WNTS Insight

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Key year-end planning opportunities for 2011

Calendar-year companies, by taking certain actions before the end of the year, can take advantage of accounting method opportunities that could increase cash flow by deferring the recognition of income or accelerating the timing of a deduction. While some of these opportunities require filing an accounting method change request, in other cases positive results may be obtained through other actions taken before year-end.

Insured reserves

Taxpayers that are fully insured, or partially insured, for future losses or other liabilities and separately record both a reserve for the liability and a corresponding insurance receivable as gross amounts may be overstating their taxable income.

Taxpayers may be mistakenly calculating their book-tax adjustments solely by reversing the gross amount of the liability reserve and failing to reverse the related insurance receivable. In this situation, taxpayers should adjust their book income only by the net profit and loss impact of the GAAP accounting for these types of partially insured liabilities.

Action item: File a non-automatic method change request to properly calculate the book-tax differences for insured losses.

Defer recognition of unbilled receivables

Because the tax law requires revenue to be recognized at the earliest of when it is due, paid, or earned, an opportunity exists to take advantage of the differences in earnings events between book and tax with respect to unbilled receivables (i.e., revenue that has been recognized for books but is not due or paid).

For example, for book purposes, taxpayers generally recognize revenue from the performance of services as such services are provided. For tax purposes, however, revenue from the performance of services generally is recognized when all contingencies are met and the required services are complete, rather than as the taxpayer engages in the activity. In addition, income from the licensing of property may be recognized for book purposes upfront using a sale model, whereas for tax purposes such income should be recognized over the period the customer has the right to use the licensed property.

Taxpayers with unbilled receivables on their balance sheets may have an opportunity to file an accounting method change request to defer the recognition of revenue for federal income tax purposes until such revenue is earned. In this case, contracts should be reviewed to determine when the revenue under the contract is earned for federal income tax purposes.

Action item*:* File a non-automatic method change request to defer recognition of income from unbilled receivables.

Disputed income

A taxpayer whose customers are disputing the payment of amounts due to the taxpayer may have an opportunity to exclude those disputed amounts from income for federal income tax purposes. In Rev. Rul. 2003-10, the IRS considered the following disputed income scenarios in the context of whether the taxpayer's right to receive the income was fixed at year-end:

- When a taxpayer overbills due to a clerical error in year 1, and the customer discovers and disputes the billing in year 2, the taxpayer does not recognize the income in year 1;
- When the taxpayer ships and bills for the wrong goods in year 1, and the customer disputes the liability in year 1, the taxpayer does not recognize income in year 1; and,
- When the taxpayer ships and bills excess goods in year 1, and the customer agrees to accept the goods and pay in year 2, the taxpayer recognizes the income in year 1.

Frequently, for financial statement purposes, taxpayers establish a reserve for disputed income or the disputed income reserve is a component of the allowance for doubtful accounts. When a reserve is established for financial statement purposes, the change in the reserve from year to year is treated as a book/tax difference. This treatment puts the taxpayer in the position of recognizing the income prior to the point the dispute is resolved.

Taxpayers typically can identify disputed income by reviewing their contra-receivable accounts -- such as an allowance for bad debts or a reserve for sales returns and allowances -- to determine whether they are improperly accelerating the recognition of revenue for federal income tax purposes when the right to receive the income is in dispute.

Action item: File a non-automatic method change request to exclude certain disputed amounts from taxable income.

Foreign pension plans

Many multinational companies that have foreign pension plans are not following the provisions of section 404A, and as a result may be improperly claiming federal income tax deductions at a later point in time. Section 404A permits U.S. employers to make an election to claim accelerated tax deductions in connection with foreign pension plans. The deduction applies both for regular federal income tax purposes when the foreign pension plan is maintained through a foreign branch and for purposes of reducing earnings and profits when the plan is maintained by a foreign subsidiary.

For unfunded foreign reserve plans, the section 404A deduction is based on a modified FAS 87 pension expense calculation. For foreign plans that are funded with a trust or trust equivalent, the deduction is tied to cash contributions to the trust and is limited based on an actuarial calculation similar to the limit applicable to U.S. qualified pension plans. Alternatively, the deduction for funded plans may be based on the modified FAS 87 calculation applicable to reserve plans. For both funded and reserve plans, the cumulative U.S. deduction under section 404A can never exceed the cumulative amount allowed as a deduction under local law.

Companies that primarily will benefit from a section 404A election are those with an unfunded reserve plan (e.g., a pension plan in Germany or Japan) that are taking pension deductions into account only when paid to the retirees for tax/E&P purposes (i.e., by reversing the pension plan liability).

Action item: File a non-automatic method change request to properly apply section 404A to determine the appropriate deduction for foreign pension plans.

Employee medical costs

Taxpayers that that are self-insured and use a Voluntary Employee Beneficiary Association (VEBA) for active employee medical costs may benefit by accruing their incurred but not reported (IBNR) liability under section 461 rather than taking into account an IBNR liability when amounts are contributed to the VEBA.

Some taxpayers still may be funding a VEBA for the IBNR medical claims of active employees. Under section 419, a deduction is permitted only when funds are contributed to a VEBA trust. Moreover, to the extent a taxpayer maintains a VEBA, the rules of section 419 override the general rules of section 461, which allow for a deduction for IBNR 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.

Therefore, although funding a VEBA can be beneficial in certain situations (e.g., funding retiree medical claims), taxpayers may find that it is more beneficial to take deductions for medical IBNR liability into account under section 461 rather than funding a VEBA for such expenses.

Action items: If a taxpayer is currently funding a VEBA for the IBNR medical claims of its active employees, the taxpayer should evaluate whether to terminate the VEBA by year-end and instead apply the rules under section 461 to determine the proper timing of the deduction. In these situations, the taxpayer also should determine whether any change in method of accounting is required.

Bonus depreciation

For taxpayers wishing to claim 100-percent bonus depreciation, qualifying property must be acquired and placed in service after September 8, 2010, and before January 1, 2012 (longer production period property (LPPP) and certain aircraft must be placed in service before January 1, 2013). Taxpayers also may be able to claim 100-percent bonus deprecation for components of larger self-constructed property acquired after September 8, 2010, and placed in service before January 1, 2012, if the larger self-constructed property meets the 50-percent bonus depreciation requirements.

President Obama recently proposed that Congress extend for another year the 100-percent bonus depreciation provision. However, with the current emphasis on deficit reduction, it is unclear whether 100-percent bonus depreciation will garner the support needed to be extended beyond 2011.

Action Items: Taxpayers not electing out of bonus depreciation should consider the following to maximize their 2011 bonus depreciation deductions:

- Entering into contracts by December 31, 2011, for LPPP and certain aircraft;
- Placing property into service by December 31, 2011 (December 31, 2012, for LPPP and certain aircraft); and
- Taking advantage of safe-harbor rules for self-constructed property.

Accrued bonuses

In Chief Counsel Advice memorandum 200949040, the IRS concluded that a taxpayer was not permitted to take into account employee bonuses accrued at year-end because the employees were required to be employed on the date that the bonuses were paid in order to receive such bonuses. Under these facts, the liability for the bonuses was not fixed until the time the bonuses were paid.

In light of this ruling, many taxpayers have reviewed their bonus plans to determine whether such plans are "fixed" at year-end. To be fixed at year-end, accrued bonuses generally must be:

- Based on either a fixed formula or a fixed minimum bonus amount approved by the company's board of directors before year-end (when the company commits to pay such minimum bonus amount to the employees as a whole -- that is, without needing to determine at the time of the resolution which employees will get the bonuses); and
- The amount so determined must be required to be paid to eligible employees; no amount can revert to the company as a result of an employee's leaving the company before the bonus is paid.

Taxpayers that are not taking into account an accrued liability for bonuses because they have determined that the liability is not fixed at year-end may have an opportunity to change the terms of the bonus plan or take other action before year-end to fix the liability at year-end. A fixed bonus liability may be taken into account to the extent the bonuses are paid within 2 1/2 months of year-end.

Action items: Change terms of bonus policy, or issue board of director resolution establishing a fixed bonus pool, before year-end to the extent the bonus liability is not otherwise fixed at year-end.

Subnormal goods

Subnormal goods (i.e., goods that are unsalable or unusable in the normal way) may be valued below cost in the following circumstances:

- Finished goods may be valued at "bona fide" selling prices less the direct costs of disposition. The bona fide selling price is the actual offering price during a period ending not later than 30 days after the inventory date.
- Raw materials or partially finished goods may be valued using a "reasonable basis."
- Goods that are intended to be scrapped at year-end may be valued at scrap value.

Note: This is allowed for FIFO inventory only. LIFO inventory may not be valued below cost (except for AMT purposes.)

Action items: Offer subnormal goods for sale within 30 days of year-end to establish bona fide selling prices (and, if necessary, file an automatic method change to properly value such goods below cost).

Final observations

The opportunities discussed above are some of the more common ways for companies to improve cash flow through accounting method planning. Each company should consider its particular situation to determine the most effective planning techniques.

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