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Creating Real Tax Savings Through Accounting Method Changes

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Your Presenters

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Nathan has 19 years of public accounting experience, including fifteen years with Big-4/national firms, with a deep focus on accounting method changes. His experience ranges from working with small privately held businesses to publicly traded, Fortune 500 companies. He has significant experience in retail, manufacturing, real estate, and hospitality industries, among others.

Nathan specializes in the following areas:

- Capitalization
- Depreciation
- Revenue Recognition

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Haley serves DHG's Federal Tax Specialty Services group in the Accounting Methods space. She has more than six years of public accounting experience, three of which were spent at a Big Four accounting firm prior to joining DHG. Haley serves clients across various sectors and ranging in size from family-owned, local companies to global Fortune 500 companies.

Haley specializes in the following areas:

- Accounting Methods
- ASC 740 Accounting for Income Taxes
- Tax planning and compliance

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Polling Question

Have you implemented a change in method of accounting in the past:

A. Year

B. Three years

C. Five years

D. N/A; Have never implemented an accounting method change.

TCJA Small Business Reforms

- Applies to any “small business,” which is defined as a taxpayer with average annual gross receipts not more than $25 million over the last three years (“gross receipts test”).
- TCJA small business reforms include:
  - Expansion of availability of cash method of accounting
  - Exemption from requirement to account for inventories and to apply UNICAP
  - Exemption from requirement to use the percentage-of-completion method for long-term contracts
  - Modification of expensing rules under §179

Small Business: Overall Cash Method of Accounting

2017 Tax Law

- Corporations and partnerships with corporate partners are prohibited from using the cash method of accounting unless their average gross receipts for the prior three taxable years is less than $5 million
  - This test must be satisfied for each of the taxpayer's tax years beginning after December 31, 1985
- Farming corporations are generally prohibited from using the cash method of accounting if annual gross receipts exceed $1 million
- Closely-held and family-owned farming businesses are permitted to use the cash method if average gross receipts do not exceed $25 million
- Qualified personal service corporations are generally permitted to use the cash method regardless of gross receipts.

Small Business: Overall Cash Method of Accounting (Cont’d)

Tax Reform Law

- All taxpayers (other than tax shelters) with 3-year average gross receipts less than $25 million (indexed for inflation) are permitted to use the cash method of accounting
- Application of this provision constitutes a change in method of accounting

Small Business: Overall Cash Method of Accounting (Cont'd)

- Factors to consider when evaluating overall cash method:
  - May be beneficial when Accounts Receivable are higher than Accounts Payable (allows taxpayer to defer income)
  - More flexibility with regard to timing of taxable income recognition (taxpayer can write checks at end of the year or bill customers near the end of the year to control expenses and income)
  - Reduced administrative burden - assuming the taxpayer does not have GAAP accrual-basis financial statements
  - Gives a better indication of cash on hand

Small Business: Inventories

2017 Tax Law

- Any business in which the production, purchase, or sale of merchandise is a material income-producing factor must generally account for inventories at the beginning and ending of each year
- Affected businesses must also use the accrual method of accounting for purchases and sales of inventory
- Taxpayers in qualifying trades or businesses may account for inventory as materials and supplies that are not incidental if average gross receipts for the prior three taxable years does not exceed $10 million
  - Must not otherwise be prohibited from using the cash method as overall method of accounting under §448

Small Business: Inventories (Cont.)

Tax Reform Law

- All taxpayers (other than tax shelters) with 3-year average gross receipts less than $25 million (indexed for inflation) are exempt from the requirement to account for inventories
- Eligible taxpayers may either treat inventories as materials and supplies that are non-incidental or conform to the taxpayer's financial accounting treatment
  - Non-incidental materials and supplies are deducted as consumed or utilized in the taxpayer's operations
- Application of this provision constitutes a change in method of accounting

Small Business: Inventories Example

FACTS

- Corporate Taxpayer producing wooden canoes
- Average annual gross receipts: $20M
- Annual purchases are fully consumed during the year of purchase – *but* 20% remains on-hand in the form of canoes in process
- Annual wood purchases as follows:

Year 1	Year 2	Year 3
$7,000,000	$9,000,000	$8,000,000

Small Business: Inventories Example

Accounting for inventory under accrual method:

	Year 1	Year 2	Year 3
(A) Beginning Inventory	$ -	$1,400,000	$1,800,000
(B) Purchases	7,000,000	9,000,000	8,000,000
(C) Ending Inventory (20% of Purchases)	1,400,000	1,800,000	1,600,000
Cost of Goods Sold (A) + (B) – (C)	$5,600,000	$8,600,000	$8,200,000

Accounting for inventory using book method if book deducts costs upon purchase (non-GAAP):

	Year 1	Year 2	Year 3
Purchases	$7,000,000	$9,000,000	$8,000,000
Consumed (100% of Purchases)	7,000,000	9,000,000	8,000,000
Cost of Goods Sold = Amount Consumed	$7,000,000	$9,000,000	$8,000,000
Difference in Taxable Income (Compared to accrual method)	($1,400,000)	($400,000)	$200,000

Polling Question

Which of the following taxpayers that was previously ineligible to use the overall cash method of accounting (prior to TCJA enactment) is now eligible to use the overall cash method of accounting?

A. C Corporation manufacturer of widgets with average annual gross receipts of $4 million

B. C Corporation retailer with average annual gross receipts of $4 million

C. Both A and B

D. Neither A or B

Small Business: UNICAP

2017 Tax Law

- Taxpayers must capitalize certain direct and indirect costs related to real or tangible property, whether produced or acquired for resale
- Qualifying resellers whose average annual gross receipts do not exceed $10,000,000 are generally exempt from these requirement with respect to personal property acquired for resale
- Other taxpayers may be exempt from the requirements of IRC 263A based on certain industry classification or other limited exceptions

Small Business: UNICAP (Cont.)

Tax Reform Law

- All taxpayers (other than tax shelters) with 3-year average gross receipts less than $25 million (indexed for inflation) are exempt from the capitalization rules of IRC 263A
- Retains specific exceptions that are not based on a gross receipts threshold
- Application of this provision constitutes a change in method of accounting

Small Business: Long-Term Contract Accounting (IRC 460)

2017 Tax Law

- Taxpayers with average gross receipts of less than $10 million for the three prior taxable years are exempt from the requirement to use the percentage-of-completion method of accounting for long-term construction contracts which are expected to be completed within two years of the date when related costs are first incurred

Tax Reform Law

- Gross receipts threshold amount is increased to $25 million for all taxpayers (other than tax shelters)
- Application of this provision constitutes a change in method of accounting

Small Business: §179 Deduction

2017 Tax Law

- Businesses may immediately expense up to $500,000 of the cost of any section 179 property placed in service during the year.
- The $500,000 available for immediate expensing is reduced by the amount by which the cost of total section 179 property placed in service during the year exceeds $2,000,000
  - These amounts are adjusted for inflation; The 2017 deduction limit and phase-out threshold are $510,000 and $2,030,000, respectively.
- Limitations on the amount that can be immediately expensed are also imposed based on the taxpayer's taxable income for the year.

Small Business: §179 Deduction (cont.)

Tax Reform Law

- Increases the deduction limit to $1,000,000
- Increases the investment phase-out threshold to $2,500,000
- Amounts are indexed for inflation beginning after 2018
- The $25,000 cost limitation for SUVs is also indexed for inflation after 2018
- Expands definition of qualified real property to include all qualified improvement property and certain improvements made to nonresidential real property (see code section)
- Effective for property placed in service after December 31, 2017

Special Rule for Taxable Year of Inclusion

2017 Tax Law

- Under §451, an accrual method taxpayer includes an amount in taxable income when "all events" have occurred which fix the taxpayer's right to receive the income and the amount can be determined with reasonable accuracy
- "All events" have occurred at the earliest time when one of the following occurs:
  - An amount is received;
  - The taxpayer has the right to bill an amount; or
  - The amount is earned
- Possible that all events have not occurred until <u>after</u> an amount is recognized for financial reporting purposes

Tax Reform Law

- The "all events" test is satisfied <u>no later</u> than when an amount is recognized as revenue in the taxpayer's applicable financial statements
- Advance payments received must be recognized as taxable revenue no later than the end of the tax year following the year of receipt

Special Rule for Taxable Year of Inclusion: Example

ADVANCE PAYMENTS UNDER §1.451-5

- ABC Co. is an accrual method taxpayer
- In Year 1, ABC receives a customer payment of $5,000 toward the $15,000 purchase price for electric motors to be provided in Year 3
- ABC follows Treasury Regulation §1.451-5, which allows a taxpayer to defer recognition of certain advance payments for goods until the taxable year in which properly accruable under its method of accounting
- ABC does not meet the all events test for this contract until Year 3

Special Rule for Taxable Year of Inclusion: Example

ADVANCE PAYMENTS UNDER §1.451-5

	Year One	Year Two	Year Three	Total
Amount Received	$5,000	$ -	$10,000	$15,000
All Events Test Met?	No	No	**Yes**	
Revenue per AFS	$ -	$ -	$15,000	$15,000
Taxable Revenue				
Pre-Reform Law	$ -	$ -	$15,000	$15,000
Post-Reform Law	$ -	$5,000	$10,000	$15,000

A lot of "unknowns" remain…

Additional guidance is needed to clarify many of the provisions included in the TCJA.

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Accounting Methods Planning
In General

Creating Value Through Deferral

EXAMPLE

Taxpayer recognizes revenue ratably as work is performed. Taxpayer changes its method to recognize revenue when earned (e.g., when work is complete or product is delivered). Taxpayer projects steady business activity and revenue going forward.

	2017	2018	2019	2020-2026	Total	Final Year
Current Method	1,000	1,000	1,000	7,000	10,000	-
New Method	750	750	750	5,250	7,500	-
Recognize PY Deferral	-	250	250	1,750	2,250	250
Total	750	1,000	1,000	7,000	9,750	250
Difference	(250)	-	-	-	(250)	250
Tax Savings @ 35%	(88)	-	-	-	(88)	**88**

Note: Example does not take into account IRR on cash tax savings. The opportunity to generate significant benefit is greater than illustrated here!

Creating Value Through Deferral

EXAMPLE

Same facts, but tax rate is 35% in 2017 and is reduced to 21% in 2018 and beyond.

	2017	2018	2019	2020-2026	Total	Final Year
Current Method	1,000	1,000	1,000	7,000	10,000	-
	35%	21%	21%	21%		21%
	350	210	210	1,470	2,240	-
New Method	750	750	750	5,250	7,500	-
Recognize PY Deferral	0	250	250	1,750	2,250	250
Total	750	1,000	1,000	7,000	9,750	250
	35%	21%	21%	21%		21%
	263	210	210	1,470	2,153	53
Annual Tax Savings	88	-	-	-	88	(53)
Permanent Tax Savings						**35**

Note: Example does not take into account IRR on cash tax savings. The opportunity to generate significant benefit is greater than illustrated here!

Making a Method Change Effective for Tax Year 2017

- Automatic method changes effective for 2017 may be filed as late as the due date of the income tax return (including extensions).
- Determining if a method change is **automatic**:
  - **Rev. Proc. 2018-31** contains a list of automatic changes
  - Check **instructions to Form 3115**, which also include a list of automatic changes
  - Consider scope restrictions (general and specific)
- IRC §481(a) adjustment
  - Favorable (i.e., negative) adjustment is deducted in full in year of change
  - Unfavorable (i.e., positive) adjustment is taken into income ratably over four years, beginning with year of change
- No IRS filing fee for automatic changes

Making a Method Change Effective for Tax Year 2017

Already filed your 2017 federal income tax return? ***Fear not!***

- The IRS grants an automatic 6 month extension for filing automatic accounting method changes, beginning from the original due date (i.e., *excluding* extensions) of the federal income tax return for the year of change.

- To implement an automatic accounting method change for the 2017 tax year, after the original 2017 tax return has already been filed, all you need to do is:

  - File an amended 2017 return within the 6-month extension period;

  - Attach the original Form 3115 *Application for Change in Accounting Method* to the amended return; and

  - Include a statement that the Form 3115 is being filed pursuant to Treas. Reg. §301.9100-2(b) of the Procedures and Administration Regulations.

- NOTE: It is not necessary to have actually submitted a request for an extension of time to file.

Making a Method Change Effective for Tax Year 2017

- The period of time for filing an advance consent (i.e., non-automatic) method change effective for 2017 has passed.

- While the permanent tax savings afforded by the TCJA's rate reduction is not available after 2017, you should consider other benefits of changing accounting methods effective for 2018 and beyond:

  - Internal rate of return on cash tax savings

  - Audit protection

Polling Question

Which of the following statements is *true*?

A. A 2017 return was filed so I can no longer make method change for 2017

B. I can still filed automatic and non-automatic method changes for 2017

C. Permanent tax savings are available for method changes filed for 2017

D. There is no benefit to filing method changes for 2018 and beyond

Other Common Automatic Method Change Opportunities

Opportunity	Rev. Proc. 2018-31	DCN*
Change to deduct bad debts that are specifically identified	Section 4.01	5
Change to deduct amounts prepaid for insurance and qualifying service contracts	Section 11.05	78
Change from an impermissible to permissible method of depreciation • Cost segregation study • Repairs Study • Other fixed asset planning	Section 6.01	7
Change to deduct qualified IRC §174 research and development costs	Section 7.01	17
Change to the deferral method for certain advance payments	Section 16.07	84
Change to deducting amounts paid within 2.5 months after year end for accrued bonuses, vacation pay, and severance pay that is fixed and determinable	Section 19.01	133, 134
Change to deduct certain accrued expenses in advance of economic performance under the recurring item exception	Section 19.11	161
Accelerate deduction for liabilities associated with eligible ratable service contracts	Section 19.12	220

*DCN – Designated Change Number

Polling Question

How many items of income or deduction do you estimate that your company has which may qualify for a favorable automatic method change?

A. 1

B. 2

C. 3

D. 4+

Relevant Guidance on Accounting Method Changes

- Rev. Proc. 2015-13 – Changes in accounting periods and in methods of accounting.
  - General procedures
- Rev. Proc. 2018-31 (supersedes Rev. Proc. 2017-30) – List of Automatic Method Changes
- Rev. Proc. 2018-1 – Administrative procedures for letter rulings and information letters

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Questions?

UPCOMING WEBINAR!

Be sure to join us for the upcoming webinar to learn more about:

Bonus Depreciation and Cost Recovery Post-TCJA

Scheduled for July 26, 2018 from 12:00 PM – 1:00 PM (EST)

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