Taxpayers may need to engage in accounting method planning by year-end

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In brief

Accounting method planning can result in permanent tax benefits as well as immediate cash tax savings. Taxpayers can implement many accounting method strategies when they file their federal income tax return either through elections or under the automatic method change procedures. However, taxpayers need to file method changes that must be made under the nonautomatic procedures by the end of the tax year for which they are to be effective.

Taxpayers also may need to act by year-end to change facts that affect their accounting methods, for example to fix a liability that could be deducted in the current tax year or delay incurring a liability until the next tax year, depending on the desired outcome.

For consideration: Calendar year taxpayers should act now to analyze whether to file any method changes under the nonautomatic procedures or whether they may benefit from changing their facts through changing terms of internal practices or policies, taking other actions, or entering into transactions before year-end.

In detail

Changes in facts

Internal taxpayer actions and practices

Incentive compensation. A taxpayer may deduct compensation in the current tax year if the liability is fixed and determinable at year-end and the taxpayer pays the compensation within 2½ months after year-end. Compensation is not fixed if an event must occur in the next tax year for an employee to have a right to receive it, for example if the employer has discretion after year-end to not pay a bonus for services performed in the current tax year or an employee must remain employed in the next tax year to receive a bonus. To fix the liability to pay bonuses in the current year, the bonuses must be based on either a fixed formula or a fixed minimum bonus amount approved by a company's board of directors before year-end and the authorized amount must be paid to eligible employees and not be able to revert to the company.

Issuing or not issuing a board resolution by year-end, and paying or not paying the compensation within 2½ months of year-end, may accelerate the deduction into the current year or delay it until the next tax year. Taxpayers desiring to accrue bonuses in the current tax year should issue a board of directors resolution by year-end and pay the compensation within 2½ months. A taxpayer that is not using the 2½ month rule for employee compensation also may need to change its method by filing a change under the automatic procedures when it files its tax return.

Bonus depreciation. Taxpayers must place property in service before 2023 to claim 100% bonus depreciation. Beginning in 2023 (2024 for longer production period property and certain aircraft), the bonus depreciation rate decreases by 20% each year. Taxpayers should evaluate whether they can place property eligible for bonus depreciation in service in 2022.

LIFO conformity. Taxpayers that maintain inventories may benefit from using the last-in, first-out (LIFO) cost-flow assumption. Under LIFO, goods sold during the year are deemed to come first from goods purchased or produced during the year and then from beginning inventory, which in inflationary periods results in including higher costs in cost of goods sold and potentially reducing taxable income significantly. A taxpayer adopts LIFO by attaching a form to its federal income tax return for the tax year. However, a taxpayer that uses LIFO for tax purposes also must use LIFO for financial reporting (book). Therefore, a company that wants to elect LIFO to compute its taxable income for 2022 must make this decision by year-end or shortly after so that it reflects LIFO in its 2022 financial statements.

Subnormal goods. Subnormal finished goods are goods that are unsalable at normal prices or unusable in the normal way due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes. A taxpayer valuing inventory at cost or lower of cost or market (and not using a LIFO method) may value subnormal finished goods in ending inventory at the actual offering price within 30 days after year-end less direct costs of disposition. Taxpayers may wish to offer subnormal goods for sale within 30 days of year-end to establish bona fide selling prices. An automatic method change may be necessary to change a method to properly value the goods below cost.

Passthrough entity state and local taxes. The 2017 tax reform act imposed a $10,000 cap on individual taxpayer itemized deductions for state and local taxes (SALT). Some states enacted passthrough entity (PTE) taxes that impose an entity-level state tax instead of a tax on the individual owner (S corporation shareholder or partner). The PTE deducts the tax at the entity level and reduces the distributive share of income allocable to owners. PTE taxes are not subject to the SALT cap. In some states, the PTE must elect to pay the PTE tax by the end of the tax year. A PTE that follows the procedures (which vary by state) to elect the PTE tax and pays the tax within 8½ months after year-end under the recurring item exception may be able to deduct the PTE tax in the current tax year. A PTE that is not currently using the recurring item exception for state taxes may need to file an automatic change to that method.

Transactions

Advance payments. Section 451(c) generally allows a taxpayer to recognize qualifying advance payments under a full inclusion method or defer recognizing advance payments for one year to the extent not recognized as revenue for book. Taxpayers that want to accelerate income may want to change their facts to receive an advance payment before the end of the tax year and recognize that payment under a full inclusion method. Changing to a full inclusion method may require a nonautomatic method change to be filed by year-end, as discussed below.

Sale and leaseback. A taxpayer may realize gain on appreciated tangible or intangible property or loss on depreciated tangible or intangible property that it wants to continue to use by selling the property and then leasing it back. To qualify to realize gain or loss, the taxpayer must transfer tax ownership of the property to the lessor.

Passthrough payments to foreign related parties. A taxpayer may be able to reduce its liability for the base erosion and anti-abuse tax if transactions involving payments it receives from a third party and remits to a foreign related party are structured so that the taxpayer is an agent or conduit. The taxpayer then has no income and no deduction resulting from the payments and the payments to the foreign related party are not base erosion payments. To qualify as an agent or conduit, the taxpayer may need to modify its agreements before year-end to provide that all rights and obligations associated with passthrough payments are with the foreign related party.

Nonautomatic accounting method changes

Revenue recognition changes in past five years. In general, a taxpayer may change its method of accounting for an item using the automatic procedures only once in five years. Although the IRS often waives this rule when statutory or regulatory rules change, in general a taxpayer must file a method change request using the nonautomatic procedures if it wants to change its method for an item again during the five-year period. As a result, taxpayers that changed their method of accounting in 2018 to comply with the 2017 enactment of Sections 451(b) and 451(c) and want to change to another method authorized under the final regulations may be required to use the nonautomatic procedures.

For example, taxpayers that want to defer income may want to change to not accrue income that is recognized for book if the taxpayer does not have an enforceable right to the income at year-end under applicable law, to use the deferral method for advance payments, or to use the cost offset method to reduce recognized income related to a future sale of inventory by incurred costs. Taxpayers that want to accelerate income may want to include in income amounts recognized as revenue for book for which they don’t have an enforceable right to payment, use the full inclusion method for advance payments, or not use the cost offset method.

Specified goods. The regulations implementing Section 451(c) exclude specified payments from the definition of advance payment. “Specified payments” are payments received two or more tax years before a specified good must be delivered. “Specified goods” are goods the taxpayer does not adequately have on hand to satisfy a contract in the year of payment for which it will recognize revenue for book purposes when the goods are delivered. However, a taxpayer may treat specified payments as advance payments eligible for deferral or full inclusion under a Section 451(c) “specified good method.” A taxpayer may change its Section 451(c) specified good method from deferral to full inclusion or vice versa using the automatic procedures, but must file a nonautomatic method change request to change from the specified good method to a Section 451(b) method.

Long-term contracts. Taxpayers generally must use the nonautomatic procedures to change to a Section 460 long-term contract method or to change methods within Section 460 (a change from one to a different long-term contract method). Section 460 methods include the overall percentage of completion (PCM) and completed contract methods as well as various submethods that could increase or decrease taxable income. A taxpayer using its book PCM method must use the nonautomatic procedures to change to a proper PCM method.

Recurring item exception. Accrual-method taxpayers must pay certain liabilities, such as for rebates and allowances, to satisfy economic performance before they may deduct the liability. However, taxpayers that use the recurring item method of accounting may deduct payment liabilities that are fixed and determinable at year-end if they pay the liabilities within 8½ months of year-end. A taxpayer that wants to accelerate income must use the nonautomatic procedures to change from the recurring item exception and deduct payment liabilities in the tax year they are paid.

Foreign pension plans. Section 404A permits US employers to elect to claim accelerated tax deductions in connection with foreign pension plans. The deduction applies both for regular federal income tax when the foreign pension plan is maintained through a foreign branch and for reducing earnings and profits when the plan is maintained by a foreign subsidiary. Multinational companies that have foreign pension plans and are not following the provisions of Section 404A may be improperly claiming federal income tax deductions in an earlier tax year and may change to properly apply Section 404A under the nonautomatic procedures. Method changes are implemented with a 15-year spread of the Section 481(a) adjustment and may result in a decrease in income once a Section 404A election is effected.

Additional information

For additional information on some of these issues and on accounting method planning in general, please see the following PwC Insights.

Accounting methods that increase income may produce tax benefits

Accounting methods planning may provide tax savings

Taxpayers should consider immediate action to adopt the LIFO inventory method to expense high inflation

Passthrough payments may allow taxpayers to forgo income and deductions

Final regulations issued on the Section 451 all-events test and advance payments

Taxpayers with inventories may use some book reserves for tax

Let’s talk

For a deeper discussion of how year-end accounting method planning might affect your business, please contact one of the PwC professionals listed below, or your local Accounting Method Services contact:

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