April 3, 2018

Tax Accounting Ideas Post-Tax Reform

Tax Reform Generally

I. Impact of Tax Reform

A. Background on domestic changes

1. The Tax Cuts and Jobs Act ("TCJA") sharply reduced corporate tax rates, as well as providing for a 20% deduction for income from certain pass through entities.

2. As a result, year-end and post year-end planning places a premium on accelerating deductions into the 2017 taxable year and deferring revenue into the 2018 taxable year.

3. Where action was required prior to the end of the taxable year that began in 2017, fiscal year taxpayers may have more time and flexibility to implement some of these timing strategies, provided their 2018 fiscal year has not yet ended.

B. Background on international changes

1. On the international side, a one-time tax is imposed on the greater of a CFC's E&P at November 2, 2017, or December 31, 2017.

2. The legislative history notes the possibility that using post-year end techniques such as accounting method changes to reduce a CFC's E&P will be prohibited, and in Notice 2018-26, the IRS and Treasury announced that they would issue regulations disregarding accounting method changes for CFCs that reduced the amount of the CFCs' E&P required to be included in U.S. taxable income under this provision.

3. However, it is not clear that a method change that corrects the calculation of a CFC's E&P can be barred simply because it was filed after November 2, 2017, and would have the effect of reducing E&P as of the measurement date.

4. Finally, a new tax, referred to as BEAT, will be imposed on certain payments by a U.S. company to its foreign affiliates, but payments includible in cost of goods sold will be excluded from the BEAT system.

5. This gives rise to planning opportunities with respect to the computation of a taxpayer's cost of goods sold. This subject will be discussed in more detail below.

Deduction Acceleration Opportunities

I. Pension Plan Contributions

A. In general

1. Ordinarily, a taxpayer may deduct contributions to a pension plan only in the taxable year the contribution is made because section 404 places accrual basis taxpayers on the cash basis when it comes to deduction for contributions to a qualified pension plan.

B. Section 404(a)(6)

1. However, section 404(a)(6) enables taxpayers to treat a contribution to a pension plan that is made as late as the extended due date for the taxpayer's tax return as being on account of the preceding year's pension liability, so that the contribution is deductible for the preceding taxable year.

2. As a result, a contribution to a calendar year taxpayer's pension plan made before October 15, 2018, may be deducted on the taxpayer's 2017 tax return.

3. What does it take to treat a payment that is made in 2018 as being "on account of" 2017?

   a. The requirements are spelled out in Rev. Rul. 75-28.

   b. However there are three open issues.

4. The first issue is does the post-year-end contribution have to meet the accrual rules prior to year end?

   a. While the IRS authorities are inconsistent, we think the better answer is that a year-end accrual as of the end of the preceding taxable year is not necessary in order to use section 404(a)(6).

5. Second, can the taxpayer treat the 2018 contribution as a deduction for 2017, but treat the contribution as satisfying any minimum contribution requirement under section 430 for 2018?

   a. Although guidance is unclear as to whether a taxpayer can treat the contribution as a deduction for a different year than the year for which the contribution is treated as satisfying the minimum funding requirements, there is a substantial line of authority suggesting that an inconsistent position on the timing of the deduction and satisfaction of the minimum funding requirements is permissible. Rev. Rul. 77-83, 1977-1 C.B. 139; Treas. Reg. § 1.404(a)-14(d)(2)(ii); Treas. Reg. § 1.412(c) 12; (2)(ii); Prop. Treas. Reg. § 1.412(e)(10)-1(c); PLRs 7945115, 9107033,

6. The third issue is whether there are any accounting method change considerations that may affect the decision to claim this deduction? For example, if a taxpayer previously treated pension plan contributions made after the end of a taxable year as a deduction for the taxable year in which the contribution is made, must the taxpayer file a Form 3115 to change prospectively to deduct the contribution in the preceding taxable year?

   a. The IRS has ruled multiple times that the first time a taxpayer makes use of section 404(a)(6) does not represent a change in method of accounting, because it constitutes a change in facts, i.e., a change in the timing of the attribution of the payment. PLR 8526068, 8303002, 8227068.

   b. We think that more recent authorities reaching a different result are distinguishable. Rev. Rul. 2002-46, 2002 C.B. 117.

   c. Thus, as discussed above, taxpayers may still make this change for their 2017 taxable year.

II. Pre-Fund VEBA Liabilities, in the case of a Fiscal Year Taxpayer, for the Fiscal Year Ending in 2018

A. Pre-fund future severance pay

1. Severance benefits that are attributable to future involuntary terminations of employment can be pre-funded in a VEBA or a taxable trust.

2. The severance costs can include the cost of any medical or other benefits payable to the severed employees.

3. However, the limit on the pre-funding is 75% of the employer's severance pay costs in any two of the last seven years.

4. A VEBA may pay severance benefits only if they qualify for the ERISA exception for severance pay plans.

5. That limits the amount of severance pay to an amount not in excess of two times the employees' pay for a period of two years or less.

6. The normal 12-month limit on deductions for prepaid expenses in the *INDOPCO* regulations does not apply to contributions to a VEBA. Treas. Reg. § 1.419-1T, Q&A-10(d).

B. Pre-fund Long-Term Disability benefits

1. Self-insured long-term disability benefits may be pre-funded in a VEBA or a taxable trust.

2. The pre-funded LTD benefits are those that have lasted for at least five months and that are expected to last for at least 12 months.

3. The LTD deduction limit is the amount necessary to fund the entire expected future stream of payments to the disabled person, subject to certain limits.

4. The amount of LTD benefit taken into account cannot exceed the lower of 75% of the participant's average annual compensation for the three highest years or $215,000.

5. Short-term STD benefits may also be pre-funded, subject to certain limits.

C. Pre-fund retiree health benefits

1. Retiree health benefits may be pre-funded under a VEBA or a taxable trust, up to the present value of the entire future liability for already-retired participants.

2. Similarly, pre-funding may be done ratably over the remaining working lives of current employees.

3. The pre-funding of retiree medical benefits in a VEBA has implications for the tax on unrelated business taxable income.

III. Reclassify Capitalized or Inventoried Costs as Section 174 Costs

A. Background

1. The rules on what constitutes research expenses are quite nebulous.

2. As a result, various accounting firms have undertaken research credit studies for clients with the hope that expenditures previously capitalized or allocated to inventory might be identified as qualifying research expenses for purposes of the research credit.

3. In order to file a refund claims for additional research credits, the taxable years for which the claims are filed must be open under the statute of limitations.

4. However, the research expenditures might also generate additional deductions from taxable income under section 174.

5. This gives rise to the question whether a change in treatment of a particular cost from either a capital expenditure or inventory cost to a section 174 expense is a change in method of accounting that requires the filing of a Form 3115 or a correction of an error that is claimed by filing an amended return.

B. Current Status

1. There are two possible ways of handling an R&E reclassification at the current time.

    a. Treat reclassification of a cost as a correction of an error and permit filing of amended returns for open years to reclassify section 174 costs.

        i. The advantage of this treatment is that is permits taxpayers to effectuate the reclassification retroactively for open years.

        ii. Another advantage is that the IRS's consent to reclassify the cost is not required.

        iii. The disadvantage of this treatment is that a taxpayer cannot implement the reclassification for closed years.

    b. Treat as a change in method of accounting, but use a cut-off transition rule.

        i. Under this alternative, the reclassification may only be made prospectively, the IRS's consent is required, and the taxpayer is unable to recoup deductions from barred years.

2. In a recent speech, Scott Dinwiddie, head of ITA for the IRS National Office suggested that the IRS is considering eliminating the amended return option.

    a. Such a change in position would undoubtedly be prospective.

    b. Accordingly, taxpayers seeking to follow an amended return approach should act soon.

    c. Under the amended return approach, taxable income for pre-2018 taxable years can still be reduced, provided the statute of limitations has not yet run on these years, without the constraints that are applicable to accounting method changes being an obstacle.

IV. Accelerate Accrual of Payroll Taxes on Unpaid Compensation

A. Basic rules

1. In Rev. Rul. 96-51, 1996-2 C.B. 36, the IRS ruled that FICA and FUTA taxes on accrued but unpaid wages at year end may be deducted in the year of accrual by an accrual-basis employer.

2, This holding is extended to state unemployment taxes as well.

3. A safe harbor method of accounting is provided in Rev. Proc. 2008-25, 2008-1 C.B. 686.

B. Procedures for changing

1. This change is eligible for the automatic consent procedures in Rev. Proc. 2017-30.

2. Consequently, this change can still be made for 2017.

3. This change is change #45 and is contained in section 19.04 of Rev. Proc. 2017-30.

V. Change to Net Method of Accounting for Cash and Trade Discounts

A. Treatment of Trade Discounts.

1. In general.

a. Reg. § 1.471-3 requires a taxpayer to reduce its purchases by the amount of any trade or other discounts.

b. However the IRS takes the position that such discounts may not be accrued until they satisfy both the "all events" test and the economic performance requirement in § 461(h).

c. As a result, some types of trade discounts may accrue at the time that goods are purchased, whereas other discounts may not be accrue until a later taxable year than the year when the goods were originally purchased.

2. Actions to be taken

   a. The net method of accounting for trade discounts is required for tax purposes.

   b. This change is eligible for the automatic consent procedures.

   c. Accordingly, a taxpayer using the gross method of accounting may file a Form 3115 for the 2017 taxable year to change to the net method and obtain a favorable section 481(a) adjustment.

B. Treatment of cash discounts

1. In general

   a. In contrast to trade discounts, taxpayers have the option of using either the gross or net method of accounting for cash discounts.

   b. If a taxpayer uses the net method of accounting for cash discounts, there is some uncertainty whether purchases may be recorded at gross and then an average percentage discount taken at year end, instead of posting purchases at the purchase price net of cash discounts.

   c. The net method would normally be favorable to taxpayers.

2. Action to be taken

   a. A change from one method to the other is eligible for the automatic consent procedures for accounting method changes.

   b. Accordingly, a taxpayer could still change from the gross to the net method of accounting for cash discounts for the 2017 taxable year and obtain a favorable section 481(a) adjustment.

Deferral of Revenue

I. New FASB on Revenue Recognition

A. The impact of the new FASB on revenue recognition and new section 451(b) is addressed in the other speech outline.

II. Elimination of Unlimited Deferral under Treas. Reg. § 1.451-5

A. Background

1. Rev. Proc. 2004-34 permits up to a one year deferral from income for advance payments received for the future performance of services, sale of goods or certain rights to use IP and licenses.

2. In contrast, Treas. Reg. § 1.451-5 permits an unlimited deferral from income for advance payments received for the sale of goods in the future, so long as such payments are deferred for financial reporting purposes.

3, However, there is a two-year limitation on such deferral in instances where the advance payment exceeds the cost of the goods.

4, If such a substantial advance payment is required to be included in income prior to the sale of the goods, the taxpayer is entitled to claim an offsetting deduction for the estimated cost of goods sold.

5. In TCJA, the provisions in Rev. Proc. 2004-34 were statutorily codified, but Treas. Reg. § 1.451-5 was repealed. This change is effective for 2018.

6. Thus, the deferral period is now limited to one year for all categories of advance payments.

B. Ramifications

1. Advance payments for sales of goods may be triggered with no offsetting cost of goods sold

2. Taxpayers may want to consider restructuring their advance payment arrangements to avoid current taxation, such as through the use of non-taxable deposits.

3. Such a change in facts would enable a taxpayer to change its treatment of new agreements without the need for filing an accounting method change request. Thus, the soonest this change could be made is 2018.

4. A taxpayer considering this approach needs to consider what types of changes must be made to sales agreements in order for an advance payment to be characterized as a deposit?

SECTION 199 ISSUES

I. Prospective Costs and Section 199

A. For purposes of section 199, it may be argued that a taxpayer may allocate certain pre-repeal deductions to post-repeal gross receipts/

1. One type of prospective cost is the bonus depreciation amount in the year the property is placed in service over the amount of depreciation that would have been taken under MACRS.

2. Compensation and benefits allocable to employees that perform planning for the future or who work on future M&A deals may be treated similarly.

3. However, to the extent that such prospective costs would be allocated to cost of goods sold under section 263A, an issue arises as to whether costs included in cost of goods sold for the current taxable year may be allocated forward to post-repeal section 199 years.

4. Thus, a taxpayer could amend open taxable years and shift the allocation of a portion of bonus depreciation to later taxable years, particularly post=2017 taxable years when section 199 is no longer in effect.

Definition of Cost of Goods Sold

I. Impact on BEAT

While this section doesn't specifically relate to the 2017/2018 transition context, nevertheless, it is a significant tax accounting issue under TCJA.

A. Background

1. To help prevent base erosion, TCJA subjects large taxpayers to a punitive tax on payments to related foreign affiliates for the use of certain intellectual property rights. This provision is effective starting in 2018.

2. However, an exception is provided for payments that are included in the payor's cost of goods sold.

3. This raises the issue of whether payments such as royalties are includible and have been included in the payor's cost of goods sold.

B. What costs are included in cost of goods sold?

1. The definition of the elements of cost of goods sold are contained in Treas. Reg. § 1.61-3(a).

2. Because that regulation was promulgated before the enactment of section 263A, the regulation makes the determination of whether a cost is included in cost of goods sold depend on its treatment under the full absorption inventory costing regulations, Treas. Reg. § 1.471-11.

3. With the subsequent enactment of section 263A, the definition of cost of goods sold is undoubtedly dependent now on whether the costs are included in inventoriable costs under the section 263A regulations.

4. Under those regulations, royalties paid to use intellectual property for the purpose of producing goods would be treated as a section 263A cost. Treas. Reg. § 1.263A-1(e)(3)(ii)(U).

5. Recently, to resolve litigation, the IRS changed these regulations to specifically include sales-based royalties, such as royalties paid to use production know-how, but measured based on the parties volume of sales, as allocated to section 263A.

6. Thus, sales-based royalties should be treated as part of cost of goods sold.

C. Changing the definition of cost of goods sold

1. If a taxpayer has not included a cost in cost of goods sold that should be so included, we obtained a ruling that a reclassification of a cost to or from cost of goods sold is not a change in method of accounting, provided the reclassification does not affect the timing of the deduction of the cost.

2. If timing is affected, a taxpayer might file a Form 3115.

3. A taxpayer might also consider making elections that increase cost of goods sold, even if collaterally the change affects inventory cost capitalization, if that reduces the tax under BEAT.

II. Planning for the Transition Tax

A. Tax Cut and Job Reduction Act of 2017

1. Section 965, added by TCJA, imposes a one-time transition tax on the E&P of foreign subsidiaries.

2. Accordingly, consideration should be given to filing accounting method change requests for CFCs to reduce their E&P.

3. However, in Notice 2018-26, the IRS announced that it will disregard any accounting method changes filed for CFCs to reduce their E&P if filed after Nov. 1, 2017 for a 2017 or 2018 taxable year.

4. The Notice does not distinguish between discretionary changes and corrections of erroneous of accounting.

B. Is the Notice valid?

1. There is at least some question as to whether the IRS has the authority to block method changes made to correct a CFC's erroneous method of accounting.

2. Under case law outside the TCJA context, it has been held that it is an abuse of discretion for the IRS to refuse to permit a taxpayer to correct an erroneous method of accounting.