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Accounting Methods after Tax Reform

Stan Babicz, CPA, MST, Principal

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  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting
- More than 5,400 employees
- Offices coast to coast
- We serve nearly 6,000 privately held manufacturers and distributors

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Speaker Introductions

Stan Babicz, CPA, MST

Principal, Milwaukee, WI

Stan is a principal in the firm's Milwaukee, Wisconsin office. He has more than 30 years of public accounting experience and specializes in tax planning services for a wide range of companies, with an emphasis on businesses in the manufacturing, technology, wholesale distribution, aerospace and defense, food processing, and construction and real estate industries. Stan is also the Wisconsin federal tax strategies practice leader, and is responsible for the development and delivery of advanced tax planning strategies to our clients.

Speaker Introductions

Leslie Boyd, CPA

Tax Principal, Indianapolis, IN

Leslie is a principal in CLA's Manufacturing industry group and leader of the Manufacturing industry for the Indianapolis office. Leslie has more than ten years of experience in public accounting, specializing in tax services for multi-state and multinational C corporations, S corporations, and partnerships.

Learning Objectives

At the end of this session, you will be able to:

- Identify the new tax accounting methods available to manufacturing and distribution companies under tax reform.
- Identify the potential accelerated tax benefits available to companies upon adoption of the accounting methods.
- Recognize the process for adopting a new accounting method on your tax return.

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Accounting Methods After Tax Reform

Simplified Tax Accounting for Small Businesses

H.R.1 – Tax Cuts and Jobs Act (TCJA)

- Official Title: "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"
- December 22, 2017: Signed into law by President Trump (Public Law No. 115-97)
- Most business provisions effective for tax years beginning after December 31, 2017

Overview of Accounting Methods

- General rule: Taxable income computed under method of accounting used for books
- Must clearly reflect income
- Overall method (i.e. cash or accrual), or a material item involving the timing of income or deduction (e.g., depreciation)
  - Adopt incorrect method: Consistent treatment in 2 years
  - Permissible method: Proper treatment in 1st year

Changing an Accounting Method

- Change in accounting method: Change in overall recognition of income or expense, or treatment of a material item
  - Does not include correction of mathematical or posting errors
- Sec. 481(a) adjustment: Difference between cumulative taxable income under old method and new method (measured as of beginning of year of change)
  - Correction to opening balance sheet
    - ◊ Positive adj. (i.e. increase in income): Four year forward spread of income
    - ◊ Negative adj. (i.e. decrease in income): Immediate deduction

Changing an Accounting Method (cont.)

- Automatic consent changes: No user fee
  - File Form 3115 any time during year up to extended due date of return
- Non-automatic/advance consent: $9,500 user fee
  - Form 3115 must be submitted within tax year
- Eligibility rule (no overall method change within last 5 years preceding year of change) temporarily inapplicable
- Adjustment may include items from closed years

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Cash Method of Accounting

Expansion of Cash Method of Accounting

- Pre-TCJA: Use of cash method of accounting limited to:
  - C corporations and partnerships with C corporations as a partner with average annual gross receipts (AAGR) ≤ $5M
  - Small businesses with AAGR ≤ $1M
  - Certain industries with AAGR ≤ $10M
- Under TCJA: Expanded availability of cash method:
  - All taxpayers with average gross receipts for three prior years ≤ $25M
  - Related businesses required to be aggregated
- Automatic consent accounting method change
  - Includes full Sec. 481(a) adjustment

Example – Accrual to Cash

ABC Manufacturing Company		
Assets	**12/31/2017**	**12/31/2018**
Cash	31,000	74,000
Accounts Receivable, Net	**736,000**	**789,000**
Inventory – Raw Materials	1,750,000	2,091,000
Inventory – Work in Process – Labor and Overhead	250,000	225,000
Inventory – Materials and Supplies	100,000	125,000
Prepaid Expenses***	**75,000**	**71,000**
Property, Plant, and Equipment, Net	450,000	450,000
Total Assets	**$3,392,000**	**$3,825,000**
Liabilities and Equity		
Accounts Payable	**303,000**	**268,000**
Mortgage Payable	1,290,000	1,170,000
Accrued Payroll	**150,000**	**170,000**
Customer Deposits	300,000	290,000
Capital Stock	200,000	200,000
Retained Earnings	1,149,000	1,727,000
Total Liabilities and Equity	**$3,392,000**	**$3,825,000**
***No prepaid election was previously made		

Example – Accrual to Cash (cont.)

§481(a) Calculation	
Deduct Assets:	
Accounts Receivable, Net	(736,000)
Prepaid Expenses	(75,000)
Addback Accrued Liabilities:	
Accounts Payable	303,000
Accrued Payroll	150,000
Net §481(a) adjustment	**(358,000)**

- *Since the §481(a) adjustment is negative, it can be taken in 2018 (a Form 3115 would be required to be filed)*

Example – Accrual to Cash (cont.)

Current Year Accrual to Cash Calculation	
Plus PY Receivables:	
Accounts Receivable, Net	736,000
Prepaid Expenses	75,000
Plus CY Payables:	
Accounts Payable	268,000
Accrued Payroll	170,000
Less CY Receivables:	
Accounts Receivable, Net	(789,000)
Prepaid Expenses	(71,000)
Less PY Payables:	
Accounts Payable	(303,000)
Accrued Payroll	(150,000)
CY Accrual to Cash adjustment	**(64,000)**

- *This example would result in a deduction of $422,000 in 2018 for the client*
  - *$358k in §481(a) adjustment and $64k deduction in CY Accrual to Cash adjustment*
  - *A second Form 3115 would be required to make the prepaid election since it is not already in place in this example.*

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Accounting for Inventories

Accounting for Inventories – Pre-TCJA

- Must account for inventories when production, purchase, or sale of merchandise is an income-producing factor
- Inventory must be accounted for under Sec. 471
  - Exceptions:
    - ◊ Small businesses with AAGR $\leq$ \$1M
    - ◊ Certain industries with AAGR $\leq$ \$10M
  - Allowed to account for inventories as non-incidental materials and supplies

Accounting for Inventories Under TCJA

- All taxpayers with average gross receipts $\leq$ \$25M not required to account for inventories under Sec. 471
- May instead:
  - Conform to financial accounting treatment of inventories; or
  - Treat inventories as non-incidental materials and supplies
- Related businesses required to be aggregated
- Automatic consent accounting method change
  - Includes full Sec. 481(a) adjustment
  - (Also permitted to use cash method)

Accounting for Inventories Under TCJA (cont.)

- Treat inventory as non-incidental materials and supplies
  - Amounts paid to acquire or produce non-incidental materials and supplies deductible in year first used or consumed
  - Merchandise considered used or consumed when sold
- No other capitalization provisions apply
  - Effectively only direct material costs required to be capitalized
  - Direct and indirect labor, overhead deductible when incurred

Example – Inventories as Non-Incidental Materials & Supplies

ABC Manufacturing Company		
Assets	**12/31/2017**	**12/31/2018**
Cash	31,000	74,000
Accounts Receivable, Net	736,000	789,000
Inventory – Raw Materials	1,750,000	2,091,000
Inventory – Work in Process – Labor and Overhead***	250,000	225,000
Inventory – Materials and Supplies	100,000	125,000
Prepaid Expenses	75,000	71,000
Property, Plant, and Equipment, Net	450,000	450,000
Total Assets	**$3,392,000**	**$3,825,000**
Liabilities and Equity		
Accounts Payable	303,000	268,000
Mortgage Payable	1,290,000	1,170,000
Accrued Payroll	150,000	170,000
Customer Deposits	300,000	290,000
Capital Stock	200,000	200,000
Retained Earnings	1,149,000	1,727,000
Total Liabilities and Equity	**$3,392,000**	**$3,825,000**
*** Excludes amounts capitalized under Sec. 263A		

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Treatment of Uniform Capitalization Rules

Sec. 263A - UNICAP

- Uniform capitalization rules require capitalization of certain direct and indirect costs allocable to inventory, or real or tangible personal property produced by the taxpayer
- Also applies to real or personal property acquired for resale
- Pre-TCJA: Taxpayers with AAGR $\leq$ \$10M exempted from Sec. 263A for *property acquired for resale*
- Interest capitalization rules use "avoided cost method"

Expansion of UNICAP Exemptions Under TCJA

- All taxpayers with AAGR $\leq$ \$25M exempt from Sec. 263A
  - Expands beyond resellers to include manufacturers/producers
- Related businesses required to be aggregated
- Automatic consent accounting method change
  - Includes full Sec. 481(a) adjustment
  - (Also permitted to use cash method and treat inventories as non-incidental materials and supplies)

Example – UNICAP Exemption

ABC Manufacturing Company		
Assets	**12/31/2017**	**12/31/2018**
Cash	31,000	74,000
Accounts Receivable, Net	736,000	789,000
Inventory – Raw Materials	1,750,000	2,091,000
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Capital Stock	200,000	200,000
Retained Earnings	1,149,000	1,727,000
Total Liabilities and Equity	**$3,392,000**	**$3,825,000**

*****Add'l $125,000 of costs capitalized to ending inventory for tax purposes only under §263A**

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Treatment of Long-term Contracts

Long-Term Contracts

- Pre-TCJA: Generally, must use percentage of completion method (PCM) for long-term contracts
  - Annually include in income the product of:
    - ◊ Gross contract price; and
    - ◊ Percentage of contract completed during taxable year
- Exception for "small construction contracts"
  - Construction or improvement of real property;
  - Contract expected to be completed within 2 years; **and**
  - Taxpayer has AAGR of $\leq$ \$10M
- Taxpayer permitted to use completed contract method, exempt-contract PCM, or any other permissible method

Long-Term Contracts Under TCJA

- Exception to required PCM for "small construction contracts" expanded to taxpayers with AAGR $\leq$ \$25M
- Related businesses required to be aggregated
- Automatic consent accounting method change
  - *Change is done on a cut-off basis – No Sec. 481(a) adjustment*
  - *Applies to new contracts entered into after December 31, 2017 in taxable years ending after December 31, 2017*
  - (Also permitted to use cash method, treat inventories as non-incidental materials and supplies, and exempt from Sec. 263A)

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Implementing Accounting Method Changes

Requirement to Aggregate Businesses

- Controlled group of businesses under common control and treated as single employer or affiliated service group must aggregate gross receipts
  - Parent-subsidiary: more than 50% common ownership
  - Brother-sister: five or fewer persons own at least 80% of stock, AND same five or fewer persons own more than 50% of stock, only considering identical ownership in each business
- Rules also apply to foreign parent in parent-subsidiary controlled group
  - Applies even if foreign parent has no U.S. filing requirement

Timing of Method Changes

Cost Segregation Analysis – 2017 vs. 2018 Benefit				
Tax Year	481(a) Adjustment	Total Additional Current Year Tax Deduction	Tax Rate	Additional Current Year Cash Flow
2017	$236,486	$242,823	X 40%	= $191,724
2018	$236,486	$242,823	X 26%	= $124,620

Takeaways

- Tax Reform has enabled true simplification of accounting methods for a much greater number of small businesses
- Automatic method changes can be requested concurrently (Rev. Procs. 2018-31 and 2018-40)
- In event business subsequently exceeds $25 million AAGR, must elect to change back, but get 4-year spread for positive (unfavorable) Sec. 481(a) adjustment

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Questions?

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- GILTI and FDII – Wednesday, September 12 at 11 am cst
- 199A and Qualified Business Income – Thursday, October 18 at 11 am cst
- Year-End Tax Planning – Wednesday, November 7 at 11 am cst

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