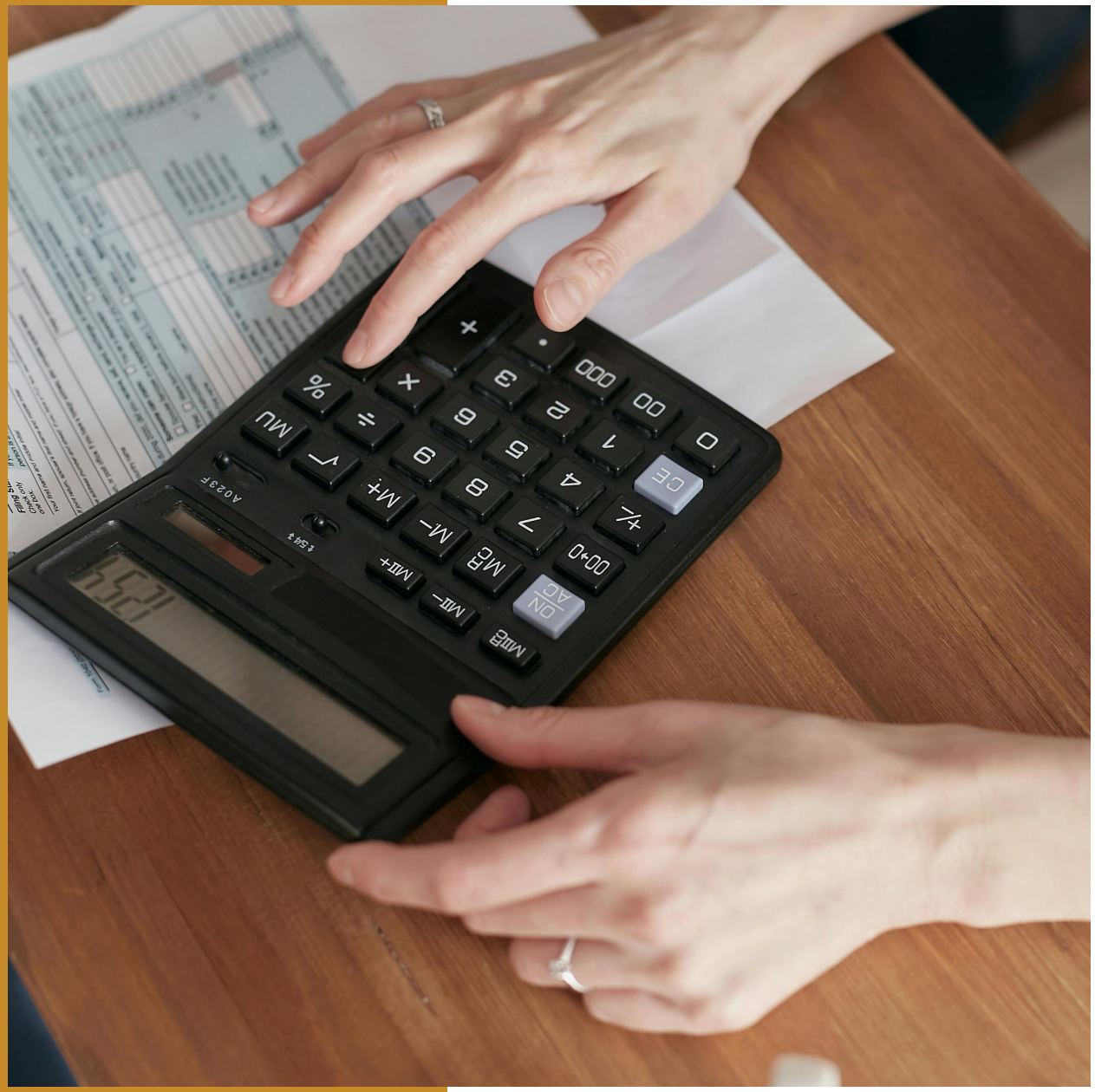


2023 YEAR-END TAX PLANNING GUIDE

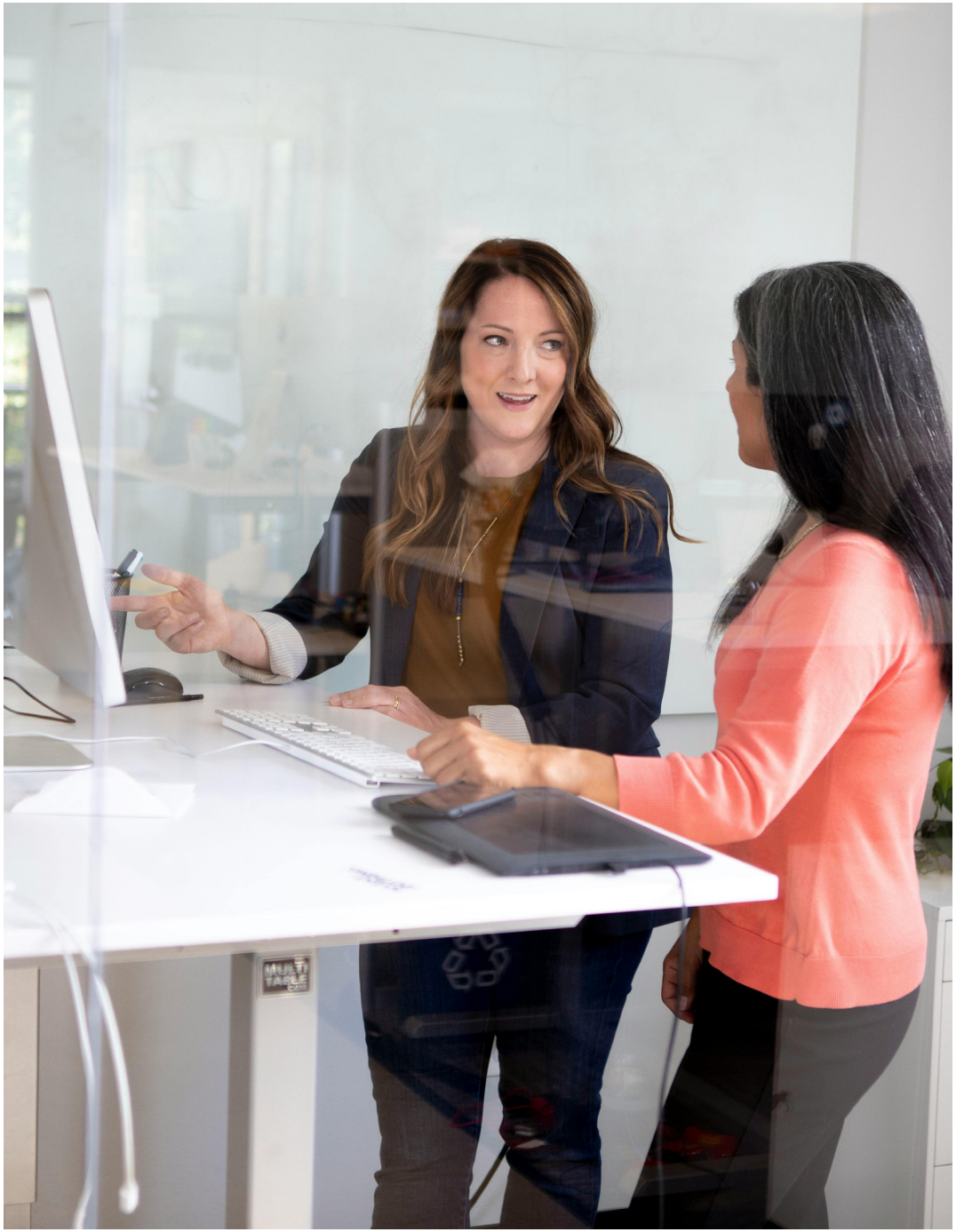
TAX ACCOUNTING METHODS

Lumsden McCormick LLP

CERTIFIED PUBLIC ACCOUNTANTS

CONTENT

This guide identifies tax strategies and considers how they may be influenced by recent administrative guidance and potential legislative changes that remain under consideration. Unless otherwise noted, the information contained in this article is based on enacted tax laws and policies as of the publication date and is subject to change based on future legislative or tax policy changes.



A taxpayer's tax accounting methods determine when income is recognized and costs are deducted for income tax purposes. Strategically adopting or changing tax accounting methods can provide opportunities to drive tax savings and increase cash flow. However, the rules covering the ability to use or change certain accounting methods are often complex, and the procedures for changing methods depend on the mechanism for receiving IRS consent — that is, whether the change is automatic or non-automatic. Many method changes require an application be filed with the IRS prior to the end of the year for which the change is requested.

Among others, taxpayers should consider the following tax accounting method implications and potential changes for 2023 and 2024, which are further discussed below.

Items taxpayers should review by year end:

- Be mindful of the December 31st deadline for non-automatic method changes
- Verify eligibility to use small business taxpayer exceptions and evaluate method implications
- Year-end clean-up Items: accelerate common deductions/losses, if appropriate
- Revisit the de minimis book safe harbor for write-offs of tangible property
- Consider methods implications of potential M&A transactions

Items to review in early months of 2024:Be mindful of the December 31st deadline for non-automatic method changes

- Review latest specified research and experimental expenditures guidance (Section 174) and evaluate implications on 2023 tax year
- Review opportunities for immediate deduction of fixed assets
- Consider the UNICAP historic absorption ratio election
- Review leasing transactions for compliance with tax rules
- Evaluate accounting method changes for controlled foreign corporations

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Items Taxpayers Should Review by Year End:

Be mindful of the December 31st Deadline for Non-automatic Method Changes

Although the IRS has continued to increase the types of accounting method changes that can be made under the automatic change procedures, some common method changes must still be filed under the non-automatic change procedures. Importantly, a calendar year-end taxpayer that has identified a non-automatic accounting method change that it needs or desires to make effective for the 2023 tax year must file the application on Form 3115 during 2023 (i.e., the year of change). (Technically, a taxpayer with a 12/31/23 year end has until Tuesday, January 2, 2024, to file because December 31 is a Sunday and Monday is the holiday observance of New Year's Day, therefore, Tuesday is the next business day after the due date).

Among the method changes that must be filed under the non-automatic change procedures are many changes to correct an impermissible method of recognizing liabilities under an accrual method (for example, using a reserve-type accrual), and long-term contract changes. Additionally, taxpayers that do not qualify to use the automatic change procedures because they have made a change with respect to the same item within the past five tax years will need to file under the non-automatic change procedures to request their method change.

Generally, more information needs to be provided on Form 3115 for a non-automatic accounting method change, and the complexity of the issue and the taxpayer's facts may increase the time needed to gather data and prepare the application. Taxpayers that wish to file non-automatic accounting method changes effective for 2023 should begin gathering the necessary information and prepare the application as soon as possible to avoid a last-minute rush.

Verify Eligibility to Use Small Business Taxpayer Exceptions and Evaluate Method Implications

A taxpayer that currently qualifies as a small business taxpayer for accounting method purposes is able to use small business taxpayer accounting methods – which include the overall cash method of accounting and other simplifying provisions, such as exemptions from:

- Section 471 inventory methods;
- Section 263A uniform capitalization (UNICAP) rules;
- The Section 460 requirements to use the percentage-of-completion method for certain long-term construction contracts; and
- The Section 163(j) limit on the deductibility of business interest expense.

Generally, a small business taxpayer is a taxpayer, other than a tax shelter under Section 448(d)(3), that meets the Section 448(c) gross receipts test for a given tax year. For a tax year beginning in 2023, a taxpayer meets the gross receipts test if it has average annual gross receipts for the three prior tax years (2022, 2021, 2020) of $29,000,000 or less. In calculating the gross receipts test, a taxpayer must follow the guidelines for items to be included or excluded from gross receipts, and include the gross receipts of all applicable entities and predecessors under the aggregation rules.

Taxpayers must evaluate each year whether they qualify as a small business taxpayer by continuing to meet the gross receipts test. In addition, taxpayers should determine whether any M&A activities they have engaged in or anticipate undertaking will affect their small business taxpayer status. If so, the taxpayer should determine for what year accounting method changes may be required, as well as whether it may be advantageous to make the method changes earlier than required.

Verify Eligibility to Use Small Business Taxpayer Exceptions and Evaluate Method Implications (Cont.)

Taxpayers should verify as early as possible whether they remain eligible to continue to use their current accounting methods. If method changes are needed, a taxpayer needs to determine whether:

- The change(s) qualify to use the automatic change procedures (in which case Form 3115 can be filed in 2024); or
- A non-automatic accounting method change needs to be filed before the end of 2023 for the change to apply in the first year the taxpayer does not qualify as a small business taxpayer.

Additionally, if accounting method changes need to be made, taxpayers should consider the impact of the Section 481(a) adjustments on their current year tax returns as well as ensure that the methods being adopted are consistently applied.

Year-end Clean-up Items: Accelerate Common Deductions/Losses

Heading into year-end tax planning season, companies may be able to take some relatively easy steps to accelerate certain deductions into 2023 or, if more advantageous, defer certain deductions to one or more later years. The key reminder for all of the following year-end "clean-up" items is that the taxpayer must make the necessary revisions or take the necessary actions before the end of the 2023 taxable year. (Unless otherwise indicated, the following items discuss planning relevant to an accrual basis taxpayer.)

Deduction of accrued bonuses. In most circumstances, a taxpayer will want to deduct bonuses in the year they are earned (the service year), rather than the year the amounts are paid to the recipient employees. To accomplish this, taxpayers may wish to:

- *Review bonus plans before year end* and consider changing the terms to eliminate any contingencies that can cause the bonus liability not to meet the Section 461 "all events test" as of the last day of the taxable year. Taxpayers may be able to implement strategies that allow for an accelerated deduction for tax purposes while retaining the employment requirement on the bonus payment date. These may include using (i) a "bonus pool" with a mechanism for reallocating forfeited bonuses back into the pool; or (ii) a "minimum bonus" strategy that allows some flexibility for the employer to retain a specified amount of forfeited bonuses.

  It is important that the bonus pool amount is fixed through a binding corporate action (e.g., board resolution) taken prior to year end that specifies the pool amount, or through a formula that is fixed before the end of the tax year, taking into account financial data as of the end of the tax year. A change in the bonus plan would be considered a change in underlying facts, which would allow the taxpayer to prospectively adopt a new method of accounting without filing a Form 3115.

- *Schedule bonus payments to recipients to be made no later than 2-1/2 months after the tax year end* to meet the requirements of Section 404 for deduction in the service year.

Deduction of commission liabilities. Taxpayers with commission liabilities should consider taking the following actions prior to the end of the 2023 taxable year:

- *Review commission agreements for needed revisions.* By analyzing the terms of the arrangements, taxpayers can determine what event(s) must occur to fix the commission liability and meet the all events test under Section 461. Companies may consider revising commission agreements to remove contingences or otherwise better align their business goals with deduction timing for tax purposes.

  One example of a contingency associated with commission liability is a requirement that a customer remain a customer for a specified time before the employee/agent is entitled to a commission. In this case, the liability would not be considered fixed until the conclusion of the specified time period, thereby precluding the taxpayer's deduction of the commission liabilities prior to that date.

- *Consider the tax treatment of prepaid commissions and associated elections.* For financial reporting purposes, many companies capitalize commissions paid to both employees and independent contractors, typically amortizing amounts over the same period as the related revenue stream under ASC 606. Tax requirements for capitalization of commissions and the timing of their deduction will differ based on the recipient of the commission and whether the recipient's efforts to earn the commission facilitate the acquisition or creation of an intangible.

Year-end Clean-up Items: Accelerate Common Deductions/Losses (Cont.)

- The Section 263(a) requirement to capitalize commissions as facilitative costs applies to commissions paid to third parties, including independent contractors, but employee compensation is exempt from this requirement. Thus, commissions paid to employees generally can be deducted in the year the commissions are incurred.

  If the taxpayer prefers to capitalize commissions paid to employees, it may opt to do so by making an annual election. The flexibility to switch between deducting and capitalizing employee commissions each year provides a helpful planning opportunity for companies.

- *Schedule accrued commission payments to employee recipients to be made no later than 2-1/2 months after the tax year end.* This timing is necessary to meet the requirements of Section 404 for a deduction in the service year. Accrued commissions to third parties (e.g., independent contractors) would generally be deductible in the year incurred.

Deductions of prepaid expenses. For federal income tax purposes, companies may have an opportunity to take a current deduction for some of the expenses they prepay, rather than capitalizing and amortizing the amounts over the term of the underlying agreement or taking a deduction at the time services are rendered.

A cash basis taxpayer can generally deduct prepaid expenses in the year of actual payment as long as the prepaid expense meets an exception referred to as the "12-month rule." Under the 12-month rule, taxpayers can deduct prepaid expenses in the year the amounts are paid (rather than having to capitalize and amortize the amounts over a future period) if the right/benefit associated with the prepayment does not extend beyond the earlier of i) 12 months after the first date on which the taxpayer realizes the right/benefit, or ii) the end of the taxable year following the year of payment. As taxpayers are required to meet the Section 461 all events test prior to applying the 12-month rule, accrual basis taxpayers must carefully examine the nature of their prepaids to determine whether there is a fixed and determinable liability and whether economic performance has occurred by year end.

The rules provide some valuable options for accelerated deduction of prepaids for accrual basis companies – for example, insurance, taxes, government licensing fees, software maintenance contracts, and warranty-type service contracts. Identifying prepaids eligible for accelerated deduction under the tax rules can prove a worthwhile exercise by helping companies strategize whether to make prepayments before year end, which may require a change in accounting method for the eligible prepaids.

Inventory write offs. Often companies carry inventory that is obsolete, unsalable, damaged, defective, or no longer needed. While for financial reporting inventory is generally reduced by reserves, for tax purposes a business normally must dispose of inventories to recognize a loss, unless an exception applies. Thus, a best practice for tax purposes to accelerate losses related to inventory is to dispose of or scrap the inventory by year end.

An important exception to this rule is the treatment of "subnormal goods," which are defined as goods that are unsaleable 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 reasons. For these types of items, companies may be able to write down the cost of inventory to the actual offering price within 30 days after year end, less any selling costs, even if the inventory is not sold or disposed of by year end.

Revisit the *De Minimis* Book Safe Harbor for Write-offs of Tangible Property

Subject to limitations, the so-called tangible property regulations (TPR) permit a taxpayer to elect to deduct the costs of items that likewise are expensed under a written financial accounting policy in place as of the beginning of the tax year. The election must be made annually and, because it is not a method of accounting, can be made for a given year without regard to whether the taxpayer has made the election for a prior year. The taxpayer can adjust the tax benefit of the safe harbor election by modifying the associated financial accounting policy prior to the beginning of the tax year for which the election will be made, changing the ceiling amount for items eligible to be deducted.

Revisit the *De Minimis* Book Safe Harbor for Write-offs of Tangible Property (Cont.)

Under the safe harbor election, taxpayers with an applicable financial statement (AFS) may deduct amounts paid for tangible property up to $5,000 per invoice or item ($2,500 per invoice or item for taxpayers without an AFS). Deductions must be substantiated by invoice.

Critical year-end action items are:

- Review and make desired changes to the associated financial accounting policy prior to the beginning of the upcoming tax year; and
- Plan to attach the required election statement to the timely-filed, original return for the year in which the election is to be effective.

Consider Methods Implications of Potential M&A Transactions

Taxpayers contemplating an acquisition, disposition, or other M&A transaction should consider the opportunities for accounting methods planning as well as any procedural requirements. Both buy-side and sell-side companies can benefit from proactively considering a transaction's effects on existing accounting methods and related potential risk mitigation or planning strategies. Below are some examples of the opportunities to consider.

Final year restrictions. In general, automatic accounting method changes are not permitted in a taxpayer's final year of a trade or business (e.g., when a taxpayer is acquired in a taxable asset acquisition). During the transaction process, taxpayers may contemplate certain changes in accounting methods, such as the correction of an impermissible method or a change in overall method. It is important to carefully consider the structure of a transaction to determine if any accounting method changes are permitted or required.

If a transaction does not result in the cessation of a trade or business, taxpayers may want to plan for the timing of an accounting method change (i.e., whether the change is made pre- vs. post-transaction). For example, certain method changes may be qualified for accelerated taxable income adjustments in a pre-transaction period. By beginning the planning process early, taxpayers may be able to include beneficial terms in the agreement, such as limiting the pre-transaction realization of potential tax benefits to the sellers or requiring the sellers to correct potential exposure items.

Due diligence preparation. A taxpayer looking to sell part or all of a company may be able to use accounting methods planning to strengthen its profile in attracting potential buyers. A comprehensive accounting method review can uncover opportunities to mitigate potential risk and identify ways to achieve desired tax attributes well in advance of the formal due diligence process.

Post-transaction alignment. Acquisitive taxpayers should consider the impact of a transaction's structure on the tax attributes — including the tax accounting methods — of acquired companies. In situations where the acquired company's accounting methods carry over, accounting method changes can align the methods being used across the group to streamline the compliance process. Alternatively, transaction structures resulting in the adoption of new methods can provide opportunities to select methods that best align with the taxpayer's tax objectives. Taxpayers able to adopt new methods may also benefit from the ability to establish methods that cannot be changed through the automatic procedures at a later date, such as certain percentage-of-completion methods under Section 460 or the 3-1/2 month rule for deducting certain prepaid services.

Items to Review in Early Months of 2024:

Review Latest Section 174 Guidance and Evaluate Implications on 2023 Tax Year

The Tax Cuts and Jobs Act (TCJA)

The Tax Cuts and Jobs Act (TCJA) made significant changes to Internal Revenue Code Section 174, which deals with the deduction of research and experimental (R&E) expenses. Prior to the TCJA, businesses could deduct these expenses in the year they were incurred. However, the TCJA introduced new rules that require businesses to capitalize and amortize R&E expenses over a five-year period or 15-year period for foreign costs, starting from the midpoint of the taxable year in which the expenses were incurred. This change applies to R&E expenses incurred in tax years beginning after December 31, 2021. The changes to Section 174 also included language defining any software developed internally or by third parties as Section 174 expenses. Prior to the change, taxpayers rarely treated its R&E expenses as Section 174 expenses and elected to deduct these costs under Section 162.

IRS Notice 2023-63

In September 2023, the IRS released Notice 2023-63, which contains substantive pre-regulatory guidance on the new Section 174 capitalization requirements and announced that the Treasury and the IRS intend to issue proposed regulations consistent with the Notice. The guidance provides taxpayers with an advance look into upcoming proposed regulations, which the IRS anticipates will apply for taxable years ending after September 8, 2023.

The Notice provides valuable guidance to taxpayers in several key areas. Specifically, it provides clarity on which indirect costs should be treated as Section 174 expenses, such as overhead, depreciation, and personnel costs and which expenses should not be treated as 174 expenses, such as G&A expenses.

Additionally, the Notice provides guidance and examples on software development costs that should and should not be treated as 174 expenses, which was a key area of confusion among taxpayers. R&E performed under contract is another key area covered by the Notice The Notice informs taxpayers that they must have no financial risk and no rights to the research in order to treat the expenses performed under contract 162 costs instead of 174 expenses.

The Notice also provides guidance to taxpayers in the following areas:

- Methodology for allocating overhead and depreciation;
- Short tax year treatment;
- Project Completion method expense and revenue treatment;
- Cost sharing agreements; and
- Recovery of the costs for business sold or cease to exist.

Taxpayers that intend to rely on this guidance for the 2023 taxable year should begin to consider how it may differ from positions taken for the 2022 taxable year or in calculating their 2023 estimated tax payments. In doing so, taxpayers should take special note of certain key areas of uncertainty.

For taxpayers with divergent prior positions, the IRS intends to issue new procedural guidance to assist taxpayers in making accounting method changes that are needed to conform to the new guidance.

Planning Considerations for M&A Transactions

Section 7 of the Notice addresses some basic consequences of asset dispositions, entity terminations, and carryover transactions for corporations. However, the Notice leaves unaddressed a number of interactions between Section 174 and other M&A tax rules, including those addressed below.

Section 338(h)(10). While the Notice does not specifically address Section 338(h)(10), the Notice appears to make clear that specified research and experimental (SRE) expenditures capitalized under Section 174 by a target should remain with the selling parent following a Section 338(h)(10) election. As such, the SRE expenditures will provide no current year reduction in gain from the deemed asset sale but may provide the seller utilizable amortization in future tax years.

Planning Considerations for M&A Transactions (Cont.)

To the extent the buyer and seller are negotiating a gross up payment in conjunction with the election, treatment of the SRE expenditures in the calculation of the gross up should be addressed.

Section 382. To date there has been no guidance on the interaction of Section 174 and the safe harbors outlined in Notice 2003-65. Notice 2003-65 provides two safe harbor methodologies for calculating the NUBIG/NUBIL and RBIG/RBIL from a loss corporation's Section 382 ownership change, the 338 approach and the 1374 approach. Under both approaches, the NUBIG/NUBIL is the net amount of gain or loss that would be recognized in a hypothetical asset sale, whereby the loss corporation sells all of its assets, and the buyer assumes all of the loss corporation's liabilities.

In the absence of specific guidance, the conservative approach has been to factor the SRE expenditures into the calculation of both NUBIG/NUBIL and RBIG/RBIL. To the extent the calculated limit under this approach does not have a detrimental impact on the tax provision or tax filing positions, a company may have the opportunity to wait to see if further guidance on this issue is released. However, for other companies, the Notice's guidance may support beneficial positions with respect to calculating NUBIG/NUBIL and RBIG/RBIL as neither the 338 or 1374 methods provide for a deemed liquidation or cessation of the loss corporation. As needed, companies should weigh the strength of these potential positions.

Unified Loss Rule. In certain situations when selling a subsidiary member at a loss, a consolidated federal income tax group can reattribute tax attributes (e.g., NOLs and deferred deductions) from the departing subsidiary to the group under an election within the unified loss rule (ULR). This election allows the group to retain valuable tax attributes.

To date there is no guidance on the interaction of SRE expenditures capitalized under Section 174 and the ULR. However, unamortized SRE expenditures (to which Section 174(d) has not been applied) appear distinguishable from deferred deductions or any other category of asset that could be electively reattributed under the ULR. As such, to the extent a group is selling a subsidiary with valuable unamortized SRE expenditures, the group should consider whether to value the SRE amortization as part of the deal consideration or seek a sale structure other than a stock sale.

Cost Sharing Arrangements (CSAs) under Reg. §1.482-7

Under the cost sharing regulations of Reg. §1.482-7, two or more participants in a qualified CSA agree to bear intangible development costs (IDCs) in proportion to each party's expected benefit from exploiting the developed intangible property. If during the course of a year, the actual IDC expenditures of each CSA participant are not in proportion to the expected benefit, cost sharing payments are made among CSA participants to achieve the proper expense/benefit allocations. Payments received by a CSA participant payee (from another CSA participant payor) are treated as contra-costs or contra-expenses, and thus serve to reduce the payee's IDCs.

Notice 2023-63 clarifies that payments made to a CSA participant payee that incurs both immediately deductible IDCs and those that are required to be charged to a capital account should be allocated among these cost categories proportionately. If a CSA payment exceeds the total amount of IDCs in these two categories, the excess is to be treated as income by the payee. Furthermore, to comply with the different amortization periods, taxpayers will have to segregate all IDCs that must be capitalized into U.S.-incurred expenses and non-U.S.-incurred expenses.

Although this guidance regarding Section 174 and cost sharing is welcome, open questions remain. For example, the guidance does not address the treatment of outsourced research and development (R&D) activities within a CSA, and it does not address intercompany R&D CSAs outside of qualified CSAs under Reg. §1.482-7.

It is important for taxpayers who have filed or have previously filed research and development (R&D) tax credits, have software development expenses, or are in a trade or business that incurs research expenses, to perform a Section 174 analysis. For others that may not have tracked or identified these costs or have not historically claimed the R&D tax credit, it is still necessary to identify Section 174 costs specifically, as they are now subject to capitalization. Taxpayers are encouraged to establish a methodology for calculating and documenting a consistent approach to comply with these new rules. Further, with limited guidance from the Treasury and IRS, taxpayers should consider other potential tax impacts.

Review Opportunities for Immediate Deduction of Fixed Assets

Although Congress is considering legislation that would delay the ongoing phase-out of bonus depreciation (which reduces from 80% in 2023 to 60% in 2024), considerable uncertainty remains as to the prospects for its passage. As such, year-end tax planning for fixed assets emphasizes cash tax savings through scrubbing fixed asset accounts for costs that can be deducted currently under Section 162 rather than being capitalized and recovered through depreciation, and reducing the depreciation recovery periods of capital costs where possible.

Fixed Asset Scrubs. Reviewing fixed asset registers for amounts that potentially may be recovered over a shorter depreciable life can yield cash tax benefits. For example, taxpayers may be able to reclassify certain interior improvements to a nonresidential building as "qualified improvement property" eligible for a shorter 15-year recovery period and bonus depreciation. The cash tax benefit from properly reducing the recovery period of depreciable property is achieved using the automatic accounting method change procedures.

Scrubbing fixed asset registers can also identify "ghost assets" that the company has physically disposed of in prior years but for various reasons have not been removed from the company's accounting records. Identifying and deducting the remaining tax basis through an automatic change in accounting method can yield cash tax benefits as well.

Materials and Supplies. Scrubbing a company's accounts for items that may be treated as materials and supplies can also yield cash tax benefits. Materials and supplies include spare parts, consumables (fuel, lubes, water, etc.) that will be used within the next 12 months; items costing no more than $200 each; and items that have an economic useful life of no more than 12 months. This definition can apply to a surprising array of items, permitting nearly immediate cost recovery in many cases. Reviewing and adjusting the process by which the company identifies items as materials and supplies and are key to maximizing this opportunity. This potential cash tax benefit is achieved through an automatic change in accounting method.

Additional potential benefits from reviewing the company's application of the TPR can be found in a Tax Notes article authored by BDO's James Atkinson. See J. Atkinson, "Preparing for a Post-Bonus Depreciation World," 179 Tax Notes 209 (April 10, 2023).

Consider the UNICAP Historic Absorption Ratio Election

Under Section 263A, taxpayers must capitalize direct and indirect costs allocable to real or tangible personal property produced or acquired for resale. The types and amounts of costs required to be capitalized under Section 263A typically go beyond those required to be capitalized for financial accounting purposes. Accordingly, many taxpayers must undertake a computation each year to capitalize "additional section 263A" costs to property acquired or produced. For taxpayers seeking to streamline this often time-consuming process, the historic absorption ratio (HAR) election may be worth considering.

The Historic Absorption Ratio Method

While the Section 263A regulations list numerous methods and sub-methods taxpayers can use to identify and allocate additional Section 263A costs to ending inventory, many taxpayers select one of the three simplified methods (simplified production method, simplified resale method, and modified simplified production method) outlined in the regulations to streamline compliance efforts and reduce potential controversy with the IRS. Although these methods are generally less administratively burdensome in comparison to other alternatives, taxpayers must still dedicate significant efforts in maintaining the annual calculations. Taxpayers currently using one of the simplified methods may be able to further streamline their compliance process by electing to use the HAR method.

A taxpayer qualifies to make the HAR election once it has consistently used one of the three simplified methods for at least three consecutive tax years. In the year the election is made, the taxpayer calculates the HAR by averaging the absorption ratios from the prior three tax years.

The Historic Absorption Ratio Method (Cont.)

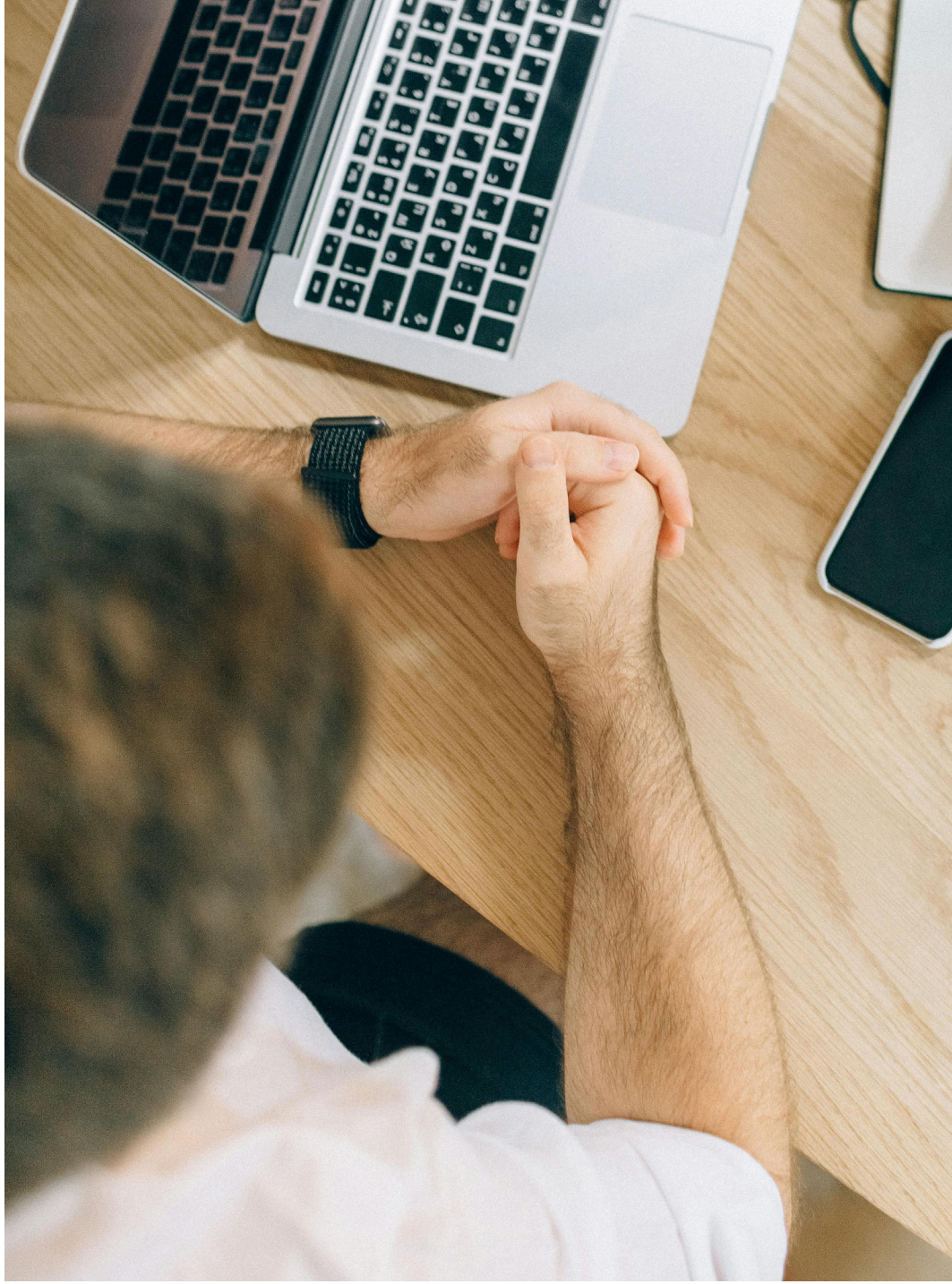
The HAR is then applied to ending inventory for the next five tax years, beginning with the election year. On the sixth year, the taxpayer must recompute the absorption ratio(s) using actual data for the year under the applicable simplified method:

- If the recomputed ratio(s) are within 0.5% of the HAR used for the preceding five years, the taxpayer can continue using the HAR for another five years.
- If the recomputed ratio(s) are not within the 0.5% range, then the taxpayer is required to begin another three year testing period of calculating the actual absorption ratios.

Thus, while the HAR election still requires taxpayers to prepare Section 263A calculations for testing period years, the ability to bypass this exercise for at least five years in a row can save taxpayers a considerable amount of time in their compliance efforts.

Making and Terminating the HAR Election – Weigh the Benefits Carefully

A taxpayer makes the HAR election by attaching an election statement to the tax return; no method change (Form 3115) or Section 481(a) catch-up adjustment is required. However, terminating the HAR election requires a non-automatic accounting method change, which the IRS generally will grant only in unusual circumstances. Therefore, given the inflexibility of the approach once the HAR election is made, taxpayers should carefully weigh the benefits of the administrative relief associated with making the HAR election against the trade-off of using a locked-in ratio in a year where the actual absorption ratio may be lower. With this in mind, taxpayers should consider making the election for a specific tax year when the absorption ratios used for the testing period are lower than usual, as this strategy might allow them to benefit both from minimizing compliance costs and capitalizing less amounts to ending inventory.



Review Leasing Transactions for Compliance with Tax Rules

The treatment of lease arrangements is a complex area due to many factors, including the diversity of lease structures, changing U.S. GAAP practices, and nuanced tax rules. In recent years, many companies have adopted ASC 842, the new GAAP standard governing lease accounting. The tax classification of an arrangement as a lease is independent of GAAP reporting, so the adoption of ASC 842 does not necessitate a tax accounting method change. However, given the changes in financial accounting practices, taxpayers adopting ASC 842 should perform a comprehensive tax review of their leases to ensure proper tax methods are maintained and to identify any tax accounting method changes that are needed.

A lease analysis for tax purposes generally focuses on the following three key areas:

Categorization. The classification of an arrangement as a "true" tax lease is a highly facts-based analysis that should be performed on each lease a taxpayer enters. While an arrangement may be presented as a lease for legal and/or financial reporting purposes, the tax classification depends more on the substance of the arrangement than the form. Tax treatment as a lease versus the financing of a purchase, provision of services, or other arrangement is based broadly on the (1) benefits and burdens of ownership and (2) economic substance of the transaction.

Timing of income/deductions. Taxpayers with leases may fall into special methods of accounting under Section 467. In general, a taxpayer is subject to Section 467 if the lease meets all of the following criteria:

- The lease is for the use of tangible property;
- Total consideration paid under the lease exceeds $250,000; and
- The rent schedule provides for increasing/decreasing payments throughout the term of the lease and/or there is a rent allocation schedule that differs from the payment schedule.

In most cases, taxpayers subject to Section 467 should recognize rental income (lessor) or rent expense (lessee) in line with the payment schedule. However, Section 467 may require the use of a different method, such as the proportional rental accrual method. Taxpayers with leases that are not subject to Section 467 should look to their overall method of accounting to determine the timing of income and deductions.

By undertaking a tax analysis prior to entering into a new lease, taxpayers may be able to negotiate more favorable lease terms that help align the timing of income/deductions with their overall tax objectives.

Maintaining the proper method. As mentioned above, adoption of ASC 842 for GAAP reporting purposes will likely change the way taxpayers compute existing book-to-tax adjustments. To ensure existing tax accounting methods are properly maintained, and to prevent errors or unauthorized method changes, taxpayers should ensure they understand any new lease-related balance sheet accounts and the appropriate tax treatment for such accounts.

Evaluate Accounting Method Changes for CFCs

Controlled foreign corporations (CFCs) are generally subject to the same requirements as U.S. taxpayers to use proper methods of accounting for tax purposes (for example, to calculate earnings and profits and to calculate tested income for GILTI). A CFC that has adopted an improper method of accounting or otherwise wishes to change an accounting method is required to file Form 3115.

A potential benefit of filing Form 3115 to correct an improper method is the ability to receive audit protection. If audit protection is granted, the IRS is precluded from challenging a taxpayer's improper treatment for open tax years prior to the year of change. For CFCs or 10/50 corporations (foreign corporations with U.S. shareholders owning at least 10% but no more than 50%), however, audit protection may be denied for a tax year before the year the method change was requested under a "150% rule." The 150% rule is met if one or more of the CFC's or the 10/50 corporation's U.S. corporate shareholders report deemed paid foreign taxes for that year that exceed 150% of the average deemed paid foreign taxes reported during the three prior tax years.

For the many CFCs that were subject to the transition tax imposed under Section 965, the 150% rule denying audit protection may have disincentivized them from filing method changes to correct improper accounting methods. Affected taxpayers may now find themselves clear of the rule for the 2023 or 2024 tax year and should consider filing method changes to clean up their impermissible methods prospectively. Some of the more common, automatic method changes that CFCs may encounter include the following:

- Changing from computing depreciation under the General Depreciation System (GDS) to the Alternative Depreciation System (ADS);
- Switching to either the full inclusion method or the one-year deferral method for advance payments;
- Changing to a proper Section 461 method to deduct liabilities such as bonuses and commissions in the year the liability is fixed and amounts are paid within 2-1/2 months of year end; and
- Complying with Section 263A and adopting the U.S. ratio method to capitalize costs to ending inventory.

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