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Your Accounting for a New Economy

# Adopting the Most Advantageous Accounting Methods

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Cash tax planning is very important in this period of economic challenges. Companies are struggling to be the best in this troubled market and compete to make a profit. Liquidity and cash flow have become more critical than ever to a company's ability to drive its strategic plan to the corporate income statement. This economic struggle has also resulted in an extremely tight lending environment for all industries.

Regardless of a company's current financial and operating status, tax planning can provide a variety of strategies to help companies preserve, acquire or maximize cash to support business objectives. Many businesses are beginning to examine their accounting method in order to determine if a change in method to defer income recognition or accelerate deductions can then ultimately result in cash benefits. An accounting method change could be used to increase a current year net operating loss to carry back to profitable years or to reduce alternative minimum taxes. A thorough review of current accounting methods can also help to ease potential FIN 48 exposure.

In order to begin to determine if a method change may be advantageous, company executives will need to consider current tax methods and assess opportunities. Documents that should be reviewed to determine if a company is using optimal methods of accounting include:

- copies of tax returns filed for the past couple of years
- tax provisions and Schedule M workpapers supporting the tax returns
- detailed schedules of deferred tax assets and liabilities for the most recent tax year
- as well as general ledger details supporting the most recent taxable year-end financial statements

The method of accounting a company uses not only involves the taxpayer's overall method of accounting but also the accounting treatment of each item of income and expense. Generally, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Frequently situations arise in which a customer disputes a bill or the particular amount charged by the taxpayer. More than often the taxpayer incorrectly recognizes a disputed amount of income, when in fact the taxpayer does not have to recognize the amount as income until the dispute is resolved. Another issue that taxpayers commonly have is the proper treatment of advance payments. They may be allowed to recognize income under a deferral method that provides for recognition in a year after receipt. In order to qualify as an advance payment, the taxpayer must have a continuing obligation under the basic contract.

Common expense items that may create an accounting method change are taxes, employee compensation and benefits, prepaid expenses, bad debts, repairs and depreciation, software development, fines and penalties, inventory, cash and trade discounts, inventory write-downs and subnormal goods, and evaluating Section 263A cost capitalization methods and embedded costs. Many taxpayers deduct tax expenses in the year in which the tax expense is paid. Under the automatic consent procedures (described below) a deduction can be accelerated to the year that the tax assessment is made so long as the taxes are paid within eight and a half months after the end of the year, or by the time the tax return is filed if that occurs earlier. There are often significant opportunities to accelerate deductions related to employee compensation and benefits. Companies that are required to prepay certain expenses may have an opportunity to take a current deduction for these expenses rather than either capitalizing and amortizing the amounts over the term of the underlying agreement or only taking a deduction at the time services are rendered. Regarding bad debts, a taxpayer should take a deduction for a debt that becomes worthless within the taxable year. A review of the treatment of costs that are capitalized as improvements, as well as reviewing the recovery period and methods of capitalized assets, will often lead to opportunities to recover missed deductions such as repairs and maintenance expenses, increase depreciation deductions not claimed in prior years, and potentially reduce state tax liability associated with certain assets. Generally software development is capitalized and amortized over 60 months. Taxpayers may be able to change their method of accounting and currently deduct such costs. Taxpayers also need to go over what is categorized as fines or penalties which could have been erroneously made in the past. An example would be amounts paid as compensatory damages and amounts paid in violation of statutes enacted to promote prompt compliance with the law are generally deductible. Companies that are using simplified methods for purposes of determining inventory capitalization costs may also want to consider changing to an alternative method, as the simplified methods often result in over capitalization.

In order to be approved for an accounting method change, the IRS has established a set of complicated and specifically defined procedural and substantive rules. (Updates may be issued annually and it is important for taxpayers to make sure that the change being requested meets the most current criteria.) The most recent rules fall under the consent procedures of Revenue Procedure 97-27 (advanced consent) or Revenue Procedure 2008-52 (automatic consent).

If a change is covered under the advanced consent ruling, the change may not be implemented on a tax return until affirmative consent is received from the IRS National Office. Application for advanced consent is made by filing an IRS Form 3115 with the IRS National Office by the filing deadline, which is no later than the last day of the tax year of change along with a filing fee of \$3,800. Special rules apply to changes made by an applicant who may be currently under examination.

Certain changes (as defined within the form instructions) may be granted automatically and advance consent is not required. A Form 3115 will still need to be filed along with the taxpayer's federal income tax return. The Commissioner is deemed to give automatic consent and the taxpayer may implement the change on the tax return in the year of the change. A duplicate copy of Form 3115 must also be filed with the IRS National Office no earlier than the first day of the tax year of change and no later than when the original is filed with the tax return. There is no filing fee under this Revenue Procedure. As with the advanced consent procedures, special rules will apply if the taxpayer is currently under examination.

In today's economic environment tax departments cannot afford to ignore these "timing issues." An increased look at the income and expense timing items can result in significant benefits to the taxpayer's cash flow will help businesses remain competitive in the market today.

**Source: Marcum, LLP**