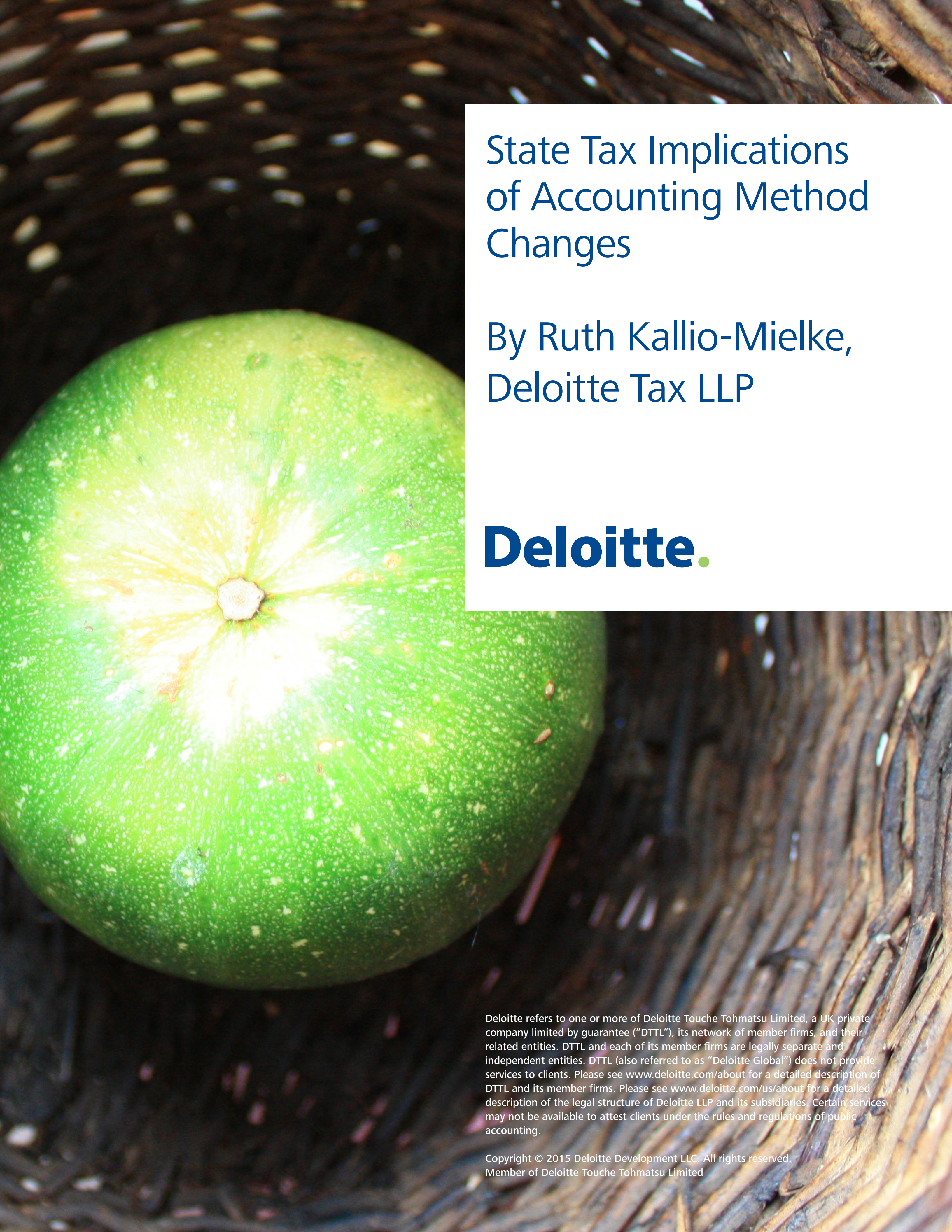

State Tax Implications of Accounting Method Changes

By Ruth Kallio-Mielke, Deloitte Tax LLP

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State Tax Implications of Accounting Method Changes

By Ruth Kallio-Mielke[1]

Federal and state income tax liabilities may potentially be reduced if tax professionals understand the issues impacting the calculation of these liabilities, including tax accounting methods.

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Introduction

Federal accounting method changes are an often overlooked area by state tax professionals. Tax professionals sometimes assume an election to change the method of accounting for a particular transaction or item of income or expense will be followed for state tax purposes with no unique ramifications apart from the federal tax implications. In many states this is true; however, there are exceptions. These exceptions can create traps for the unwary as well as potential missed opportunities. The purpose of this article is to summarize various state compliance requirements and highlight certain situations where an accounting method change that produces different federal and state tax effects may potentially present an opportunity for tax savings.

Federal Background

An accounting method for tax purposes is not formally defined in the Internal Revenue Code ("the Code") or Treasury Regulations. A general description of an accounting method can be found in Treasury Reg. §1.446-1(a)(1) and involves the timing of income and deductions for federal income tax purposes. Electing or changing a particular method of accounting for an item of income or a deduction does not permanently affect the taxpayer's lifetime income.

RUTH KALLIO-MIELKE is a Director in Multistate Tax with Deloitte Tax LLP in Milwaukee.

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Accounting methods addressed here can also include overall methods of accounting, such as:

- Cash
- Accrual
- Hybrid

Also included are methods of accounting for material individual items. A material item is any item involving the proper time for the inclusion of income or taking of a deduction.[2]

In order to be considered an acceptable method of accounting for federal income tax purposes, it must possess certain qualities. The accounting method must:

Clearly Reflect Income—In general, a method of accounting consistent with the Code or the Treasury Regulations is presumed to clearly reflect income. Taxable income generally is computed under the same method of accounting that the taxpayer uses for book purposes,[3] but there can be significant differences, however, between net income for book purposes and taxable income.

*The goal of tax accounting is to determine when to recognize items of income and expense (*i.e.*, the timing of income inclusion or expense deduction).*

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Consistency—Taxpayers must use the same method of accounting from year to year. An accounting method clearly reflects income only if all items of gross income and expenses are treated the same from year to year. If a taxpayer does not regularly use an accounting method that clearly reflects income, the income will be refigured under the method that, in the opinion of the Internal Revenue Service (IRS), does clearly reflect income

Multiple Trades or Businesses—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.[4] A "separate and distinct trade or business" is defined as a trade or business with:

- "Complete and separable" books and records
- Separate management

A trade or business will NOT be considered "separate and distinct" if, as a result of the use of different methods, there is a "creation or shifting of profits and losses."

Book/Financial vs. Tax Accounting

Book and tax accounting methods are not necessarily the same, but each impacts the other. Each has different objectives, is subject to different rules, and serves different purposes. Items of income or expense may be recognized in different periods for tax and financial reporting. Income tax liability consists of two pieces for financial statement purposes:

- Current: tax expense/benefit reported in same period
- Deferred: tax expense/benefit is reported in a later period

Adopting a Method

Reg. §1.446-1(e)(1) provides that a taxpayer may adopt any permissible overall method of accounting with their initial tax return. Taxpayer may also adopt a method for an individual item in the first tax return that reflects the item; consent is not required to adopt permissible methods on the initial tax return.

Establishing a Method

Under Rev. Rul. 90-38,[5] a method of accounting is established by a taxpayer using a correct method on a tax return for one year *or* using an incorrect method on two consecutively filed tax returns.

Changing Methods

Generally, once adopted or established, a taxpayer must secure the consent of the IRS Commissioner to change a method by filing a Form 3115.[6] The change is reflected in one of two ways on the tax return:

- Change with IRC § 481(a) adjustment ("catch up" adjustment required to avoid duplications/omissions of income/expense caused by the change); or
- Change with cut-off method (prospective without an adjustment for prior treatment)

Goal of Tax Accounting Methods

The goal of tax accounting is to determine when to recognize items of income and expense (*i.e.*, the timing of income inclusion or expense deduction). When recognition is deemed to occur depends on the relationship between a taxpayer's methods of accounting and their tax year. This relationship creates an allocation of income and expense to specific periods, which is necessary for many practical reasons, not the least of which is the government's need for a predictable flow of revenue.

What is a Change in Accounting Method?

Generally, once adopted or established, a taxpayer must secure the consent of the IRS Commissioner to change a method.[7] If a change is desired, the taxpayer must file Form 3115, requesting a change in method for one of the following:

- Overall accounting method
- Material item method
- Submethod(s)

What is NOT a Change in Accounting Method?

A change in accounting method is not required for:

- A correction of a mathematical error (*e.g.*, an error in calculating foreign tax credit or net operating loss).
- A re-characterization of an item of income or deduction (*e.g.*, salary expense revised to be treated as a dividend distribution).
- A change in underlying facts (*e.g.*, a change in type of vacation pay plan utilized).
- A formation of new entities (IRC §§351 and 721).
- New type of income or deduction not previously experienced by the taxpayer.

Automatic vs. Manual Accounting Method Changes

Certain types of accounting method changes are automatically granted by the IRS, and others require that permission be obtained. The following chart summarizes the primary differences between automatic and manual (those requiring permission) accounting method changes.[8]

Why File an Accounting Method Change?

It is necessary to file for an accounting method change with the IRS to obtain federal audit protection from an IRS challenge to the method, thus providing some certainty regarding how your tax liability will be determined. Protection is available for both automatic and manual accounting method changes. Protection is generally granted with respect to the method being changed as soon as the Form 3115 (described below) is filed with the IRS National Office. The IRS will be precluded from making any adjustments with respect to that method in any prior tax years that are examined, even if the old method was an incorrect method, as long as the taxpayer complies with all of the terms and conditions of the change.

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What is a Form 3115?

Form 3115 is the application to be filed with the IRS. This form gives the IRS information needed to determine if the accounting method requested should be available to the taxpayer.

When should companies file form 3115?

For manual accounting method changes, Form 3115 should be filed before the tax year end. For automatic changes, the Form 3115 can be filed along with the tax return for the year it is to take effect.

If taxpayer is under IRS exam, there are certain limitations on the ability to file an accounting method change. These requirements are beyond the scope of this article and will not be addressed.

	AUTOMATIC	MANUAL
Definition	IRS grants in advance a taxpayer's permission to change	IRS formally considers the taxpayer's request to change
Timing	Attach to timely filed (including extensions) tax return for year of change	File by last day of the year of change
Procedural Guidance	Rev. Proc. 2011-14, 2011-1 C.B. 330 (Jan. 10, 2011)	Rev. Proc. 97-27, 1997-1 C.B. 680 (Jan. 1997)
IRS National Office	Does not issue consent letter	Consent letter is issued
Filing Fee	None	\$5,000 for 1st Application + \$150 for other Applications
Audit Protection	Yes	Yes

Core Federal Accounting Method Changes

The following are some of the most common changes in accounting methods:

- **Tangible Property Regulations**—New regulations include multiple accounting method changes that need to be made with a 2013 federal income tax return. The IRS has released new regulations regarding tax accounting methods for tangible property; the following should be noted in considering accounting method changes relating to these regulations:
  - The regulations are long and complex and affect nearly all business taxpayers by forcing them to file tax accounting method changes
  - There is a two-year window to get in compliance with the regulations
  - Changes are automatic and made by filing a Form 3115
  - Multiple changes can be included on a single Form 3115 filing
  - Provides taxpayers the opportunity to "refresh" capitalization policies to be in compliance with the regulations going forward and take uncertainty out of tax positions

Far too often the compliance teams have little time to look for the rules regarding appropriate attachments while trying to get the returns out the door.

- **Prepaids**—Accelerating deduction of prepaid expenses
- **IBNR**—Accelerating deduction for incurred but not reported (IBNR) self-insured medical expenses
- **Accrued Bonus**—Deducting accrued bonus payments
- **Disputed Sales and Bad Debts**—Deferring income recognition for disputed sales and deducting bad debts

General State Issues Connected with Federal Method Changes

State conformity to a particular federal accounting method may require separate permission by certain states, or if separate permission is not required by the state, separate notification of the change in method may be required. States also do not always recognize IRC §481 adjustments resulting from accounting method changes to income or expense items at the same time as they may be recognized for federal income tax purposes.

State Compliance/Federal Attachments to State Returns

As tax professionals finalize their corporate state income tax returns, they must tackle the fundamental question—**"What attachments should I include with this state return?"** Far too often the compliance teams have little time to look for the rules regarding appropriate attachments while trying to get the returns out the door. Although it would be unusual for a state to change or add to the required attachments late in the filing season, it is possible and users should be on the alert for changes in state rules related to the required attachments to state tax returns. For example, most states will require a copy of the full federal consolidated or *pro-forma* tax return with attachments to be filed along with the relevant state return for the entity(ies). The attachments to the federal return will generally include a copy of a Federal Form 3115 filed for that tax year. Various states, including Hawaii, Iowa, Nebraska, and West Virginia, specifically require taxpayers to submit a copy of the approved Form 3115 filed with the IRS to the first return affected by the change but do not require the full *pro-forma* or consolidated federal return to be attached.[9]

Separate Permission/Notification Required

In certain states, taxpayers are also required to obtain approval before utilizing a new accounting method. For example, the California Franchise Tax Board (FTB) requires that taxpayers have permission to use a new accounting method.[10] Under California law, a safe harbor exists that allows a taxpayer to utilize the new method without prior FTB approval if approval to use the method was timely obtained from the IRS and proof of this approval if forward to the FTB.[11]

Various states, including California, allow a taxpayer to change accounting methods for state purposes only.[12]

The Texas State Comptroller allows a taxpayer to change its method of accounting to compute its margin once every four years without consent of the Comptroller.[13]

Georgia requires taxpayers to apply for a change in method of accounting within 90 days of the start of the tax return year.[14] In addition to IRS approval, Mississippi and New Mexico also require prior permission be granted

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before an accounting method will be accepted by the state in computing state taxable income.[15]

Connecticut requires taxpayers to file a separate copy of the IRS consent to an accounting method change with the Connecticut Commissioner of Revenue within 10 days of receiving the consent.[16]

State Tax Planning Related to Accounting Methods

Certain states allow for different accounting methods used in calculating state taxable income that are separate from methods utilized for federal income tax purposes. Other states may not allow for the federal method to be utilized in calculating state tax income because the method is not allowed under the version of the Code adopted in calculating state taxable income (*e.g.*, California conforms to the Code as amended through January 1, 2009).

California Worldwide Combined Return LIFO Treatment

Global taxpayers who utilize thelast-in/first-out (LIFO) method of accounting for inventory for U.S. financial statement and tax purposes are presented with a potential opportunity to apply the LIFO inventory method to non-U.S. inventory if electing to file their California franchise tax return on a worldwide combined filing group basis. To adopt the LIFO method for non-U.S. inventory on the California return, it is necessary to attach to the California return a federal Form 970 or a statement documenting the ability to file under this method as well as the method utilized to calculate the LIFO adjustment for non-U.S. inventory.

Installment Sales

Not all states recognize the installment method for reporting sales. Some states may require recognition of the entire gain in the year of sale even if proceeds from the sale are received over a period of years. If a state recognizes the installment sale method of accounting, the impact on the sales factor should be reviewed on a state-by-state basis to determine how to calculate the factor to be applied in determining state tax on the gain.

Percentage of Completion vs. Completed Contract Method

In Florida, as with other states that adopt a modified version of the Code vs. federal taxable income as a starting point for determining state taxable income, the opportunity exists to use different methods of accounting for items of income or deduction than is used for federal tax purposes. For example, it is possible to utilize percentage of completion for recognizing income on a long-term contract when the completed contract method is being utilized for federal tax purposes.[17]

Recognition of IRC §481 Adjustments

IRC §481 adjustments are made to federal taxable income to make sure that no items of income or deductions are double counted or lost as the result of a change in accounting method. For federal purposes, if the adjustment is favorable to the taxpayer, it is recognized all in the year of change. If the adjustment is negative, the adjustment can be recognized *pro-rata* over four years beginning with the year of change.

Certain states, like Alabama, do not recognize IRC §481 and therefore do not allow for the spreading of any 481 adjustment.[18]

Kansas, Maine, and Virginia, have special rules on spreading the tax impact of the 481 adjustment over three tax years if recognizing the entire adjustment in one year exceeds a certain amount.[19]

Conclusion

Federal accounting method changes are an important part of federal and state taxable income compliance and planning. Our intent in this article was to provide a high level understanding of accounting method changes and their general impact on federal and state taxation.

ENDNOTES

1 This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

2 *See*, Reg. §1.446-1(e).

3 *See*, IRC §446(a).

4 *See*, IRC §446(d).

5 Rev. Rul. 90-38, 1990-1 CB 57 (April 30, 1990).

6 *See*, IRC §446(e) and Reg. §1.446-1(e).

7 *See*, IRC §446(e) and Reg. §1.446-1(e).

8 *See*, Rev. Proc. 2008-52, 2008-2 CB 340 (Aug. 18, 2008), as modified by Announcement 2008-84, IRB 2008-38, Aug. 29, 2008, and as further modified by Rev. Proc. 2009-39, 2009-2 CB 371 (Aug. 27, 2009) and Announcement 2009-37.

9 *See*, for example, Instructions, 2013 Hawaii Form N-30 "Corporate Income Tax Return," Instruction, 2013 Nebraska Form 1120N "Corporate Income Tax Booklet," 701 Iowa Admin. Code 59.14(422) and W. Va. Code. § 11-24-8(d).

10 Cal. Rev. & Tax. Code § 24651(e).

11 Cal. Rev. & Tax. Code § 23051.5(e) and FTB Notice 2000-8 (Nov. 7, 2000).

12 FTB Notice 2000-8 (Nov. 7, 2000).
13 Tex. Tax Code Ann. § 171.1121(c).
14 Ga. Comp. R. & Regs. R. 560-7-5-.02(3).
15 Code Miss. R. 35.III.1.13 and N.M. Stat. Ann. § 7-1-10(c).
16 Conn. Agencies Regs. § 12-242-9.
17 Fla. Stat. Ann. § 220.42. Special rules apply to the revocation of this election. Fla. Stat. Ann. § 220.42(3).
18 Ala. Admin. Code r. 810-3-13-.04(3).
19 Kan. Stat. Ann. § 79-32, 114(d)(ii); Kan. Admin. Regs. § 92-12-19 and ME. Rev. Stat. Ann., tit. 36, § 5259(2) and Va. Code Ann. § 58.1-440(D).

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