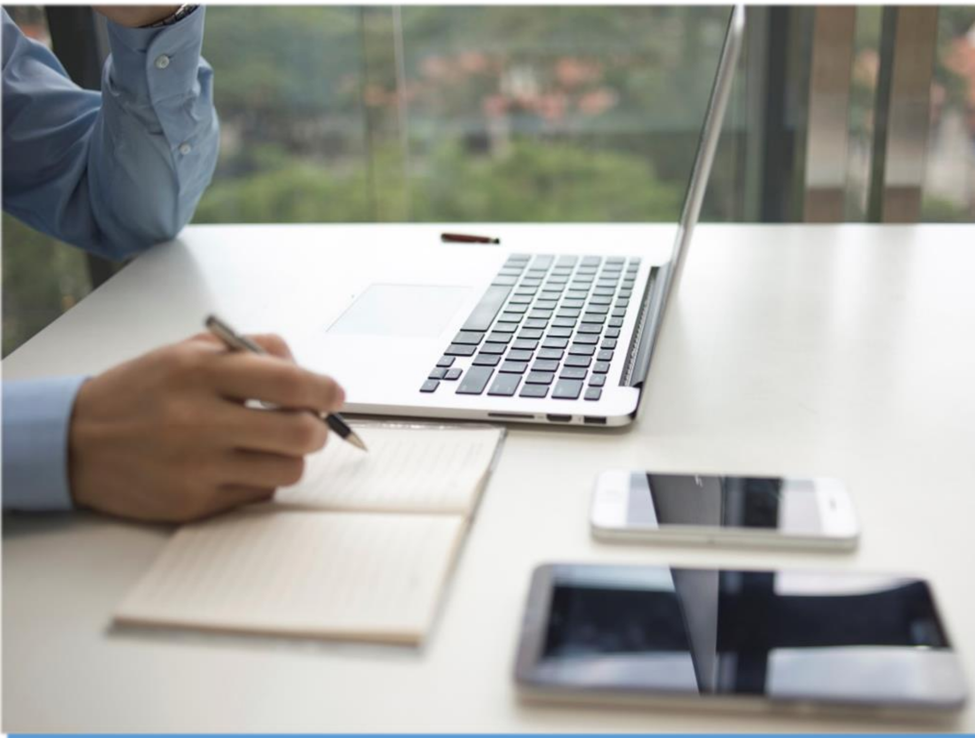

Clear Law Institute

New IRC 448 Accounting Method Rules for Small Businesses

Presented by:
Ron Wainwright
Andrew Kosoy

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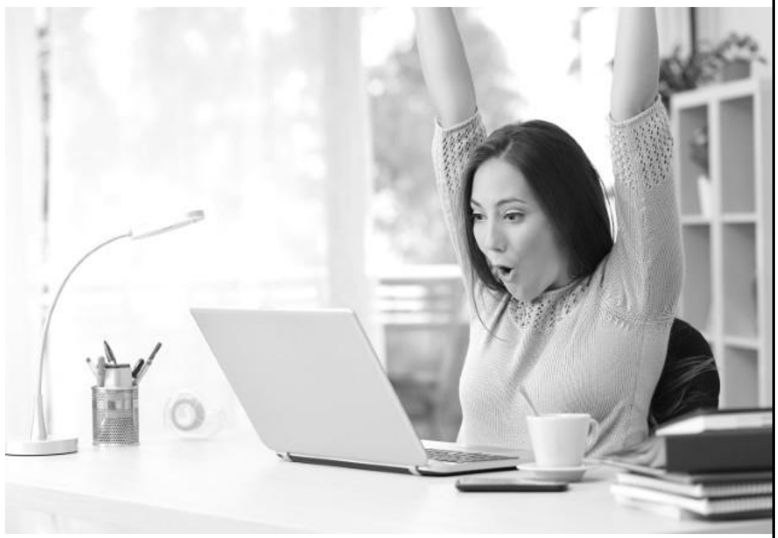
New IRC 448 Accounting Method Rules for Small Businesses and Other Recent Updates

Speakers

Ronald G. Wainwright, Jr., CPA, MST
Partner, National Leader
Credits and Accounting Methods

Andrew R. Kosoy, CPA
Senior Manager, Tax Services
Credits and Accounting Methods



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Objectives

- Review What is An Accounting Method & How to Change a Method of Accounting
- New Small Business Taxpayer Definition
- Understanding New Accounting Method Changes
- Other Accounting Method Updates

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What is an Accounting Method?

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What is an Accounting Method?

- The term “method of accounting” includes
  - An overall plan of accounting, such as for gross income and deductions
  - The treatment of any material item
- Requirements applicable to all methods of accounting:
  - Conformity
  - Clear reflection of income
  - Consistency

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Timing

- Must involve a ***timing*** item in order to be a method of accounting
- Timing impacts ***when*** to recognize an item of income or expense
  - **Not Timing** – if the item permanently changes the amount of the taxpayer's lifetime taxable income (e.g., M&E deduction, tax credits)
  - **Timing** – if the item ***could*** change the taxable year(s) in which the item is taken into account

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Adoption of a Method

- A ***method*** of accounting is adopted with consistent treatment
- Taxpayers engaged in more than one trade or business may use different methods for each trade or business
- Adopting a method of accounting
  - **2-year Rule**
    - The treatment of a material item in the same way in determining the gross income or deductions in ***two or more consecutively*** filed federal income tax returns, represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(a)
  - **1-year Rule**
    - If a taxpayer treats an item ***properly*** in the first federal income tax return that reflects the item, a valid method has been established

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Consequence of Adopting a Method

- Once a method of accounting is adopted, it cannot be changed without IRS consent
- If a method has not been adopted, the taxpayer should amend the incorrect return and use a proper method in subsequent returns
  - For example, if the taxpayer uses an improper accounting practice in one (and only one) return, it has not adopted a method.

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Changing a Method of Accounting

- Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for any item for federal income tax purposes.
- A taxpayer may not change an established method of accounting by amending its prior federal income tax return(s).

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Changing a Method of Accounting

- A change in method of accounting occurs when:
  - The ***proposed method***, the method to be used by the taxpayer for an item in computing its taxable income for the year of change is different than
  - The ***present method***, taxpayer's established method of accounting used to compute the taxpayer's taxable income for the immediately preceding taxable year.
    - This must be clearly defined when filing for a change in method of accounting – surprisingly, not always as easy as it may seem!

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Incentives to Change a Method of Accounting

- Provides audit protection
- Prevents the assessment of interest and penalties on impermissible methods of accounting
- Allows for the spread of an unfavorable (positive, or increase to income) § 481(a) adjustment over a 4 year period
- May allow for the choice of permissible methods
- Favorable (negative, or decrease to income) § 481(a) adjustments can reduce current year tax or increase NOLs

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General Application Procedures

- Generally, separate Form 3115 required for each change (exceptions specifically noted)
- Filed in duplicate (original, copy)
- Special rules if under exam
- Form 3115 must be complete

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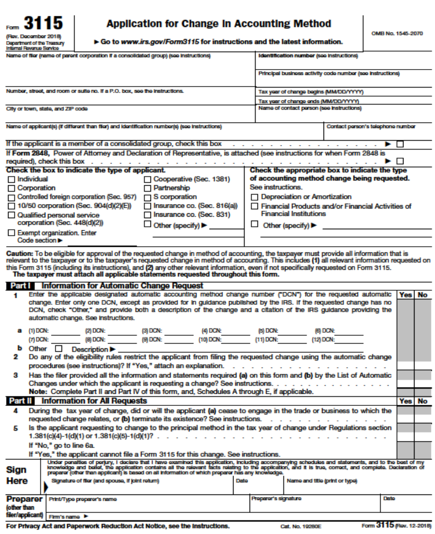
Form 3115



Form **3115** (Rev. December 2018) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

► Go to *www.irs.gov/Form3115* for instructions and the latest information.

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions) | Identification number (see instructions)
Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions. | Tax year of change begins (MM/DD/YYYY) | Tax year of change ends (MM/DD/YYYY)
City or town, state, and ZIP code | Name of contact person (see instructions)
Name of applicant(s) (if different than filer) and identification number(s) (see instructions) | Contact person's telephone number

If the applicant is a member of a consolidated group, check this box ► ☐
If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box ► ☐

Check the box to indicate the type of applicant.
☐ Individual
☐ Corporation
☐ Controlled foreign corporation (Sec. 957)
☐ 10/50 corporation (Sec. 904(d)(2)(E))
☐ Qualified personal service corporation (Sec. 448(d)(2))
☐ Exempt organization. Enter Code section ►
☐ Cooperative (Sec. 1381)
☐ Partnership
☐ S corporation
☐ Insurance co. (Sec. 816(a))
☐ Insurance co. (Sec. 831)
☐ Other (specify) ►

Check the appropriate box to indicate the type of accounting method change being requested. See instructions.
☐ Depreciation or Amortization
☐ Financial Products and/or Financial Activities of Financial Institutions
☐ Other (specify) ►

Caution: To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115. **The taxpayer must attach all applicable statements requested throughout this form.**

Part I Information for Automatic Change Request (Yes / No)

1 Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.
a (1) DCN: (2) DCN: (3) DCN: (4) DCN: (5) DCN: (6) DCN:
(7) DCN: (8) DCN: (9) DCN: (10) DCN: (11) DCN: (12) DCN:
b Other ☐ Description ►
2 Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.
3 Has the filer provided all the information and statements required **(a)** on this form and **(b)** by the List of Automatic Changes under which the applicant is requesting a change? See instructions.
Note: Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.

Part II Information for All Requests (Yes / No)

4 During the tax year of change, did or will the applicant **(a)** cease to engage in the trade or business to which the requested change relates, or **(b)** terminate its existence? See instructions.
5 Is the applicant requesting to change to the principal method in the tax year of change under Regulations section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)?
If "No," go to line 6a.
If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.

Sign Here Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.
Signature of filer (and spouse, if joint return) | Date | Name and title (print or type)

Preparer (other than filer/applicant) Print/Type preparer's name | Preparer's signature | Date
Firm's name ►

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions. Cat. No. 19280E Form **3115** (Rev. 12-2018)

- 8 page form
- Multiple parts and schedules; some are applicable for all changes, some only for specific changes
- Can be accompanied by additional supplemental statements

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Automatic Changes

- Form 3115 filed in duplicate
  - Original with Return – attached to timely filed return (including extensions)
  - Copy with Service Center – must be signed & filed on or before date of filing the tax return
    - Use Address in Instructions - Covington, KY
    - Can be filed during year of change up until filing of tax return
- No user/consent fee
- No acknowledgment of receipt
- Consent deemed granted if compliance with procedures of Rev. Proc. 2015-13 & Rev. Proc. 2018-31 & change implemented on tax return in year of change
- Audit Protection unless noted otherwise

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Additional Requirements to File an Automatic Change

- The change is described in the list of automatic changes (Rev. Proc. 2018-31)
- Meets all requirements to file as an automatic change
- Taxpayer did not engage in Section 381(a) transaction during year of change
- Not the final tax year for the trade or business
- No overall method change during the past 5 years, including the year of change
- No change for the same item during the past 5 years, including the year of change

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Non-Automatic Changes

- File Form 3115 during the requested year of change
- User/Consent Fee: identified annually in the procedures Rev. Proc. – currently Rev. Proc. 2019-1, Appendix A, Schedule of User Fees - $10,800
- File directly with IRS National Office
- Will be notified via letter ruling of IRS consent or denial
- If agree to letter ruling, must sign & return to IRS
  - Copy of consent agreement must be attached to tax return

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What is Audit Protection?

- In general, audit protection applies when an application for change in accounting method is granted
  - Section 8.01 of Rev. Proc. 2015-13: "…when a taxpayer timely files a Form 3115 under this revenue procedure, the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change."
- Form 3115 – Line 7b – lists how the taxpayer may qualify to receive audit protection
- There are exceptions to when a taxpayer may not receive audit protection

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Year of Change

- First tax year the applicant uses the proposed method, even if no affected items are taken into account for that year
- Effective on the first day of the taxable year
- IRC § 481 adjustments

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§ 481(a) Adjustment Period

- Negative Adjustment (Favorable)
  - One taxable year (year of change)
- Positive Adjustment (Unfavorable)
  - Ratably over four taxable years (year of change and next three years)
- Short period as a separate taxable year
  - If the year of change or any other taxable year during the § 481(a) adjustment period for a positive adjustment is a short taxable year, the taxpayer must take the § 481(a) adjustment into account as if that short taxable year were a full 12-month taxable year.

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Small Business Taxpayer

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Small Business Taxpayer

Taxpayer, other than a tax shelter, that meets the §448(c) gross receipts test

- Average of three prior years annual gross receipts
  - Must be $25 million or less
  - Commonly controlled businesses must aggregate gross receipts when common employer tests apply
- Gross receipts test adjusts for inflation
  - 2019 - $26 million, see Rev. Proc. 2018-57

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Tax Shelters & Sections 163(j), 448(c)

- A tax shelter is a vehicle used by taxpayers to minimize or decrease their taxable incomes and, therefore, tax liabilities.
  - A partnership, LLC or S Corp. that has 35% or more of allocable losses to limited partners or "limited entrepreneurs" (i.e., owners that do not materially participate in management)
- Ineligible to use the Small Business Taxpayer exception of Sec. 163(j), regardless of whether their average gross receipts are under $25 Million.
- Not eligible to use the cash method under Sec. 448(c) nor any of the other simplified accounting methods generally available to taxpayers with average gross receipts < $25 Million.
- Can only be fixed via technical corrections

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Small Business Taxpayer – Accounting Method Changes

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Rev. Proc. 2018-40

- Accrual to Cash
- Exception from UNICAP
- Exception from Accounting for Inventories under §471
- Exceptions from Accounting for Long-term Contracts under §460 or from UNICAP on Home Construction Contracts

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Overall Method – Accrual to Cash

- Small business taxpayers
  - Excludes banks or farmers
- §481(a) - benefit when revenues recognized exceed expenses recognized under prior accrual method
  - Service business – typically, A/R over A/P
  - Goods business – additional analysis to perform on inventory

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Cash Method Taxpayers

Cash basis taxpayers recognize income when:
- Actually receive it, or
- Have constructive receipt of it

Not subject to the 4 part all-events test

Some taxpayers may want to avoid the complications of the new rules by using the overall cash method

Revised § 448 provides an opportunity for entities with average annual gross receipts less than $25 million that would otherwise not be able to use the cash method

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Accrual -> Cash (Before - Accrual BS)

Assets		Liabilities & Equity	
Cash	150,000	A/P	1,000,000
Accts Receivable	4,000,000	Mortgage Payable	1,000,000
Fixed Assets	2,000,000	Retained Earnings	4,150,000
TOTAL	6,150,000	TOTAL	6,150,000

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Maximize Tax Benefits

Accrual -> Cash (After - Cash BS)

Assets		Liabilities & Equity	
Cash	150,000	~~A/P~~	~~1,000,000~~
~~A/R~~	~~4,000,000~~	Mortgage Payable	1,000,000
Fixed Assets	2,000,000	Retained Earnings	1,150,000 ~~4,150,000~~
TOTAL	2,150,000 ~~6,150,000~~	TOTAL	2,150,000 ~~6,150,000~~

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Maximize Tax Benefits

Accrual -> Cash §481(a) Calculation

1) Deduct Revenue Recognized under Accrual Method
   - Accounts Receivable: ($4,000,000)

2) Addback Expenses Recognized under Accrual Method
   - Accounts Payable: $1,000,000

= Net §481(a) Adjustment: ($3,000,000)
(favorable) reduction to taxable income for 2018

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Maximize Tax Benefits

Another Example

Revenue Recognized but not Received:	
Accounts Receivable	**(3,000,000)**
Expenses Paid but not Deducted:	
Deposits and Prepaid Expenses	**(25,000)**
Expenses Deducted but not Paid:	
Accounts Payable	**300,000**
Payroll Accrued	**75,000**

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Exception from UNICAP

- Small business taxpayers
  - Excludes home construction contracts
- No longer required to capitalize additional §263A costs
- §481(a) – current year benefit of completely expensing all capitalized §263A costs

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Removing UNICAP

1)	2017 – Old Method ending §263A balance	($2,000,000)
2)	2018 – New Method beginning §263A balance	$ 0
=	Net §481(a) Adjustment (favorable) reduction to taxable income for 2018	($2,000,000)

- 2018 and forward: no need for UNICAP calculation and book/tax adjustment related to UNICAP

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Exception from §471 Inventory

- Small business taxpayers
- Two options:
  - Treat inventory as non-incidental materials and supplies
    OR
  - Conform to taxpayer's method of accounting reflected in financials
- §481(a) – expense inventory items earlier; may have significant book/tax difference as a result

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Non-Incidental Materials & Supplies

- Treas. Reg. §1.162-3(a)(1)
  - *amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayer's operations.*

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The New Rules of TPR

Treas. Reg. § 1.162-3 (h) Example (7):

materials and supplies as units of property

50 scanners purchased:

- 35 scanners in use, expense costs
- 15 scanners in storage, capitalize costs
  -- items are not *consumed*

Treas. Reg. § 1.162-3 (h) Example (12):

materials and supplies for use in production of property

Jigs, dies, molds purchased

- Dies and molds go into production, expense costs
- Jigs, molds still in storage, capitalize costs
  -- items are not *used*

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§471 -> Non-Incidental Materials and Supplies

- Example – Ending inventory balances.
  How much is deductible in the current year under the §471 method as opposed to if the items had been treated as non-incidental materials and supplies

§471	Ending Balance
Raw Materials	100
WIP	400
Finished Goods	1,000
Total	1,500

N-I Materials	Ending Balance
Raw Materials	100
WIP	-0-
Finished Goods	-0-
Total	100

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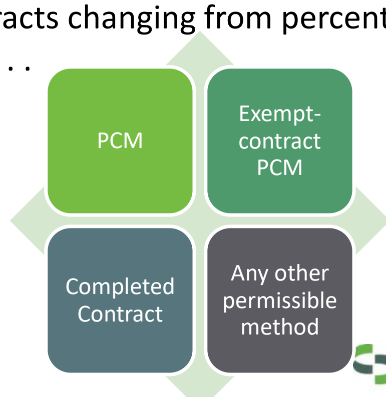
Exception from §460 Long Term Contracts or §263A for Home Construction Contracts

- Small business taxpayers with long-term contracts
  - Exempt from §460(a) requirements to use PCM
- Exempt long-term construction contracts changing from percentage-of-completion to permissible methods . . .
- No §481(a) adjustment -- new contracts use new method



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Benefits to Making These Changes

- Generally, favorable §481(a)
- Simplification of accounting and recordkeeping
- Generally, a deferral of taxable income
- Usually, more control over balance sheet at year end

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Accounting Method Change Guidance

- Tax year applicability
- Concurrent changes filed together
- Reduced filing requirements
- Scope limitations on eligibility for automatic changes waived
- Section §481(a) adjustment or cut off method

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Other Accounting Method Items

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§ 451 and TCJA

- The TCJA fundamentally alters the relationship between financial and tax accounting.
- § 451(b) effectively imposes a book-tax conformity rule for recognizing income for tax purposes.

Under the new rule, an accrual-method taxpayer may not treat the all-events test as being met for any item of gross income (or portion thereof) any later than when that item is taken into account as revenue in either an applicable financial statement (AFS) or another financial statement that Treasury and the IRS identify as applying for this purpose.

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The Intersection of New §451 and ASC 606

- TCJA changed how accrual-method taxpayers determine when to recognize income for federal tax purposes.
- New §451 requires tax departments to be vigilant for situations in which the new financial accounting standards (ASC 606) accelerate the recognition of revenue for book purposes.
- For federal tax purposes, taxpayers must now allocate the contract's "transaction price" among each performance obligation in the same way it is allocated for financial accounting purposes.

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When is Revenue Recognized?

Determinable

Amount can be **determined with reasonable accuracy**

Fixed

Amount is **fixed upon the earliest:**

a) **Earned** when required performance or events have taken place, or

b) **Due** to taxpayer based on contract terms, or

c) **Received** by taxpayer

§ 451(b)

Requires taxpayers to recognize income **at the earlier of**:

a) when amount is fixed, or

b) when taken into account in applicable financial statements

Special Rules

Advance payments, Long-term contracts, Installment sales

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Rev. Proc. 2018-60

- Adds new automatic accounting method change to comply with new §451(b)
  - Meets all-events test (including earliest of book recognition) or
  - Not adopting ASC 606/New Standards (did not file change per Rev. Proc. 2018-29) and wants to allocate revenue pursuant to §451(b)(4)
- Must have Applicable Financial Statements
- Short Form 3115
- Streamlined Procedures

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Business Interest Limitation

- The TCJA limits the business interest deduction for taxpayers with more than $25 million in average gross receipts.
- Certain taxpayers can elect out of these limitations in Section 163(j)(7)
- In order for an electing real property trade or business to elect out of Section 163(j), nonresidential real property, residential rental property, and qualified improvement property must be depreciated using ADS
- Similarly, an electing farming business must depreciate all property with a recovery period of 10 years or more using ADS

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ADS Recovery Period – Residential Rental Property

- If placed in service prior to January 1, 2018, will still be depreciated using the 40 year ADS recovery life.

- If placed in service after December 31, 2017, the ADS recovery period for residential rental property has been reduced to 30 years

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New Building Placed in Service in 2017

Asset	d t	Property Description	Date In Service	Tax Cost	Sec 179 Exp Current = c	Tax Bonus Amt	Tax Prior Depreciation	Tax Current Depreciation	Tax End Depr	Tax Net Book Value	Tax Method	Tax Period
Group:												
1		5-Year	11/09/17	854,410.00	0.00c	427,205.00	0.00	448,565.25	448,565.25	405,844.75	200DB	5.0
2		7-Year	11/09/17	1,978,670.00	0.00c	989,335.00	0.00	1,024,668.39	1,024,668.39	954,001.61	200DB	7.0
3		15-Year	11/09/17	1,283,139.00	0.00c	641,569.50	0.00	649,589.12	649,589.1	[illegible]	150DB	15.0
4		39-Year	11/09/17	28,682,799.00	0.00c	0.00	0.00	91,932.05	91,932.0	28,590,866.95	S/L	39.0
			No Group	32,799,018.00	0.00c	2,058,109.50	0.00	2,214,754.81	2,214,754.81	30,584,263.19		
			Grand Total	32,799,018.00	0.00c	2,058,109.50	0.00	2,214,754.81	2,214,754.81	30,584,263.19		

Cost Seg Study!

Maximize Tax Benefits

Real Property Trade or Business Election out of §163(j)

Description Of Asset	Method	Life	Net Tax Basis at election
5 Year Property	**GDS MACRS**	5	405,845
7 Year Property	**GDS MACRS**	7	954,001
15 Year Parking Lot	**GDS MACRS**	15	633,550
39 Year Building	**ADS Straight Line**	40	28,590,867
Total			**30,584,263**

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Electing Out of 163(j): Depreciation Example

- Purchase Nonresidential Real Property that is placed into service January 1, 2015 with an adjusted basis of $39K and depreciate using GDS mid-month convention. In 2018, elect out of 163(j) and switch to ADS.

Tax Year	Depreciation Year / Years Remaining	Depreciation Expense	Accumulated Depreciation	New Adjusted Basis
2015	1 / 39	$960	$960	$38,040
2016	2 / 38	$1,000	$1,960	$37,040
2017	3 / 37	$1,000	$2,960	$36,040
2018	4 / 37	$974	$3,934	$35,066
2019	5 / 36	$974	$4,908	$34,092

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Rev. Proc. 2019-8

- Rev. Proc. 2019-8 provides guidance to real property trades or businesses and farming businesses that have the ability to elect out of Section 163(j) interest limitations
- If the real property trade or business or farming business elects out of Section 163(j) they MUST depreciate certain property using ADS
- When electing out and performing the required change to ADS depreciation, taxpayers are NOT required to file an accounting method change
- New guidance is extremely taxpayer friendly

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Maximize Tax Benefits

"Negative" §263A Regulations

- Applicable for tax years beginning on or after November 20, 2018
- Created a new Modified Simplified Production Method ("MSPM") for calculating additional Section 263A costs.
- Clarified how certain inventory costs are calculated and allocated under the new methods.
- Provided guidance on *de minimis* rules for direct labor and direct materials costs.
- Detailed the rules of prohibiting the use of negative amounts when calculating 263A costs.
- Provided a list of a number of new or amended automatic accounting method changes, including temporarily permitting taxpayers to file automatic changes revoking a HAR election or changing to a different simplified method, including the new MSPM, without the HAR election.

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Modified Simplified Production Method

- The new method allocates Section 263A costs, including negative adjustments, to raw materials, work-in-process and finished goods inventories on hand at the end of the taxable year.
- Taxpayers may now include negative amounts in allocating additional Section 263A costs by using a pre-production cost absorption ratio and a production cost absorption ratio.
- It expands the types of methods that are allowed to be used to allocate mixed service costs between pre-production and production.
- Under the new method, taxpayers are not required to separately track direct material costs that are integrated into the inventories of work-in-process and finished goods.

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Thank you!

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