5 TAX ACCOUNTING METHOD CHANGES THAT CAN GENERATE SAVINGS AND CASH FLOW

Cash flow preservation remains an important focus for many companies as the COVID-19 pandemic continues to create uncertainty for businesses. Accounting method changes provide a valuable opportunity for taxpayers to reduce their current tax expense and increase cash flow by accelerating deductions and/or deferring income. Changing to an optimal method of accounting often results in a taxpayer claiming a favorable "catch-up" adjustment on the federal tax return for the year of the change, which can significantly reduce taxable income or generate a net operating loss that can be carried back to higher tax rate years.

Whether it makes sense to change a method of accounting depends on the taxpayer's tax posture, future company performance and goals. Taxpayers should keep in mind that current tax proposals would raise tax rates and make other changes to the federal income tax system for corporations and individuals. These proposals should be monitored and their potential effects considered when evaluating the short- and long-term benefits of a tax accounting method change.

The deadline for requesting certain "automatic" method changes is the date the taxpayer timely files its federal income tax return for the year of change. Thus, businesses should not only begin to review method changes that may make sense for 2021; they may still have time to make beneficial method changes for 2020. Five common beneficial method changes to consider for 2020 include the following:

1. Payroll taxes deferred by CARES Act

Taxpayers that deferred payments of the employer portion of 2020 social security taxes until 2021 and 2022 (as allowed by the CARES Act) may wish to consider adopting what's known as the "recurring item exception" method of reporting payroll taxes.

Taxpayers generally will be allowed to deduct these payments in the year they are paid, i.e., in 2021 and 2022 when a business takes advantage of the maximum deferral period. However, a taxpayer that is willing to remit the taxes earlier may claim the deduction in 2020 if:

- The taxes are paid by the earlier of (a) the date the taxpayer timely files its 2020 federal income tax return or (b) eight and a half months after the close of its 2020 tax year; and
- The taxpayer uses the recurring item exception for deducting payroll taxes. Taxpayers that are not currently using the recurring item exception for payroll taxes can request the method change with the timely filed 2020 federal income tax return.

2. Advance payments

Accrual method businesses that currently recognize and pay tax on certain advance payments in the year of receipt may change their method to defer the recognition of a portion of the payment to the next tax year. To qualify for the one-year deferral, a portion of the advance payment must be recognized in a subsequent tax year for financial reporting purposes. Furthermore, businesses that are currently deferring advance payment recognition may engage in reverse planning to change the method to pick up the advance payment in the year of receipt.

3. Software development costs

For a limited time, taxpayers can accelerate deductions of qualifying software development costs incurred through 2021 to the year the costs are paid or incurred, rather than capitalize and amortize the costs over a period of years. This method change applies to the costs of developing software either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others. Note that the Tax Cuts and Jobs Act requires software development costs incurred after 2021 to be capitalized and amortized.

4. Qualified improvement property

Qualified improvement property (QIP) includes certain improvements made by a taxpayer to an interior portion of an existing nonresidential building. QIP placed in service after December 31, 2017 is depreciable over 15 years for tax purposes and qualifies for first year 100% bonus depreciation. Taxpayers that are depreciating QIP over 39 years can change to using the shorter 15-year recovery period and claim bonus depreciation by requesting an automatic method change.

5. Residential rental property

Taxpayers that have made a "real property trade or business election" and own residential rental property placed in service prior to 2018 may be entitled to request a method change to depreciate such property over 30 years instead of 40 years.

How We Can Help

We can help taxpayers of all industries and sizes proactively identify and assess tax method opportunities, determine the rules and deadlines for filing accounting method changes and serve as a liason with the IRS as needed.