

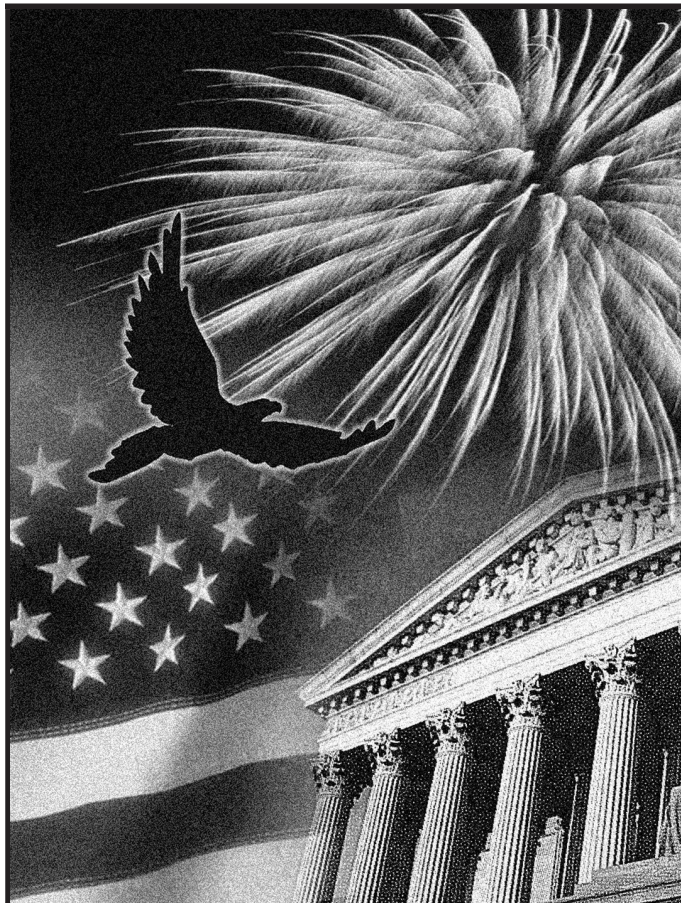


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# Accounting Periods and Methods



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## Introduction

Every taxpayer (whether an individual or a business entity) must figure taxable income on an annual accounting period called a tax year. The calendar year is the most common tax year. Other tax years are a fiscal year and a short tax year which are discussed later.

Each taxpayer must also 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: **(a)** cash method; and **(b)** accrual method.

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

Under an accrual method, generally you report income in the tax year in which 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 many cases you may have to refer to the cited sources for a fuller explanation of the topic.*

This publication is not intended as a guide to general business and tax accounting rules. Section references are to the Internal Revenue Code and regulation references are to the Income Tax Regulations.

**Comments and suggestions.** We welcome your comments about this publication and your suggestions for future editions.

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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
- 3115** Application for Change in Accounting Method  
See *How To Get Tax Help* at the end of this publication for information about getting these publications and forms.

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## 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 maintain your books

and records and report your income and expenses using the same tax year.

## 52-53-Week Tax Year

You can elect to use a 52-53-week tax year if you keep your books and records and report your income and expenses on that basis. If you make this election, your 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 2006 tax year will end on March 26, 2007.

**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, 2007, 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, 2007, is treated as beginning on July 1, 2007.

## 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, 2007. It elected the calendar year as its tax year. Therefore, its first tax return was due March 17, 2008. This short period return will cover the period from July 1, 2007, through December 31, 2007.

**Example 2.** A calendar year corporation dissolved on July 22, 2007. Its final return is due by October 15, 2007. It will cover the short period from January 1, 2007, through July 22, 2007.

**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, 2007. Her final income tax return must be filed by April 15, 2008. It will cover the short period from January 1, 2007, to March 6, 2007.

## 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).

**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). 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 Publication 542, or 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 under the requirements of

Revenue Procedure 85-15 in Cumulative Bulletin 1985-1. 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. 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 a section 444 election.

- 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	Profits Interest	Months of Deferral	Interest × Deferral
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	Profits Interest	Months of Deferral	Interest × Deferral
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 accounting periods for partnerships, see the Instructions for Form 1128. For information about changing a partnership's tax year, see Revenue Procedure 2006-46 for automatic approval requests and Revenue Procedure 2002-39 or its successor for ruling requests.

## 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. 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, Election by a Small Business Corporation, instead of filing Form 1128. For information about changing an S corporation's tax year, see the Instructions for Form 1128. See also Revenue Procedure 2006-46 for automatic approval requests and Revenue Procedure 2002-39 or its successor for ruling requests.

## 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. 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, see the Instructions for Form 1128. See also Revenue Procedure 2006-46 for automatic approval requests and Revenue Procedure 2002-39 or its successor for ruling requests.

## Section 444 Election

A partnership, S corporation, electing S corporation, or PSC can elect under section 444 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, 2002. 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, 2002, 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, Election To Have a Tax Year Other Than a Required Tax Year, 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.

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, 2007, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 13, 2007. AB must file Form 8716 by January 15, 2008, which is the due date of the partnership's tax return for the period from September 13, 2007, to September 30, 2007.

**Example 2.** The facts are the same as in *Example 1* except that AB begins operations on October 21, 2007. AB must file Form 8716 by March 17, 2008, the 15th day of the 6th month of the tax year for which the election will first be effective.

**Example 3.** B is a corporation that first becomes a PSC for its tax year beginning September 1, 2007. B qualifies to

make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 2007. B must file Form 8716 by December 17, 2007, the due date of the income tax return for the short period from September 1, 2007, to September 30, 2007.

**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 Personal Service Corporation (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.

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## Accounting Methods

An accounting method is a set of rules used to determine when income and expenses are reported. 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 books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same 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 your income.

**Methods you can use.** In general, except as otherwise required and subject to the preceding rules, 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.
- Combination (hybrid) method using elements of two or more of the above.

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 and its 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*.

**Combination (hybrid) method.** Generally and except as otherwise required, 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.

**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. No business is separate and distinct, however, 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* 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 2007. You neither withdraw it nor enter it into your books until 2008. You must include the amount in gross income for 2007, the year that you constructively received it.



*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 2007 for a business insurance policy that is effective for three years (36 months), beginning on July 1, 2007. 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 2007, \$1,000 ( $12/36 \times \$3,000$ ) is deductible in 2008, \$1,000 ( $12/36 \times \$3,000$ ) is deductible in 2009, and the remaining \$500 is deductible in 2010.

**Example 2.** You are a calendar year taxpayer and pay \$10,000 on July 1, 2007, for a business insurance policy that is effective for only one year beginning on July 1, 2007. The 12-month rule applies. Therefore, the full \$10,000 is deductible in 2007.

## 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 (defined in section 447(d)(2)(C)) engaged in farming, the exception applies if gross receipts were \$25 million or less for each prior tax year after 1985. See section 447 and 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 an accrual method of accounting, generally you report income in the year 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 as 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 2007 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 2007 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 2007 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.

In *Examples 3 and 4*, if you do not perform part of the services by the end of the following tax year (2008), you must still include advance payments for the unperformed services in gross income for 2007.

**Example 3.** You own a dance studio. On October 1, 2007, you receive payment for a one-year contract for 48 one-hour lessons beginning on that date. You give eight lessons in 2007. Under this method of including advance payments, you must include one-sixth (8/48) of the payment in income for 2007, and five-sixths (40/48) of the payment in 2008, even if you do not give all the lessons by the end of 2008.

**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 2007 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 2007, 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 2007, but it was not delivered and accepted until January 2008. For tax purposes, you include the \$8,000 advance payment in gross income for 2007; and include the remaining \$12,000 of the contract price in gross income for 2008.

**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 includible in inventory because of the agreement.

**Example.** You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In 2004, you entered into a contract for the sale of goods properly includible in your inventory. The total contract price is \$50,000 and you estimate that your total inventoriable costs for the goods will be \$25,000. You receive the following advance payments under the contract.

2004 . . . . .	\$17,500
2005 . . . . .	10,000
2006 . . . . .	7,500
2007 . . . . .	5,000
2008 . . . . .	5,000
2009 . . . . .	5,000
<b>Total contract price</b> . . . . .	<u><u>\$50,000</u></u>

Your customer asked you to deliver the goods in 2010. In your 2005 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 2005 were more than the costs you estimated, the payments are substantial advance payments.

Include in income for 2007 all payments you receive by the end of 2007, the second tax year following the tax year in which you received substantial advance payments. You must include \$40,000 in sales for 2007 (the total amounts received from 2004 through 2007) 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 2010.

**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 2007. You receive the supplies and the bill in December, but you pay the bill in January 2008. You can deduct the expense in 2007 because all events have occurred to fix the fact of liability, the liability can be determined, and economic performance occurred in 2007.

Your office supplies may qualify as a recurring item, discussed later. If so, you can deduct them in 2007, even if the supplies are not delivered until 2008 (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 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 inventorable items as materials and supplies that are not incidental (discussed later).

- A qualifying taxpayer under Revenue Procedure 2001-10 in Internal Revenue Bulletin 2001-2.
- A qualifying small business taxpayer under Revenue Procedure 2002-28 in Internal Revenue Bulletin 2002-18.



*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).

**Gross receipts test for qualifying taxpayers.** To determine if you meet the gross receipts test for qualifying taxpayers, use the following steps:

1. **Step 1.** List each of the test years. For qualifying taxpayers under Revenue Procedure 2001-10, the test years are each prior tax year ending on or after December 17, 1998. For 2007, the test years are 1998, 1999, 2000, 2001, 2002, 2003, 2004, 2005, and 2006 for a calendar year taxpayer.



2. **Step 2.** Determine your average annual gross receipts for each test year listed in Step 1. Your average annual gross receipts for a tax year is determined by adding the gross receipts for that tax year and the 2 preceding tax years and dividing the total by 3. For example, if gross receipts are \$200,000 for 1998, \$800,000 for 1999, and \$1,100,000 for 2000, the average annual gross receipts for 2000 are \$700,000  $((\$200,000 + \$800,000 + \$1,100,000) \div 3 = \$700,000)$ . See section 5 of Revenue Procedure 2001-10 for more information.
3. **Step 3.** You meet the gross receipts test for qualifying taxpayers if your average annual gross receipts for each test year listed in Step 1 is \$1 million or less.

See *Table 1* for a summary of these rules for 2007.

**Table 1. 2007 Gross Receipts Test for Qualifying Taxpayers under Revenue Procedure 2001-10**

Step 1. Test year (prior tax years ending on or after December 17, 1998).	Step 2. Determine your average annual gross receipts for each test year.
1998	$(1996 + 1997 + 1998) \div 3$
1999	$(1997 + 1998 + 1999) \div 3$
2000	$(1998 + 1999 + 2000) \div 3$
2001	$(1999 + 2000 + 2001) \div 3$
2002	$(2000 + 2001 + 2002) \div 3$
2003	$(2001 + 2002 + 2003) \div 3$
2004	$(2002 + 2003 + 2004) \div 3$
2005	$(2003 + 2004 + 2005) \div 3$
2006	$(2004 + 2005 + 2006) \div 3$

**Qualifying small business taxpayer.** You are a qualifying small business taxpayer under Revenue Procedure 2002-28 only if:

- You satisfy the gross receipts test for each prior tax year ending on or after December 31, 2000 (see *Gross receipts test for qualifying small business taxpayers*, next). Your average annual gross receipts for each test year (explained in Step 1, listed next) must be \$10 million or less.
- You are not prohibited from using the cash method under section 448.
- Your principle business activity is an eligible business. See *Eligible business*, later.
- You have not changed (or have not been required to change) from the cash method because you became ineligible to use the cash method under Revenue Procedure 2002-28.

**Note.** Revenue Procedure 2002-28 does not apply to a farming business of a qualifying small business taxpayer. A taxpayer engaged in the trade or business of farming generally is allowed to use the cash method for any farming business. See *Special rules for farming businesses under Cash Method*, earlier.

**Gross receipts test for qualifying small business taxpayers.** To determine if you meet the gross receipts test for qualifying small business taxpayers, use the following steps:

1. **Step 1.** List each of the test years. For qualifying small business taxpayers under Revenue Procedure 2002-28, the test years are each prior tax year ending on or after December 31, 2000. For 2007, the test years are 2000, 2001, 2002, 2003, 2004, 2005, and 2006 for a calendar year taxpayer.
2. **Step 2.** Determine your average annual gross receipts for each test year listed in Step 1. Your average annual gross receipts for a tax year is determined by adding the gross receipts for that tax year and the 2 preceding tax years and dividing the total by 3. For example, if gross receipts are \$6 million for 2005, \$9 million for 2006, and \$12 million for 2007, the average annual gross receipts for 2007 are \$9 million  $((\$6 \text{ million} + \$9 \text{ million} + \$12 \text{ million}) \div 3 = \$9 \text{ million})$ . See section 5 of Revenue Procedure 2002-28 for more information.
3. **Step 3.** You meet the gross receipts test for qualifying small business taxpayers if your average annual gross receipts for each test year listed in Step 1 is \$10 million or less.

See *Table 2* for a summary of these rules for 2007.

**Table 2. 2007 Gross Receipts Test for Qualifying Small Business Taxpayers under Revenue Procedure 2002-28**

Step 1. Test year (prior tax years ending on or after December 31, 2000).	Step 2. Determine your average annual gross receipts for each test year.
2000	$(1998 + 1999 + 2000) \div 3$
2001	$(1999 + 2000 + 2001) \div 3$
2002	$(2000 + 2001 + 2002) \div 3$
2003	$(2001 + 2002 + 2003) \div 3$
2004	$(2002 + 2003 + 2004) \div 3$
2005	$(2003 + 2004 + 2005) \div 3$
2006	$(2004 + 2005 + 2006) \div 3$

**Eligible business.** An eligible business is any business for which a qualified small business taxpayer can use the cash method and choose to not keep an inventory. You

have an eligible business if you meet any of the following requirements.

1. Your principal business activity is described in a North American Industry Classification System (NAICS) code other than any of the following.
  - a. NAICS codes 211 and 212 (mining activities).
  - b. NAICS codes 31-33 (manufacturing).
  - c. NAICS code 42 (wholesale trade).
  - d. NAICS codes 44-45 (retail trade).
  - e. NAICS codes 5111 and 5122 (information industries).
2. Your principal business activity is the provision of services, including the provision of property incident to those services.
3. Your principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.

Information about the NAICS codes can be found at <http://www.census.gov/naics> or in the instructions for your federal income tax return.

**Gross receipts.** In general, gross receipts must include all receipts from all your trades or businesses that must be recognized under the method of accounting you used for that tax year for federal income tax purposes. See the definition of gross receipts in Temporary Regulations section 1.448-1T(f)(2)(iv) for details.

**Business not owned or not in existence for 3 years.** If you did not own your business for all of the 3-tax-year period used in determining your average annual gross receipts, include the period of any predecessor. If your business has not been in existence for the 3-tax-year period, base your average on the period it has existed including any short tax years, annualizing the short tax year's gross receipts.

**Materials and supplies that are not incidental.** If you account for inventoriable items as materials and supplies that are not incidental, you will deduct the cost of the items you would otherwise include in inventory in the year you sell the items, or the year you pay for them, whichever is later. If you are a qualifying taxpayer under Revenue Procedure 2001-10 and a producer, you can use any reasonable method to estimate the raw material in your work in process and finished goods on hand at the end of the year to determine the raw material used to produce finished goods that were sold during the year. If you are a qualifying small business taxpayer under Revenue Procedure 2002-28, you must use the specific identification method, the first-in first-out (FIFO) method, or an average cost method to determine the amount of your allowable deduction for non-incidental materials and supplies consumed and used in your business. See section 4.02 in Revenue Procedure 2001-10 or section 4.05 in Revenue Procedure

2002-28 for more information. Also, see *Example 15* and *Example 17* through *Example 20* in section 6 of Revenue Procedure 2002-28.

**Changing methods.** If you are a qualifying taxpayer or qualifying small business taxpayer and want to change to the cash method or to account for inventoriable items as non-incidental materials and supplies, you must file Form 3115. Both changes can be requested under the automatic change procedures of Revenue Procedure 2002-9 and 2006-12 in Internal Revenue Bulletins 2002-3 and 2006-3 (or their successors). For additional guidance, see section 6 of Revenue Procedure 2001-10 for qualifying taxpayers or section 7 of Revenue Procedure 2002-28 for qualifying small business taxpayers. You can file one Form 3115 if you choose to request to change to the cash method and to account for inventoriable items as non-incidental materials and supplies.

**More information.** For more information about the qualifying taxpayer exception, see Revenue Procedure 2001-10. For more information about the qualifying small business taxpayer exception, see Revenue Procedure 2002-28.

## Items Included in Inventory

Your inventory should include all of the following.

- Merchandise or stock in trade.
- Raw materials.
- Work in process.
- Finished products.
- Supplies that physically become a part of the item intended for sale.

**Merchandise.** Include the following merchandise in inventory.

- Purchased merchandise if title has passed to you, even if the merchandise is in transit or you do not have physical possession for another reason.
- Goods under contract for sale that you have not yet segregated and applied to the contract.
- Goods out on consignment.
- Goods held for sale in display rooms, merchandise mart rooms, or booths located away from your place of business.

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

**Containers.** Containers such as kegs, bottles, and cases, regardless of whether they are on hand or returnable, should be included in inventory if title has not passed to the buyer of the contents. If title has passed to the buyer,

exclude the containers from inventory. Under certain circumstances, some containers can be depreciated. See Publication 946.

**Merchandise not included.** Do not include the following merchandise in inventory.

- Goods you have sold, but only if title has passed to the buyer.
- Goods consigned to you.
- Goods ordered for future delivery if you do not yet have title.

**Assets.** Do not include the following in inventory.

- Land, buildings, and equipment used in your business.
- Notes, accounts receivable, and similar assets.
- Real estate held for sale by a real estate dealer in the ordinary course of business.
- Supplies that do not physically become part of the item intended for sale.



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

## Identifying Cost

You can use any of the following methods to identify the cost of items in inventory.

### Specific Identification Method

Use the specific identification method when you can identify and match the actual cost to the items in inventory.

Use the FIFO or LIFO method, explained next, if:

- You cannot specifically identify items with their costs.
- The same type of goods are intermingled in your inventory and they cannot be identified with specific invoices.

### FIFO Method

The FIFO (first-in first-out) method assumes the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of. The items in inventory at the end of the tax year are matched with the costs of similar items that you most recently purchased or produced.

### LIFO Method

The LIFO (last-in first-out) method assumes the items of inventory you purchased or produced last are the first

items you sold, consumed, or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

**LIFO rules.** The rules for using the LIFO method are very complex. Two are discussed briefly here. For more information on these and other LIFO rules, see sections 472 through 474 and the corresponding regulations.

**Dollar-value method.** Under the dollar-value method of pricing LIFO inventories, goods and products must be grouped into one or more pools (classes of items), depending on the kinds of goods or products in the inventories. See section 1.472-8 of the regulations.

**Simplified dollar-value method.** Under this method, you establish multiple inventory pools in general categories from appropriate government price indexes. You then use changes in the price index to estimate the annual change in price for inventory items in the pools.

An eligible small business (average annual gross receipts of \$5 million or less for the 3 preceding tax years) can elect the simplified dollar-value LIFO method.

For more information, see section 474. Taxpayers who cannot use the method under section 474 should see section 1.472-8(e)(3) of the regulations for a similar simplified dollar-value method.

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

## Differences Between FIFO and LIFO

Each method produces different income results, depending on the trend of price levels at the time. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, the opposite will hold.

## Valuing Inventory

The value of your inventory is a major factor in figuring your taxable income. The method you use to value the inventory is very important.

The following methods, described below, are those generally available for valuing inventory.

- Cost.
- Lower of cost or market.
- Retail.

**Goods that cannot be sold.** These are goods you cannot sell at normal prices or they are unusable in the usual way



because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You should value these goods at their bona fide selling price minus direct cost of disposition, no matter which method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, you must value them on a reasonable basis, considering their usability and condition. Do not value them for less than scrap value. For more information, see section 1.471-2(c) of the regulations.

## Cost Method

To properly value your inventory at cost, you must include all direct and indirect costs associated with it. The following rules apply.

- For merchandise on hand at the beginning of the tax year, cost means the ending inventory price of the goods.
- For merchandise purchased during the year, cost means the invoice price minus appropriate discounts plus transportation or other charges incurred in acquiring the goods. It can also include other costs that have to be capitalized under the uniform capitalization rules of section 263A.
- For merchandise produced during the year, cost means all direct and indirect costs that have to be capitalized under the uniform capitalization rules.

**Discounts.** A trade discount is a discount allowed regardless of when the payment is made. Generally, it is for volume or quantity purchases. You must reduce the cost of inventory by a trade (or quantity) discount.

A cash discount is a reduction in the invoice or purchase price for paying within a prescribed time period. You can choose either to deduct cash discounts or include them in income, but you must treat them consistently from year to year.

## Lower of Cost or Market Method

Under the lower of cost or market method, compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value.

This method applies to the following.

- Goods purchased and on hand.
- The basic elements of cost (direct materials, direct labor, and certain indirect costs) of goods being manufactured and finished goods on hand.

This method does not apply to the following. They must be inventoried at cost.

- Goods on hand or being manufactured for delivery at a fixed price on a firm sales contract (that is, not

legally subject to cancellation by either you or the buyer).

- Goods accounted for under the LIFO method.

**Example.** Under the lower of cost or market method, the following items would be valued at \$600 in closing inventory.

Item	Cost	Market	Lower
R .....	\$300	\$500	\$300
S .....	200	100	100
T .....	450	200	200
<b>Total</b> .....	<b>\$950</b>	<b>\$800</b>	<b>\$600</b>

You must value each item in the inventory separately. You cannot value the entire inventory at cost (\$950) and at market (\$800) and then use the lower of the two figures.

**Market value.** Under ordinary circumstances for normal goods, market value means the usual bid price on the date of inventory. This price is based on the volume of merchandise you usually buy. For example, if you buy items in small lots at \$10 an item and a competitor buys identical items in larger lots at \$8.50 an item, your usual market price will be higher than your competitor's.

**Lower than market.** When you offer merchandise for sale at a price lower than market in the normal course of business, you can value the inventory at the lower price, minus the direct cost of disposition. Determine these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices that vary materially from the actual prices will not be accepted as reflecting the market.

**No market exists.** If no market exists, or if quotations are nominal because of an inactive market, you must use the best available evidence of fair market price on the date or dates nearest your inventory date. This evidence could include the following items.

- Specific purchases or sales you or others made in reasonable volume and in good faith.
- Compensation amounts paid for cancellation of contracts for purchase commitments.

## Retail Method

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

To figure the average markup, apply the following steps in order.

1. Add the total of the retail selling prices of the goods in the opening inventory and the retail selling prices of the goods you bought during the year (adjusted for all markups and markdowns).

2. Subtract from the total in (1) the cost of goods included in the opening inventory plus the cost of goods you bought during the year.
3. Divide the balance in (2) by the total selling price in (1). The result is the average markup percentage.

Then determine the approximate cost in three steps.

1. Subtract the sales at retail from the total retail selling price. The result is the closing inventory at retail.
2. Multiply the closing inventory at retail by the average markup percentage. The result is the markup in closing inventory.
3. Subtract the markup in (2) from the closing inventory at retail. The result is the approximate closing inventory at cost.

**Closing inventory.** The following example shows how to figure your closing inventory using the retail method.

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

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

Using the retail method, determine your closing inventory as follows.

Item	Cost	Retail Value
Opening inventory . . . . .	\$52,000	\$60,000
Plus: Purchases . . . . .	53,000	78,500
Net markups (\$2,000 – \$500 markdowns) . . .		1,500
Total . . . . .	\$105,000	\$140,000
Minus: Sales . . . . .		98,000
Closing inventory at retail . . . . .		\$42,000
Minus: Markup* (.25 × \$42,000) . . . . .		10,500
Closing inventory at cost . . . . .		\$31,500

\* See *Markup percentage*, next, for an explanation of how the markup percentage (25%) was figured for this example.

**Markup percentage.** The markup (\$35,000) is the difference between cost (\$105,000) and the retail value (\$140,000). Divide the markup by the total retail value to get the markup percentage (25%). You cannot use arbitrary standard percentages of purchase markup to determine markup. You must determine it as accurately as possible from department records for the period covered by your tax return.

**Markdowns.** When determining the retail selling price of goods on hand at the end of the year, markdowns are recognized only if the goods were offered to the public at the reduced price. Markdowns not based on an actual

reduction of retail sales price, such as those based on depreciation and obsolescence, are not allowed.

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

**Price index.** If you are using the retail method and LIFO, adjust the inventory value, determined using the retail method, at the end of the year to reflect price changes since the close of the preceding year. Generally, to make this adjustment, you must develop your own retail price index based on an analysis of your own data under a method acceptable to the IRS. However, a department store using LIFO that offers a full line of merchandise for sale can use an inventory price index provided by the Bureau of Labor Statistics. Other sellers can use this index if they can demonstrate the index is accurate, reliable, and suitable for their use. For more information, see Revenue Ruling 75-181 in Cumulative Bulletin 1975-1.

**Retail method without LIFO.** If you do not use LIFO and have been determining your inventory under the retail method except that, to approximate the lower of cost or market, you have followed the consistent practice of adjusting the retail selling prices of goods for markups (but not markdowns), you can continue that practice. The adjustments must be bona fide, consistent, and uniform and you must also exclude markups made to cancel or correct markdowns. The markups you include must be reduced by markdowns made to cancel or correct the markups.

If you do not use LIFO and you previously determined inventories without eliminating markdowns in making adjustments to retail selling prices, you can continue this practice only if you first get IRS approval. You can adopt and use this practice on the first tax return you file for the business, subject to IRS approval on examination of your tax return.

**Figuring income tax.** Resellers who use the retail method of pricing inventories can determine their tax on that basis.

To use this method, you must do all of the following.

- State that you are using the retail method on your tax return.
- Keep accurate records.
- Use this method each year unless the IRS allows you to change to another method.

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

## Perpetual or Book Inventory

You can figure the cost of goods on hand by either a perpetual or book inventory if inventory is kept by following

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

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

## Loss of Inventory

You claim a casualty or theft loss of inventory, including items you hold for sale to customers, through the increase in the cost of goods sold by properly reporting your opening and closing inventories. You cannot claim the loss again as a casualty or theft loss. Any insurance or other reimbursement you receive for the loss is taxable.

You can choose to claim the loss separately as a casualty or theft loss. If you claim the loss separately, adjust opening inventory or purchases to eliminate the loss items and avoid counting the loss twice.

If you claim the loss separately, reduce the loss by the reimbursement you receive or expect to receive. If you do not receive the reimbursement by the end of the year, you cannot claim a loss for any amounts you reasonably expect to recover.

**Forgiveness of indebtedness by creditors or suppliers.** If your creditors or suppliers forgive part of what you owe them because of your inventory loss, this amount is treated as taxable income.

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

## Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of property you produce or acquire for resale, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.



*Special uniform capitalization rules apply to a farming business. See chapter 6 in Publication 225.*

**Activities subject to the rules.** You are subject to the uniform capitalization rules if you do any of the following, unless the property is produced for your use other than in a trade or business or an activity carried on for profit.

- Produce real or tangible personal property.

- Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are \$10 million or less.

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

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

**Exceptions.** The uniform capitalization rules do not apply to:

- Resellers of personal property with average annual gross receipts of \$10 million or less (small resellers).
- Property produced to use as personal or nonbusiness property or for uses not connected with a trade or business or an activity conducted for profit.
- Research and experimental expenditures deductible under section 174.
- Intangible drilling and development costs of oil and gas or geothermal wells or any amortization deduction allowable under section 59(e) for intangible drilling, development, or mining exploration expenditures.
- Property produced under a long-term contract, except for certain home construction contracts described in section 460(e)(1).
- Timber and certain ornamental trees raised, harvested, or grown, and the underlying land.
- Qualified creative expenses paid or incurred as a free-lance (self-employed) writer, photographer, or artist that are otherwise deductible on your tax return.
- Costs allocable to natural gas acquired for resale to the extent these costs would otherwise be allocable to cushion gas stored underground.
- Property produced if substantial construction occurred before March 1, 1986.
- Property provided to customers in connection with providing services. It must be *de minimus* in amount and not be included in inventory in the hands of the service provider.
- Loan origination.
- The costs of certain producers who use a simplified production method and whose total indirect costs are \$200,000 or less. See section 1.263A-2(b)(3)(iv) of the regulations for more information.



**Qualified creative expenses.** Qualified creative expenses are expenses paid or incurred by a free-lance (self-employed) writer, photographer, or artist whose personal efforts create (or can reasonably be expected to create) certain properties. These expenses do not include expenses related to printing, photographic plates, motion picture films, video tapes, or similar items.

These individuals are defined as follows.

- A writer is an individual who creates a literary manuscript, a musical composition (including any accompanying words), or a dance score.
- A photographer is an individual who creates a photograph or photographic negative or transparency.
- An artist is an individual who creates a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print item. The originality and uniqueness of the item created and the predominance of aesthetic value over utilitarian value of the item created are taken into account.

**Personal service corporation.** The exemption for writers, photographers, and artists also applies to an expense of a personal service corporation that directly relates to the activities of the qualified employee-owner. A qualified employee-owner is a writer, photographer, or artist who owns, with certain members of his or her family, substantially all the stock of the corporation.

**Inventories.** If you must adopt the uniform capitalization rules, revalue the items or costs included in beginning inventory for the year of change as if the capitalization rules had been in effect for all prior periods. When revaluing inventory costs, the capitalization rules apply to all inventory costs accumulated in prior periods. An adjustment is required under section 481(a). It is the difference between the original value of the inventory and the revalued inventory.

If you must capitalize costs for production and resale activities, you are required to make this change. If you make the change for the first tax year you are subject to the uniform capitalization rules, it is an automatic change of accounting method that does not need IRS approval. Otherwise, IRS approval is required to make the change.

**More information.** For information about the uniform capitalization rules, see the section 263A regulations.

## Change in Accounting Method

Generally, you can choose any permitted accounting method when you file your first tax return. You do not need to obtain IRS approval to choose the initial accounting method. You must, however, use the method consistently from year to year and it must clearly reflect your income. See *Accounting Methods*, earlier.

Once you have set up your accounting method and filed your first return, generally, you must receive approval from the IRS before you change the method. In general, you must file a current Form 3115 to request a change in either

an overall accounting method or the accounting treatment of any item.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. A material item is one that affects the proper time for inclusion of income or allowance of a deduction. Although an accounting method can exist without treating an item consistently, an accounting method is not established for that item, in most cases, unless the item is treated consistently.

**Approval required.** The following are examples of changes in accounting method that require IRS approval.

- A change from the cash method to an accrual method or vice versa.
- A change in the method or basis used to value inventory.
- A change in the depreciation or amortization method (except for certain permitted changes to the straight-line method).

**Approval not required.** The following are examples of types of changes that are not changes in accounting methods and do not require IRS approval.

- Correction of a math or posting error.
- Correction of an error in figuring tax liability (such as an error in figuring a credit).
- An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it.
- Certain adjustments in the useful life of a depreciable or amortizable asset.

For additional information, see the Instructions for Form 3115.

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## How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Contacting your Taxpayer Advocate.** The Taxpayer Advocate Service is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the Taxpayer Advocate Service by calling toll-free 1-877-777-4778 or TTY/TTD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, The Taxpayer

Advocate Service of the IRS — Your Voice at the IRS. You can file Form 911, Application for Taxpayer Assistance Order, or ask an IRS employee to complete it on your behalf. For more information, go to [www.irs.gov/advocate](http://www.irs.gov/advocate).

**Free tax services.** To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



**Internet.** You can access the IRS website at [www.irs.gov](http://www.irs.gov) 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2007 refund. Click on *Where's My Refund*. Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at [www.irs.gov/individuals](http://www.irs.gov/individuals).
- Determine if Form 6251 must be filed using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040 (for individuals) or 1-800-829-4933 (for businesses).

- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* To check the status of your 2007 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

**Evaluating the quality of our telephone services.** To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



**Walk-in.** Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you're more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call your local

Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to [www.irs.gov/local-contacts](http://www.irs.gov/local-contacts) or look in the phone book under *United States Government, Internal Revenue Service*.



**Mail.** You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

National Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903



**CD/DVD for tax products.** You can order Publication 1796, IRS Tax Products CD/DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD - Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- The CD which is released twice during the year.
  - The first release will ship the beginning of January

2008.

– The final release will ship the beginning of March 2008.

Purchase the CD/DVD from National Technical Information Service (NTIS) at [www.irs.gov/cdorders](http://www.irs.gov/cdorders) for \$35 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD/DVD for \$35 (plus a \$5 handling fee). Price is subject to change.



**CD for small businesses.** Publication 3207, The Small Business Resource Guide CD for 2007, is a must for every small business owner or any taxpayer about to start a business. This year's CD includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2007.
- Tax Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- "Rate the Product" survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive "Teens in Biz" module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting [www.irs.gov/smallbiz](http://www.irs.gov/smallbiz).





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