IRS’s consent, according to at least two court cases. An S corporation, however, can elect a different accounting method than a predecessor partnership.

.03 Cash Method of Accounting

As a rule, the IRS is hostile to the cash method of accounting because of the manipulation that can occur with the receipt of income. By definition, the cash method prescribes that income is not earned by an S corporation until received. Consequently, if a cash-basis corporation wants to reduce its income, it can enter into an agreement prior to performing a contract that the corporation is not to be paid until the following

year. In the case of Austin, the IRS attacked the cash-basis method of a service business. In losing the attack, the IRS had to pay more than $15,000 in legal fees to the taxpayer. The facts were as follows:

> Associated Services of Accountable Professionals Ltd. (ASAP) was incorporated in 1986 and elected to be an S corporation in 1989. ASAP was in the business of providing nurses to hospitals and other health-care facilities at an agreed hourly rate. ASAP paid the nurses and billed the clients at their contracted rates. ASAP had no inventory, had never had gross receipts that exceeded $5 million, and had always used the cash method of accounting. The IRS audited ASAP, and prior to trial, the Commissioner conceded the method of accounting issue stipulating that the only deficiency would be $4,898 for travel and entertainment expenses. Because the Court felt that the IRS was not substantially justified in its attack of the taxpayer's method of accounting, legal fees were awarded to the taxpayer.

A number of cases have arisen concerning the use of the cash method. RACMP Enterprises held that contractors could use the cash method of accounting if the material that was utilized in providing services are deemed "not merchandise held for sale. As to another taxpayer victory, Osteopathic Medical Oncology and Hematology, P.C. held that drugs used as part of chemotherapy treatment were not considered merchandise, because their use was an indispensable and inescapable part of the rendering of services. However, in Von Euw & L.J. Nunes Trucking, the Court distinguished RACMP Enterprises, holding that a company that acquires and transports sand and gravel for its customers is required to maintain inventories, even though the company usually has no goods on hand at the end of the day.

There is no absolute rule that income and deductions have to match in transactions between S corporations and related parties. For instance, P.E. Catalano v. Comm'r held that when a 100-percent shareholder leased boats to his S corporation to entertain clients, he had to pay tax on the lease income even though the IRS disallowed the S corporation's entertainment expense deduction.

Code Sec. 448(b)(3) and (c) details that the cash method of accounting may be used by S corporations, other than tax shelters which satisfy a gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. Code Sec. 448(c) details that the gross receipts test will allow S corporations with annual average gross receipts that do not exceed $32 million for the three prior taxable-year period (the ''$32 million gross receipts test'') to use the cash method for reporting income, expense, etc. The amount is indexed for inflation.

Code Sec. 448(c)(3) has some rules for determining gross receipts, such as:

A. Not in existence for entire three-year period.—If the entity was not in existence for the entire three-year period, the determination of gross receipts shall be applied on the basis of the period during which such entity (or trade or business) was in existence.

B. Short taxable years.—Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

C. Gross receipts.—Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.

D. Treatment of predecessors.—Code Sec. 448's provisions shall include a reference to any predecessor of such entity.

502 CALENDAR- OR FISCAL-YEAR REPORTING

.01 Selection Considerations

An S corporation can use a calendar year, 52-53 week or a fiscal year to report its income, whether it is a new or existing corporation. With fiscal-year reporting, unless a business purpose can be established (e.g., a cherry orchard harvests its crop in April each year), there is a price to be paid for this special treatment: an interest-free deposit to the IRS that is adjusted each year to reflect changes in S corporation income (i.e., if the S corporation income goes up, the deposit has to go up; if the income decreases, then a refund has to be made). Further, the S corporation can only choose a fiscal year ending September 30, October 31, or November 30.

From a tax perspective, there is really no long-term benefit to fiscal-year reporting due to deposit requirements. However, from a bookkeeping perspective, fiscal-year reporting eases an accountant's work load since some S corporation tax returns will be due on dates other than March 15.

In the course of operations, an S corporation may desire to change its taxable year. However, Reg. § 1.442-1 prescribes that once a taxpayer adopts a taxable year, it can only be changed by permission of the Internal Revenue Service. To obtain the year change, the taxpayer has to file a Form 1128 and pay a user fee. The Service issued three lengthy Revenue Procedures to prescribe guidelines in terms of adopting fiscal years, which are detailed below.

- Rev. Proc. 2006-45 which applies to C corporations and S corporations electing S status. The Revenue Procedure sets forth procedural rules when

the IRS will automatically approve retention of a corporation's taxable year when it adopts S status or changes the corporation's taxable year.

- Rev. Proc. 2006-46 provides for situations where the Service will automatically grant approval for an S corporation to use fiscal years.
- Rev. Proc. 2002-39 provides for situations where the Service will not grant automatic approval.

Tax Pointer

If a corporation is under audit, the automatic change rules of Rev. Procs. 2006-45 and 2006-46 do not apply.

.02 Calendar-Year Reporting

Newly formed S corporations. Newly formed S corporations (i.e., those starting de novo as an S corporation and never having existed as a C corporation) must use a calendar or a 52-53-week year for reporting income, loss, gain, etc., unless they can justify a fiscal-year status.

C corporations. For C corporations converting to S status, the process for establishing a calendar year is slightly more complex.

Calendar-year C corporation converting to S status. If a calendar-year C corporation is electing S status, it can retain calendar-year status without IRS consent by filing Form 2553, filling in Item I, and checking Item O, Box 2.

Fiscal-year C corporation converting to calendar-year S status. A fiscal-year C corporation can change to calendar-year S status on conversion without consent of the IRS by filing Form 2553, filling in Item I, and checking Item O, Box 3.

.03 Fiscal Year Reporting

If an S corporation wishes to establish a natural business year, the S corporation has to qualify under one of the following three tests:

- Natural business-year test
- Ownership tax-year test
- Relevant facts and circumstance test

Natural business year. Rev. Proc. 2002-38 provides that the Internal Revenue Service will automatically approve a natural business year for operation of the S corporation. In order to qualify for this fiscal year reporting, Rev. Proc. 2006-46, Sec. 5.07

prescribes that the S corporation must satisfy a mechanical gross receipts test, namely that 25 percent of the S corporation's gross receipts are consistently recorded in the final two months of the selected year. In order to obtain this type of fiscal year reporting, the S corporation first computes its gross receipts from sales and services during the most recent 12-month period selected as the desired tax year. Gross receipts for the last two months of this 12-month period are also computed. This yearly figure is divided into the two-month figure, and must equal at least 25 percent. The same calculations are made for two 12-month periods preceding the 12-month period used for the initial calculations. Gross receipts for the last two months of the two preceding 12-month periods must also equal or exceed 25 percent of the total.

Procedure. Rev. Proc. 2006-46, Sec. 7, details the procedural requirements for obtaining natural business year. Part II of Form 2553 must be completed as well, with the S corporation checking the appropriate box in Item O, and completing Box P1.

S Corporation no longer qualifies under the natural business year test. Rev. Proc. 2006-46, Sec. 6.05, prescribes that if the S corporation no longer qualifies for a natural business year, the S corporation must change to another permitted taxable year; otherwise, the S corporation will forfeit its S corporate status.

Ownership taxable year. Rev. Proc. 2006-46 prescribes that an S corporation can obtain a fiscal year based on the fiscal year of the shareholders owning a majority of the stock. Rev. Proc. 2006-46, Sec. 5.08, prescribes that an S corporation satisfies the ownership taxable year test if the shareholder(s) owning more than one-half of the stock as of the first day of the desired fiscal year, maintains or concurrently changes to the same fiscal year. If a Code Sec. 501 tax-exempt charity is a shareholder, its taxable year is generally disregarded. However, if the S corporation is wholly owned by tax-exempt entity(ies), then the taxable year for the majority shareholder is utilized.

Procedure. Rev. Proc. 2006-46, Sec. 7.03 prescribes that if the S corporation can qualify for the ownership taxable year test, the corporation checks the second box under Item P, as well as fills in the appropriate box under Item O of Part II of Form 2553. At the top of the first page of Form 2553 or 1128 (if applicable), state that "Form is filed under Rev. Proc. 2006-46. If the S corporation is under audit, then it must comply with Rev. Proc. 2006-46, Sec. 7.03.

Facts and circumstances text. Rev. Proc. 2002-39 and Rev. Rul. 87-57 prescribe that for a corporation to obtain a fiscal year reporting, non-tax considerations must be compelling. Rev. Rul. 87-57 sets forth various examples where a fiscal year would be appropriate (for example, weather conditions requiring a business to be operated only during certain months). Examples where a corporation would not be granted a fiscal