

WNTS Insight

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Top automatic accounting method changes for 2011 returns

Differing considerations may affect taxpayer decisions on accounting method changes. For example, taxpayers seeking to increase cash flow and decrease their current cash tax liability may benefit from accounting method changes that accelerate deductions or defer revenue. At the same time, because of the increased IRS focus on uncertain tax positions, taxpayers also may want to file accounting method changes to correct improper methods of accounting and obtain audit protection. An accounting method change from an improper to a proper method of accounting may increase taxable income.

Over recent years, the number of changes that can be made without prior IRS consent has increased dramatically. One advantage to being able to file a change automatically is the deadline. A taxpayer that is not currently under IRS examination may file an automatic Form 3115, *Application for Change in Accounting Method*, at any time on or before the due date of the taxpayer's timely filed federal income tax return (including extensions). For example, the deadline for calendar-year corporations with a six-month filing extension is September 15.

Below is a list of common accounting method changes that can be requested automatically, assuming the prerequisites for making the particular accounting method change are met. Currently, there are approximately 180 different automatic accounting method changes. As a result, eligible taxpayers that are in the process of preparing their federal income tax returns for 2011 still have some time to consider whether any of these automatic accounting method changes could help achieve their tax planning objectives.

The discussion of each accounting method described below is intended to be a general overview of each item. Careful analysis is required regarding a particular taxpayer's specific facts to determine whether the desired change can be made automatically.



Accounting method changes to decrease taxable income

The following are accounting method changes that may provide taxpayers with opportunities to accelerate deductions or defer revenue recognition.

Self-insured medical accruals/IBNR

Taxpayers may deduct incurred but not reported (IBNR) self-insured medical claims at the time such medical services are provided to the extent that, under the employer's self-insured medical plan, the medical service provider, rather than the employee, submits the claim for payment. This opportunity applies to medical IBNR accruals related to active employees, retired employees (i.e., FAS 106 liability), and worker's compensation claims.

This opportunity may be particularly significant for taxpayers that currently are receiving a benefit from the deduction of the Medicare Part D subsidy, which generally is recorded as a component of the FAS 106 liability for financial statement purposes. In tax years beginning after December 31, 2012, taxpayers no longer will be allowed to deduct the cost of retiree prescription drug benefits covered by the Medicare Part D subsidy. Therefore, for eligible taxpayers, accelerating the IBNR deduction could result in cash tax savings.

Software development costs

Taxpayers that capitalize costs attributable to the development of software for internal use -- including costs incurred in developing websites or implementing enterprise resource planning (ERP) software packages -- may be able to file an automatic accounting method change to deduct those costs currently in accordance with Rev. Proc. 2000-50.

Uniform capitalization

Taxpayers that produce real or personal property, or acquire real or personal property to resell in the ordinary course of business, are subject to the uniform cost capitalization rules under section 263A. Due to the complexity of the uniform capitalization rules, taxpayers may find that they are overcapitalizing costs. In many cases, a taxpayer can file an automatic accounting method change to properly apply section 263A.

Depreciation

While there are many automatic accounting method changes related to fixed assets, the most common accounting method changes may provide taxpayers with the opportunity to change to a shorter recovery period, claim missed bonus depreciation, or begin to depreciate assets that have not been properly depreciated.

Advance payments

Taxpayers that receive advance payments related to certain goods, services, the use of intellectual property, computer software, or guaranty or warranty contracts and recognize income for federal income tax purposes when received may be able to defer income recognition for those payments to the next succeeding tax year in accordance with Rev. Proc. 2004-34.

Inventory valuation

Taxpayers with large inventory balances may be able to benefit from a change in their inventory valuation methods. Proper inventory valuation planning -- which can include changes to the timing of deductions related to subnormal goods, estimating inventory shrinkage, or changing to the lower of cost or market method -- may help taxpayers increase the deduction for cost of goods sold and therefore decrease taxable income.

Bad debts

Taxpayers that determine their book/tax difference for bad debts by analyzing the change in balance from year to year may be able to benefit from a change in method of accounting to deduct accounts receivable reserves related to specific customers that are either wholly worthless or partially worthless and charged off.

Prepaid payment liabilities

Taxpayers that currently are capitalizing prepaid expenses such as prepaid insurance, warranties, software maintenance, licenses, fees, and permits with a useful life of 12 months or less may have an opportunity to change their method of accounting to deduct those items when paid.

Cash-to-accrual method for a specific item

Accrual-method taxpayers sometimes may follow the cash method for certain items -- i.e., recognize a deduction for the item when payment is made, not when the item is fixed, determinable, and economic performance has occurred. Taxpayers may be able to file an automatic accounting method change to deduct those items using a proper accrual method. Examples of items that could be covered by this change include legal and other professional fees and environmental remediation costs.

Changes from improper to proper methods

The following changes in method of accounting may benefit taxpayers that currently are using an improper method of accounting for the item by providing audit protection. In some cases, these changes will result in an increase to taxable income.

Uniform capitalization

Taxpayers that currently are using an improper method of accounting for their section 263A costs -- such as applying a fixed percentage each year without having made a historic absorption ratio election or failing to properly capitalize certain costs -- may be able to file an automatic accounting method change to begin properly applying section 263A.

Accrued bonuses

Taxpayers may take accrued bonuses into account to the extent the liability is fixed and reasonably determinable at year-end, economic performance has occurred, and payment is made within 2.5 months after year-end. However, some taxpayers may be accelerating incorrectly the deduction for accrued bonuses for which the liability is not fixed at year-end. Taxpayers in this situation may be able to file an automatic accounting method change to apply properly the provisions of section 461 to determine when the bonus should be taken into account.

Section 467 rental agreements

Taxpayers may be following their book method of accounting and taking rental deductions into account ratably over the term of the lease. However, if the rental agreement is subject to section 467, taxpayers generally are required to accrue rental deductions for tax purposes in accordance with the rental agreement. An automatic accounting method change may be available, provided the rental agreement is not subject to proportional rental or at risk for constant rental.

Losses, expenses, and interest between related parties

Taxpayers that have transactions with related parties and are not following the "matching rule" in sections 267(a)(2) and (3) may be taking deductions into account too soon. Taxpayers in this situation may be able to file an automatic accounting method change to properly apply the provisions of section 267 and the regulations thereunder.

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