Income tax accounting methods — more than just timing

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Agenda

- What is a method of accounting?
- Adopting a method of accounting
- Changing a method of accounting
- Categories of method changes
- Accounting method change considerations — permanent benefits
- Questions?

What is a method of accounting?

What is a method of accounting?

- The phrase “method of accounting” is not defined in the Internal Revenue Code or Treasury Regulations.
- Key elements of a method of accounting:
  - Timing
  - Consistency
  - Certainty
  - Predictability
- Generally, it is any regularized practice for determining when to recognize items of income and expense:
  - “When” not “whether”

What is a method of accounting? (cont.)

- Overall method of accounting vs. a method of accounting for special items.
- Defining the “item” is critical to in determining whether a method exists and/or whether a method has changed.
- Three requirements for all methods of accounting:
    1. Book conformity (doesn’t necessarily mean you follow GAAP)
    2. Clear reflection of income
    3. Consistent use

Adopting a method of accounting

Adopting a method of accounting

- Taxpayers have discretion to choose their method of accounting.
- Taxpayers can use different methods for each of their separate and distinct trades or businesses:
  - The courts have considered many factors when determining whether a separate and distinct trade or business exists.
- Adopting a method of accounting for an item:
  - General Rule (Rev. Proc. 2015-13, Sec. 2.01(2)):
    - Permissible method — first return reflecting the item.
    - Impermissible method — consistent treatment on two or more consecutive returns (but exception exists for depreciation if desired).
  - Special methods and elections:
    - Compliance with the rules in the provisions of Code or Regs authorizing use (e.g., a statement may be required with the return).
  - Foreign corporation exception:
    - Adopt once earnings and profits (E&P) is significant.

Changing a method of accounting

Changing a method of accounting

- What is a change in method of accounting?
  - A change in the overall plan of accounting for gross income or deductions (e.g., cash to accrual).
  - A change in the treatment of any material item:
    - A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.
    - Generally, the dollar amount is not relevant.
  - Generally, a method for an item must have been adopted/established (i.e., consistent treatment) for a change in method to occur.

Changing a method of accounting (cont.)

- What is not a change in method of accounting?
  - Correction of an error:
    - A change in method of accounting does not include correction of mathematical or posting errors or errors in the computation of tax liabilities (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit).
    - Consider errors within a method (deviations for certain “sub items”).
  - Change in character:
    - Determining the character of an item is not a method of accounting; however, once the character of the item is known, the method of determining when that item is reportable income or deductible, is indeed a method of accounting.
  - Change in underlying fact:
    - A change in business practices, certain business relationships or an altered fact situation may cause a change in facts sufficient to alter tax reporting. Such a change is not a change in method of accounting.
  - Tax implications are impacted by whether a change in the treatment of an item is or is not considered a change in the method of accounting.

Categories of method changes

Categories of method changes — in general

- Different rules for different types of accounting method changes.
- **Category of changes include:**
  - Voluntary changes
  - Involuntary changes (i.e., IRS-initiated changes)
  - Statutorily mandated changes
  - Changes arising from Section 381(a) transactions
  - Unauthorized changes

Categories of method changes — voluntary changes

- Automatic change vs. non-automatic changes:
  - Rev. Proc. 2015-13 and the list of automatic changes in Rev. Proc. 2025-23 (or successor).
- IRS consent is required:
  - If not requested the change is unauthorized (no audit protection).
- Consider potential eligibility limitations (e.g., final year of trade or business).
- Section 481(a) adjustments and audit protection.

Categories of method changes — voluntary changes (cont.)

- Section 481(a) adjustment — a "catch-up" adjustment.
  - A negative adjustment is taken into account in the year of change.
  - A positive adjustment is taken into account ratably over four years, beginning with the year of change (i.e., "the four-year spread").
  - Character of the Section 481(a) adjustment.
- Audit protection — if the method change is properly implemented under the applicable voluntary change procedures, the IRS may not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change:
  - IRS cannot raise the issue on exam and propose an adjustment with interest and penalties
  - Under exam exceptions
  - Special rules for controlled foreign corporations

Categories of method changes — voluntary changes (cont.) Automatic

- Automatic method changes — Rev. Proc. 2015-13 and Rev. Proc. 2025-23 (or successor), as modified, clarified and amplified:
  - **What** — An IRS-listed method change for which consent is automatically granted upon filing a Form 3115 and complying with the relevant procedures.
  - **How** — File a Form 3115 (Application for Change in Accounting Method).
  - **Who** — Multiple taxpayers may generally file a single Form 3115 if certain conditions are met.
  - **When** — Must file by the due date of the tax return, including timely filed extensions, for the year of change.
  - **Where** — Copy of Form 3115, with the applicable statements/attachments must be separately filed with the IRS on or before the day that the tax return for the year of change is filed. The original Form 3115, along with the applicable statements/attachments is required to be attached to the tax return.
  - **What happens then?**

Categories of method changes — voluntary changes (cont.)
Non-automatic

- Non-automatic method changes — See Rev. Proc. 2015-13, as modified, clarified and amplified:
  - **What** — A method change for which consent is not automatically granted (i.e., IRS manually reviews).
  - **How** — File a Form 3115 (Application for Change in Accounting Method):
    - The taxpayer is required to provide a legal analysis supporting the change.
    - Application must also be accompanied by a "user fee."
  - **Who** — Generally each taxpayer must file a separate Form 3115 for each trade or business. Exceptions exist for certain related parties making identical method changes.
  - **When** — To be effective for a particular tax year (i.e., the year of change), the Form 3115 must be filed on or before the last day of that year.
  - **Where** — The IRS National Office. The IRS National Office will review and issue a ruling letter and consent agreement if they agree to the change. Consent agreement must be attached to return for year of change.
  - **What happens then?**

Using the voluntary change procedures
A change in underlying facts

- **Facts**
  - Company A, a calendar year accrual basis taxpayer, has an employee bonus plan whereby it annually pays $4m in employee bonuses.
  - Bonus amounts approved at end of calendar year and paid out by March 15 of subsequent year.
  - Employees must be employed on the payment date to receive amounts, and no bonus pool amounts to redistribute to eligible employees.
- **IRS position**
  - Bonus amounts are NOT fixed at year-end because employees must be employed on the payment date. Under the current facts, payment fixes the liability. Thus, bonus approved in 2025 should be deducted in 2026 (the year the liability is fixed).

Using the voluntary change procedures
A change in underlying facts (cont.)

- **Resolution/ potential opportunity**
  - File an automatic method change for the 2025 tax year to change to a permissible method (i.e., deduct bonuses in the year the liability fixes — the year paid).
  - Also, change in the taxpayer's bonus plan (i.e., change in underlying facts) so that the liability fixes in the year of accrual and not the year of payment.
  - This result is that the taxpayer deducts both 2024 and 2025 bonuses in 2025 while deferring the unfavorable Section 481(a) adjustment over four years. Considering the time value of money and the recurring nature of the liability, this effectively provides a permanent benefit in the year of change.
  - Notably, the approach depends on the taxpayer's willingness to change and document the *substance* of their bonus plan, such that it meets the requirements of being fixed in the year of the accrual (e.g., bonus plan updated such that bonus pool established in 2025 must be paid out in 2026, regardless of new facts that may exist in 2026).

Example: use of voluntary change procedures
A change in facts and taxpayer impact

The table below shows the impact to taxable income in a scenario where the taxpayer simply files a change in method of accounting without also changing the 2025 bonus plan underlying/substantive facts (i.e., the 2025 bonus plan liability does not fix until 2026).

	2024	2025	2026	2027	2028	2029
Deduction — 2024 bonus liability	$(4,000,000)	$(4,000,000) [due to method change]				
Deduction — 2025 bonus liability			$(4,000,000)			
Deduction — 2026 bonus liability				$(4,000,000)		
Deduction — 2027 bonus liability					$(4,000,000)	
Deduction — 2028 bonus liability						$(4,000,000)
Section 481(a) Adjustment		$1,000,000	$1,000,000	$1,000,000	$1,000,000	
Total taxable income impact	$(4,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(4,000,000)

Example: use of voluntary change procedures
A change in facts and taxpayer impact (cont.)

The table below shows the impact to taxable income in a scenario where the taxpayer files a method change and, in conjunction with that method change, also changes its facts pertaining to the bonus plan so that the bonuses fix in the year prior to payment.

	2024	2025	2026	2027	2028	2029
Deduction — 2024 bonus liability	$(4,000,000)	$(4,000,000) [due to method change]				
Deduction — 2025 bonus liability		$(4,000,000) [due to change in underlying facts]				
Deduction — 2026 bonus liability			$(4,000,000)			
Deduction — 2027 bonus liability				$(4,000,000)		
Deduction — 2028 bonus liability					$(4,000,000)	
Deduction — 2029 bonus liability						$(4,000,000)
Section 481(a) Adjustment		$1,000,000	$1,000,000	$1,000,000	$1,000,000	
Total taxable income impact	$(4,000,000)	$(7,000,000)	$(3,000,000)	$(3,000,000)	$(3,000,000)	$(4,000,000)

Categories of method changes
Involuntary changes

- When an improper method of accounting for a particular item is identified, IRS may either:
  - Change the taxpayer’s method of accounting for such item.

    Or
  - Propose an adjustment for the years at issue without actually changing the taxpayer’s method of accounting.
- Generally, the IRS will use one of the above approaches when:
  - The taxpayer’s method of accounting is impermissible and found to understate income.

    Or
  - The taxpayer changed its method of accounting to a more favorable method without the IRS’s consent (unauthorized change).
- Rev. Proc. 2002-18 provides the procedures for the IRS to follow when they identify an accounting method change issue on exam.

Categories of method changes
Involuntary changes (cont.)

- Involuntary change (approach 1):
  - Generally, where method of accounting is found to understate income, the change will be made in earliest open year under examination. Alternatively, made in a later year under examination.
  - The required Section 481(a) adjustment will generally be taken into account in full in the year of change, even if unfavorable.
  - Interest and penalties will be assessed.
  - Amended tax returns will likely need to be filed for intervening tax years.

Categories of method changes
Involuntary changes (cont.)

- Adjustments with no change in tax accounting method (approach 2):
  - Resolved on either an alternative timing basis or a time value of money basis.
- Alternative timing basis:
  - Adjustments are made to current and possibly future years without a change in method of accounting.
- Time value of money basis:
  - Pay an amount that approximates the time value of money benefit derived from using the method of accounting for the taxable years before appeals or before a federal court, reduced by an amount to reflect the hazards of litigation.
  - The amount paid is not deductible for federal income tax purposes.
  - Taxpayer must continue to file its subsequent tax returns using its present method of accounting unless closing agreement is to the contrary.

Accounting method change considerations — permanent benefits

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Scenario 1 — Section 163(j) limitation

- **The regime:**
  - Section 163(j) limits interest expense to 30% of adjusted taxable income (ATI).
  - Capitalized interest is not subject to the Section 163(j) limitation.
  - Starting in 2025, depreciation and amortization are added back in determining ATI.
- **The issue:**
  - Taxpayer's interest deduction is otherwise limited under Section 163(j).
- **The next steps:**
  - Review ability to capitalize interest via mandatory and elective interest capitalization provisions.
  - Evaluated whether any Section 162 deductions would be appropriately capitalized into the basis of depreciable property eligible for 100% bonus depreciation.

Scenario 2 — BEAT

- **The regime:**
  - Minimum tax regime under which base erosion payments to foreign-related parties are disallowed in computing the minimum tax base.
  - Payments to foreign related-party generally must be “allowable as a deduction” to qualify as a base erosion payment.
- **The issue:**
  - Permanent base erosion and anti-abuse tax (BEAT) liability due to effective disallowance of payments to foreign related-party.
- **The next steps:**
  - Review ability to capitalize payments to foreign-related parties that are otherwise deductible (e.g., to inventory) thus disqualifying them from classification as a base erosion payment.
  - Model expected impact on BEAT liability.

Scenario 3 — FDII deduction

- **The regime:**
  - Section 250 provides a deduction, i.e., a foreign-derived intangible income (FDII) deduction, generally equal to a specified percentage of a US corporation's income that is derived from certain outbound sales and services, i.e., FDII.
  - For 2025 taxable years, FDII is required to be reduced by all expenses and deductions properly allocable to such income. For taxable years beginning after December 31, 2025, FDII is only required to be reduced by expenses and deductions, *other than interest expense and research or experimental expenditures*, properly allocable to such gross income.
- **The issue:**
  - Taxpayer incurs significant domestic research or experimental expenditures and is evaluating whether it can enhance its FDII deduction.
- **The next steps:**
  - Review ability to defer pre-2026 domestic research or experimental expenditures through method change analysis and planning (recent legislation provides multiple possible deferral options depending on applicable facts and circumstances). Potential to enhance the 2025 FDII deduction (permanent benefit) while not reducing future FDII deductions.

Scenario 4 — investment tax credits

- **The regime:**
  - Several federal income tax credits, many of which were added to the IRC or enhanced by new tax legislation, are equal to a specified percentage of the tax basis of eligible property produced by the taxpayer for use in its trade or business.
  - See Section 46 and the credits listed therein.
- **The issue:**
  - Taxpayer qualifies for an investment tax credit and is assessing existing eligible costs that could increase the credit amount.
- **The next steps:**
  - Consider ability to capitalize otherwise deductible costs to the basis of the investment credit property (e.g., under Section 263A).

Questions?

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