

# Tax Accounting Methods in 2020: Changes and Developments for Current and Future Planning

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NEWMAN  
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# WHO WE ARE



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# What you'll hear today



The basics of tax accounting methods

How to change a tax accounting method

Impact of Tax Cuts & Jobs Act

Impact of CARES Act

Does it make sense?

Questions



# THE BASICS OF TAX ACCOUNTING METHODS

# TAX ACCOUNTING METHODS

- Method of Accounting – “any practice involving the treatment of the overall plan of accounting for items or the treatment of any specific material item of income or expense..” Treas. Reg. Sec. 1.446-1(e)(2)(ii)(a)
- “Adoption” of the Method occurs when taxpayer treats an item in a similar manner for two consecutive years, even if erroneous.
- Accounting Method under GAAP does not always equal Accounting Method for Tax purposes.



# EXAMPLE – TAXABLE INCOME CALCULATION: CASH VS. ACCRUAL

ABC, Inc., incorporated in 2020, provides IT support services for local businesses. The Company offers its customers the option of month-to-month contracts or an annual contract. For the month-to-month contracts, payment is due 30 days after it is issued. Payment for the annual contracts however are due 50% at the beginning of the term and the remaining 50% at the end. During 2020, ABC, Inc. invoices \$250,000 but still has \$70,000 of Accounts Receivables at yearend. The remaining \$70,000 will be collected in 2021.

- What is its taxable income under the Cash and Accrual method?
- What method should ABC, Inc. choose for its tax filing?

# EXAMPLE – TAXABLE INCOME CALCULATION: CASH VS. ACCRUAL

	2020	2021	Total
Cash Method	\$180,000	\$70,000	\$250,000
Accrual Method	\$250,000	\$0	\$250,000
Difference	(\$70,000)	\$70,000	\$0

- Cash Method
  - Defers paying tax on income until following year
  - Ensures ABC, Inc. has cash to pay tax associated with it
- Accrual Method
  - Pays tax currently
  - Excess cash on hand in 2021 when revenue is collected

# CHANGING A METHOD OF ACCOUNTING FOR TAX PURPOSES





# PROCEDURE FOR ACCOUNTING METHOD CHANGES

- Form 3115
- Automatic Changes vs. Non-Automatic:
  - Revenue Procedure 2019-43
  - Do not need IRS Approval to use Method
  - Must be filed by original due date of return, including extension.
  - Filed with IRS National Office during effective year
- Voluntary Changes vs. Non-Voluntary:
  - Taxpayer initiated or result of IRS change
  - Additional Income = relief to spread additional income over four years
  - Additional Expense = can be taken entirely in year of change.

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

**Application for Change in Accounting Method**  
► Go to [www.irs.gov/Form3115](http://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) \_\_\_\_\_

City or town, state, and ZIP code \_\_\_\_\_

Tax year of change ends (MM/DD/YYYY) \_\_\_\_\_

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 ☐ **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 ☐ Cooperative (Sec. 1381) ☐ Check the appropriate box to indicate the type of accounting method change being requested. See instructions.

☐ Corporation ☐ Partnership ☐ Depreciation or Amortization

☐ Controlled foreign corporation (Sec. 957) ☐ S corporation ☐ Insurance co. (Sec. 816(a)) ☐ Financial Products and/or Financial Activities of Financial Institutions

☐ 10/50 corporation (Sec. 904(d)(2)(E)) ☐ Insurance co. (Sec. 831) ☐ Other (specify) \_\_\_\_\_

☐ Qualified personal service corporation (Sec. 448(d)(9)) ☐ Other (specify) \_\_\_\_\_

☐ Exempt organization, Enter Code section \_\_\_\_\_

**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**

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. **Yes No**

a (1) DCN: \_\_\_\_\_ (2) DCN: \_\_\_\_\_ (3) DCN: \_\_\_\_\_ (4) DCN: \_\_\_\_\_ (5) 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**

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. **Yes No**

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 the 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 filer) 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) \_\_\_\_\_ Preparer's signature \_\_\_\_\_ Date \_\_\_\_\_

Filer/applicant \_\_\_\_\_

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 15080E Form 3115 (Rev. 12-2018)

# PROCEDURE FOR FILING OF ACCOUNTING METHOD CHANGES

- Calculation
  - Effective date of Change
  - Adjustment for tax as though new method was always applicable.
- No calculation required for cut-off changes (prior items continue to be accounted for under old method).

# EXAMPLE – CHANGE FROM ACCRUAL TO CASH METHOD OF ACCOUNTING

ABC, Inc., an accrual basis taxpayer, is in the business of storage and distribution. The Company does not own the product that is shipped/stored in its facilities. For tax years 2017 through 2019, revenue has been stable at \$12 million/year. Accrual basis net income for 2020 is projected to be \$1 million. As of the end of 2019, the Company had Fixed Assets of \$2 million and Accounts Payable of \$200K.

What is its taxable income if converted to the cash method of accounting for 2020 tax year?



# EXAMPLE – CHANGE FROM ACCRUAL TO CASH METHOD OF ACCOUNTING

	2020	2021	2022	2023	2024
Book Income	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Sec 481(a) Adj.	\$50,000	\$50,000	\$50,000	\$50,000	\$0
Taxable Income	\$1,050,000	\$1,050,000	\$1,050,000	\$1,050,000	\$1,000,000

- Accrual Method
  - \$200K deduction reported in 2019
  - No cash outlay until 2020
- Cash Method
  - Add back \$200K deduction
  - Additional income = spread over 4 year period.

# IMPACT OF TAX CUTS & JOBS ACT ON ACCOUNTING METHODS



# CASH METHOD OF ACCOUNTING

	Prior to December 31, 2017	New Law beginning January 1, 2018
General Rule	C Corp. or Partnerships with C Corp. partners required to use Accrual Method of accounting unless average gross receipts < \$5 million	Able to use Cash Method if average gross receipts < \$25 million

- Average Gross Receipts based on the prior three tax years
- \$25M is indexed for inflation
- Considered a voluntary change (i.e. “Automatic Change”)
- Other exemptions from rule still apply (i.e. Professional Service Corporations)

# UNIFORM CAPITALIZATION ("UNICAP") REQUIREMENTS

	Prior to December 31, 2017	New Law beginning January 1, 2018
General Rule	Capitalize certain costs related to real or tangible property if acquired for resale, with average gross receipts > \$10 million, or manufactured	Exemption from UNICAP if average gross receipts < \$25 million for both resellers and manufacturers.

- Average Gross Receipts based on the prior three tax years
- \$25M is indexed for inflation
- Considered a voluntary change (i.e. "Automatic Change")
- If still applicable, UNICAP calculation does not change

# EXEMPTION FROM INVENTORIES

	Prior to December 31, 2017	New Law beginning January 1, 2018
General Rule	<p>Taxpayers with inventory required to use Accrual Method of accounting unless:</p> <ul style="list-style-type: none"><li>• average gross receipts &lt; \$1 million</li><li>• average gross receipts &lt; \$10 million and treat inventory as non-incidental supplies</li></ul>	<p>Able to use Cash Method if average gross receipts &lt; \$25 million and either:</p> <ul style="list-style-type: none"><li>• Treat inventory as non-incidental supplies</li><li>• Conform to taxpayer's method of accounting reflected in books and records or financial statements.</li></ul>

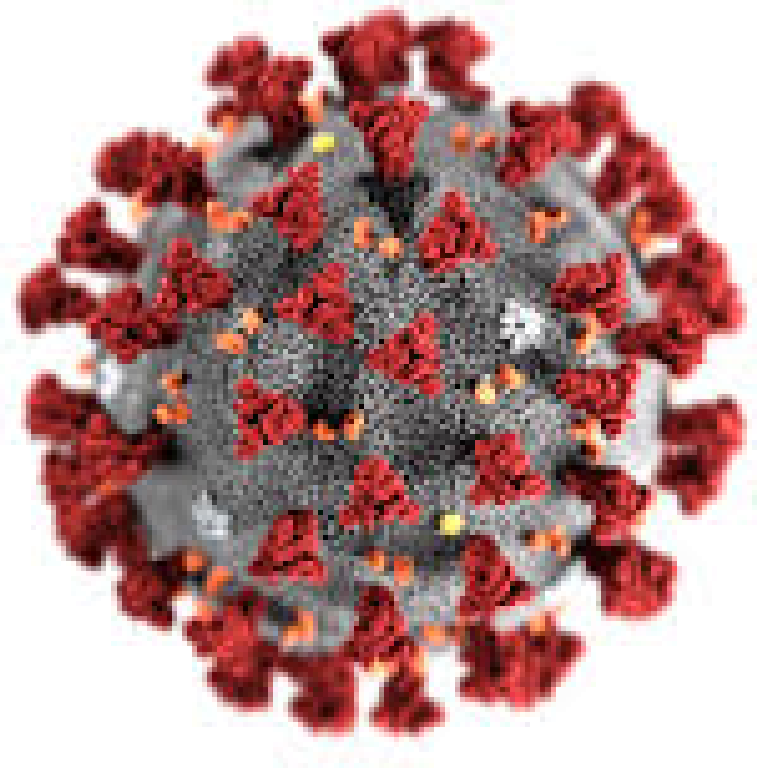
- Average Gross Receipts based on the prior three tax years
- \$25M is indexed for inflation
- Considered a voluntary change (i.e. “Automatic Change”)



# PERCENTAGE OF COMPLETION (“POC”) FOR LONG-TERM CONTRACTS

	Prior to December 31, 2017	New Law beginning January 1, 2018
General Rule	Taxpayers with estimated completed contracts less than two years required to use Percentage of Completion Method of accounting unless average gross receipts < \$10 million	Able to use Completed Contract Method (or other permissible exempt contract method) if average gross receipts < \$25 million

- Average Gross Receipts based on the prior three tax years
- \$25M is indexed for inflation
- Valid on contracts entered into after December 31, 2017
- Cut-off change



# IMPACT OF CARES ACT ON ACCOUNTING METHODS

# TECHNICAL CORRECTION FOR QUALIFIED IMPROVEMENT PROPERTY ("QIP")

	Prior to CARES Act	New Law per CARES Act
General Rule	Qualified Improvement Property is not eligible for 15-year useful life.	<ul style="list-style-type: none"><li>• Qualified Improvement Property no longer excluded from 15-year Property.</li><li>• Eligible for Bonus Depreciation</li></ul>

- Late relief for Bonus Depreciation Election
- Valid on QIP placed in service after December 31, 2017
- Revenue Procedure 2020-25 (Section 6.19)

# PLANNING

**FOR ACCOUNTING  
METHOD  
CHANGES**

# PLANNING OPPORTUNITIES

- Will you need to change to allowable method soon?
  - Are you planning to adopt or have you adopted any US GAAP Standards that will deviate for tax?
- COVID-19 impact on current year financial results
  - Would it be beneficial to incur adjustment in 2020 or 2021?
- November 3rd, 2020
  - Will TCJA be repealed? Will tax rates go up?
- Future projected activity
  - Sale transactions, additional revenue streams

# We'd love to hear from you.



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**Stay tuned for more details about our next event in our business tax webinar series!**

You can find all the information here:

<https://1b2044-2705.icpage.net/Business-Taxes--2020-What-You-Need-to-Know--BNN-Webinar-Series>

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