Tax Accounting Methods

INTRODUCTION

In 2024, FustCharles continued our commitment to talent development, innovation, and teamwork to provide our clients with a best-in-class service experience. As we turn the page on 2024, there is plenty of uncertainty in the tax landscape. Many TCJA provisions are set to expire at the end of 2025, however as Republicans hold the White House, and have a slim majority in both chambers of Congress, there is an increased likelihood that 2025 will have some level of tax legislation through the budget reconciliation process.

FustCharles tax professionals grasp the intricate connections between evolving laws, economic dynamics, and the tax implications of various business decisions, and are well-positioned to serve as strategic advisors, steering companies toward success. Tax planning remains a vital aspect for businesses seeking to optimize cash flow by managing their long-term tax obligations.

Our 2024 Year-End Tax Planning Guide delves into effective tax strategies, considering recent administrative guidance and potential legislative changes that are currently under review. For further information and assistance, please reach out to a member of our expert tax team.

Unless explicitly stated otherwise, the information provided in this guide is based on existing tax laws and policies as of the publication date, and it may be subject to adjustments in response to future legislative or tax policy changes.

Corporations and pass-through entities may have opportunities to effectively improve their federal income tax positions and, in turn, enhance their cash tax savings by strategically adopting or changing tax accounting methods. Companies that want to reduce their current year tax liability (or create or increase a current year net operating loss (NOL)) should consider accounting method changes that accelerate deductions and defer income recognition. On the other hand, for various reasons (for example, to utilize an NOL), companies may choose to undertake accounting methods planning to accelerate income recognition and defer deductions. Importantly, when undertaking any future tax planning, companies should also keep in mind current tax proposals as well as changes that could result from the post-election tax agenda of the new presidential administration.

The rules covering the ability to use or change certain accounting methods are often complex, and the procedure for changing a particular method depends on the mechanism for receiving IRS consent — i.e., 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 tax year for which the change is requested.

The following are some of the many important issues and developments for companies to consider when reviewing their tax accounting methods in 2024:

- December 31st deadline for non-automatic method changes
- Modified procedural guidance for Section 174 R&E costs
- Claiming abandonment and casualty losses
- Tax rules for calculating percentage of completion revenue
- Tax accounting for sales of IRA credits
- Year-end opportunities to accelerate common deductions and losses
- IRS insights into treatment of transferable incentives

December 31st Deadline for Non-automatic Method Changes

Although the IRS allows many types of accounting method changes to be made using the automatic change procedures, some common method changes must still be filed under the non-automatic change procedures. A calendar year-end taxpayer that has identified a non-automatic accounting method change that it needs or desires to make effective for the 2024 tax year must file the application on Form 3115 during 2024 (i.e., the year of change).

Notably, Rev. Proc. 2024-23, released on April 30, 2024, removed from the IRS list of permissible automatic method changes any change made to comply with the Section 451 all-events test applicable for accrual method taxpayers. Effective for Forms 3115 filed on or after April 30, 2024, for a year of change ending on or after September 30, 2023, this method change may only be made using the non-automatic change procedures.

Among the other 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), deferred compensation accruals, and long-term contract changes under Section 460. 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. Therefore, taxpayers that wish to file non-automatic accounting method changes effective for 2024 should begin gathering the necessary information and prepare the application as soon as possible.

IRS Releases Modified Procedural Guidance for Section 174 R&E Costs

On August 29, 2024, the IRS issued Rev. Proc. 2024-34, which provides modified procedural guidance permitting taxpayers with short taxable years in 2022 or 2023 to file an automatic accounting method change for a 2023 year for specified research or experimental expenditures (SREs) under Internal Revenue Code Section 174. The revised procedures are effective for Forms 3115 filed on or after August 29, 2024.

Effective for tax years beginning in 2022, the Tax Cuts and Jobs Act requires taxpayers to capitalize SREs in the year the amounts are paid or incurred and amortize the amounts over five or 15 years. Due to this shift in treatment, taxpayers using a different method of accounting for Section 174 costs were required to file a method change to comply with the new rules for their first taxable year beginning after December 31, 2021.

Rev. Proc. 2024-34 Provides Taxpayers Additional Flexibility

Taxpayers may want or need to file successive accounting method changes to comply with new technical guidance issued by the IRS or correct or otherwise deviate from the positions taken with the initial method change. Prior to the issuance of Rev. Proc. 2024-34, taxpayers seeking to file successive automatic changes to comply with the updated Section 174 rules could only do so for changes made for the first and second tax years (including short tax years) beginning after December 31, 2021. Thus, a taxpayer with two short taxable years in 2022 (for example, due to a transaction) that filed an automatic Section 174 method change for one or both of those years previously would not have been able to file another automatic Section 174 method change for its 2023 year. Rev. Proc. 2024-34 provides taxpayers with additional flexibility to file an automatic Section 174 method change for *any* taxable year beginning in 2022 or 2023, regardless of whether the taxpayer has already made a change for the same item for a taxable year beginning in 2022 or 2023. Therefore, taxpayers that have not yet filed a federal income tax return for 2023 or have timely filed their 2023 return and are within the extension period for such return (even if no extension was filed), may be able to file an automatic change for SREs even if an accounting method change has been filed for a year beginning after December 31, 2021.

Rev. Proc. 2024-34 also modifies the existing procedural rules to permit taxpayers that are in the final year of their trade or business to use the automatic procedures to change to the required accounting method for SREs for any tax year beginning in 2022 or 2023. Under the prior guidance, taxpayers could only file an

SRE method change in the final year of their trade or business for their first or second taxable year beginning after December 31, 2021.

Audit Protection May Not Be Available

Importantly, the updated guidance clarifies that if a taxpayer did not change its method of accounting to comply with Section 174 for its first taxable year beginning after December 31, 2021, the taxpayer will not receive audit protection for a change made in any taxable year beginning in 2022 or 2023. With this revision, the IRS is effectively denying audit protection for all taxpayers (regardless of whether they had short periods or full 12-month years in 2022 and 2023) that did not originally file a change to comply with Section 174 with their first taxable year beginning after December 31, 2021, unless they defer filing a method change until a tax year beginning in 2024 or after.

Claiming Abandonment and Casualty Losses

A taxpayer may be able to claim a deduction for certain types of losses it sustains during a taxable year — including losses due to casualties or abandonment, among others — that are not compensated by insurance or otherwise. To be allowable as a deduction under Section 165, a loss must be:

- Evidenced by a closed and completed transaction,
- Fixed by an identifiable event, and
- Actually sustained during the taxable year.

The loss is allowed as a deduction only for the taxable year in which it is sustained. Further, the loss can be claimed on an originally filed tax return or on an amended tax return. It is important for businesses to be aware of any potential loss that has occurred, or may occur, in a taxable year, and to ensure that appropriate documentation and actions are taken within the taxable year to support the loss deduction.

Abandonment Losses

To substantiate an abandonment loss, some act is required to evidence a taxpayer's intent to permanently discard or discontinue the use of an asset in its business. No deduction is allowed if a taxpayer holds and preserves an asset for possible future use or for its potential future value. Suspending operations or merely not using an asset is not sufficient to establish an act of abandonment, nor is a decline in value of an asset sufficient to claim an abandonment loss. To demonstrate abandonment of an asset, a taxpayer must show both written evidence of an intention to irrevocably abandon the asset and an affirmative act of abandonment. Although some guidance exists on when a tangible asset is considered abandoned, showing abandonment of intangibles can be more challenging, and little guidance exists related to current technologies such as software, internet, or website-related intangibles.

Casualty Losses

The IRS defines a casualty broadly to include, for example, earthquakes, fires, floods, government-ordered demolitions, or relocations of property deemed unsafe by reason of disasters, mine cave-ins, shipwrecks, sonic booms, storms (including hurricanes and tornadoes), terrorist attacks, vandalism, and volcanic eruptions. Importantly, casualty losses arise only from identifiable events that are sudden, unexpected, or unusual in nature, such as a natural disaster. A casualty loss does not include slow, progressive deterioration.

For a business taxpayer that needs to determine whether its gains or losses during the taxable year are treated as capital or ordinary under Section 1231, there is a special rule for involuntary conversions, which include casualties. An involuntary conversion, in relevant part, is the loss by fire, storm, shipwreck, or other casualty, or by theft, of property used in the taxpayer's business or any capital asset that is held for more than one year. If losses from involuntarily converted property exceed gains from such property, Section 1231 does not apply to determine the character of the gain or loss. A net loss will be treated as an ordinary loss. If the taxpayer does not have losses from the involuntarily converted property, the general rules under Section 1231 must be followed.

Federally declared disasters. Generally, casualty losses are deducted only in the year in which the casualty event occurs. However, if the casualty loss is attributable to a federally declared disaster, a taxpayer may elect to take the deduction in the prior tax year. Disaster declarations are published on the Federal Emergency Management Agency (FEMA) website. The IRS typically publishes notifications in the Internal Revenue Bulletin shortly after a declaration as well.

Note that for individuals that experience a casualty event between 2018 through 2025, casualty losses are deductible only to the extent they are attributable to a federally declared disaster.

For more information on deducting abandonment, casualty, and theft losses, see Developing an Action Plan for Casualty Gains and Losses .

Tax Rules for Calculating Percentage of Completion Revenue

The percentage of completion method (PCM) for long-term contracts, governed by Section 460 of the Internal Revenue Code, is often misapplied by taxpayers as a method of tax accounting. Taxpayers with qualifying construction or manufacturing contracts frequently follow their book methodologies with minimal, if any, adjustments for tax purposes; however, the rules governing PCM under Section 460 differ significantly from those governing over-time recognition under GAAP. Further, PCM method changes are typically non-automatic; thus, calendar-year taxpayers seeking to change their method for long term contracts must file a Form 3115 by December 31, 2024, to implement the change for their 2024 tax year.

Defining Long-term Contracts – Eligibility for PCM

Qualification as a PCM-eligible long-term contract is determined on a contract-by-contract basis and has two broad requirements: (i) the contract must be for a qualifying activity (either construction or manufacturing), and (ii) the contract must qualify as long-term.

Construction is considered a qualifying activity if one of the following must occur to satisfy the taxpayer's contractual obligations:

- The building, construction, reconstruction, or rehabilitation of real property (i.e., land, buildings, and inherently permanent structures as defined in Treas. Reg. §1.263A-8(c)(3));

- The installation of an integral component to real property (property not produced at the site of the real property but intended to be permanently affixed to the real property); or
- The improvement of real property.

Manufacturing will satisfy the activity requirement if the item being produced (i) normally requires more than 12 calendar months to produce (regardless of the actual time from contract to delivery); or (ii) is "unique." In this context, unique means far more than mere customization. The Section 460 regulations provide several safe harbors to assist taxpayers with determining whether the item being manufactured is unique.

To be considered long-term under the PCM rules, a contract must begin and end in two different taxable years. Therefore, in theory, even a two-day contract from December 31 to January 1 could qualify as a long-term contract.

PCM Calculation

For tax purposes, the taxpayer's inception-to-date contract revenue corresponds to the ratio of inception-to-date contract costs incurred to total estimated contract costs. With respect to expense recognition, Section 460 mandates the accrual method for contract costs, such that deduction generally occurs in the same year the costs are considered in the PCM ratio's numerator. As previously noted, the tax rules governing PCM likely deviate from the book treatment of income/expenses in several aspects. For instance, under Section 460, taxpayers must follow how to determine the types and amounts of costs that are considered in the project completion rule. Further, there are specific rules pertaining to the treatment of pre-contracting costs (e.g., bidding and proposal costs), as well as look-back rules, which require a taxpayer, after the completion of a long-term contract, to perform a hypothetical recalculation of its prior years' income using the actual total contract price and actual total contract costs, rather than the estimated total contract price and estimated total contract costs used for its prior year returns.

Interplay with Section 174

Many taxpayers with long-term contracts may be impacted by the requirement to capitalize Section 174 R&E expenditures. Taxpayers with significant contract-specific R&E expenditures may see some opportunity to defer the recognition of income in line with the deferral of R&E expense based on the IRS's requirements for including R&E costs within the numerator and denominator of the completion percentage formula. Notice 2023-63 has clarified that the numerator of the completion percentage formula contains only the amortization of the capitalized R&E costs, not the gross amount of the year's R&E expenditures. More recent guidance (Rev. Proc. 2024-09, released on December 22, 2023) provides some limited flexibility concerning the inclusion of Section 174 costs in the denominator.

Tax Accounting Considerations for Sales of IRA Tax Credits

Taxpayers either purchasing or selling certain federal income tax credits under the Inflation Reduction Act of 2022 (IRA) should be aware of specific tax accounting rules governing the treatment of amounts paid or received for those credits. These special rules are provided in Section 6418 of the Internal Revenue Code, as well as in final Treasury regulations published in the Federal Register on April 30, 2024.

Taxpayers unaware of the new rules might overlook them and mistakenly apply the more familiar general rules instead, potentially resulting in sellers overstating their taxable income and purchasers claiming impermissible deductions.

The special tax accounting rules apply in preparing federal income tax returns of taxpayers engaging in qualifying transfers of eligible credits in 2023 or later years.

Eligible Credits

The new tax accounting rules apply to qualifying sales of "eligible credits," which Section 6418(f)(1) defines as the following tax credits:

- The portion of the credit for alternative fuel vehicle refueling property allowed under Section 30C that is treated as a credit listed in Section 38(b);
- The renewable electricity production credit determined under Section 45(a);
- The credit for carbon oxide sequestration determined under Section 45Q(a);
- The zero-emission nuclear power production credit determined under Section 45U(a);
- The clean hydrogen production credit determined under Section 45V(a);
- The advanced manufacturing production credit determined under Section 45X(a);
- The clean electricity production credit determined under Section 45Y(a);
- The clean fuel production credit determined under Section 45Z(a);
- The energy credit determined under Section 48;
- The qualifying advanced energy project credit determined under Section 48C; and
- The clean electricity investment credit determined under Section 48E.

Section 6418 allows taxpayers to elect to [transfer eligible credits]() to an unrelated person (but an eligible credit can only be transferred one time). Specific requirements and procedures apply in making such an election.

Special Tax Accounting Requirements

Qualifying transfers of eligible credits are subject to specific tax accounting rules that differ from tax accounting principles generally applicable to the sale or exchange of property. Section 6418(b) provides that with respect to consideration paid for the transfer of an eligible credit, that amount:

- Must be "paid in cash";
- Is not includible in the seller's gross income; and
- Is not deductible by the purchaser of the eligible credit.

In the case of eligible credits determined with respect to any facility or property held directly by a partnership or S corporation, if the partnership or S corporation makes a qualifying election to transfer an eligible credit:

- Any amount received as consideration for the transfer of the credit is treated as tax-exempt income for purposes of Section 705 (dealing with the basis of a partner's interest in a partnership) and Section 1366 (dealing with pass-through of items to S corporation shareholders); and
- A partner's distributive share of the tax-exempt income must be based on the partner's distributive share of the otherwise eligible credit for each taxable year.

Just as the seller would not have realized income had it used the eligible credit to reduce its own federal tax liability rather than selling the credit, the final regulations provide a step-in-the-shoes rule for the eligible credit's purchaser. The purchaser will not realize income upon its use of the credit to reduce its federal tax liability, even if the tax savings exceed the consideration paid to acquire the eligible credit.

For any eligible credit (or portion of an eligible credit) that the taxpayer elects to transfer in accordance with Section 6418, the purchaser takes the credit into account in its first taxable year ending with, or after, the seller's taxable year with respect to which the credit was determined.

Basis Adjustment Rules

Under Section 6418 and the final regulations, if a Section 48 energy credit, Section 48C qualifying advanced energy project credit, or a Section 48E clean electricity investment credit is transferred, the basis reduction rules of Section 50(c) apply to the applicable investment credit property as if the transferred eligible credit was allowed to the seller, rather than to the purchaser. Section 50(c) generally provides that if a credit is determined with respect to any property, the basis of the property is reduced by the amount of the credit (subject to certain recapture rules).

The basis adjustment will affect the computation of the seller's available cost recovery deductions for the investment property with respect to which the transferred credits arose, and so must be considered in preparing the returns of taxpayers engaged in the sale of eligible credits.

Applicability Dates

Section 6418 applies to taxable years beginning after December 31, 2022. Sellers must elect to transfer all or a portion of an eligible credit on the seller's original return for the taxable year for which the credit is determined by the due date of that return (including extensions), but not earlier than February 13, 2023.

The final regulations are applicable for taxable years ending on or after April 30, 2024. Taxpayers may apply the final regulations to taxable years ending prior to that date but must apply them in their entirety if they choose to do so.

Year-end Opportunities to Accelerate Common Deductions and Losses

Heading into year-end tax planning season, companies may be able to take some relatively easy steps to accelerate certain deductions into 2024 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 2024 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 2.5 months after the tax year end* to meet the requirements of Section 404 for deduction in the service year.

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. Under the so-called "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. Note that accrual method taxpayers must first have an incurred liability under Section 461 to accelerate a prepayment under the 12-month rule.

The rule provides 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.

Continued phase-out of bonus depreciation. For eligible property placed in service during 2024, the applicable bonus percentage is 60%. 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 (e.g., as repairs and maintenance costs) rather than being capitalized and recovered through depreciation, assessing eligibility for immediate Section 179 expensing, and reducing the depreciation recovery periods of capital costs where possible.

CCA Provides Insight into Treatment of Transferable Incentives

CCA 202304009 addresses whether a pharmaceutical or biotechnology company must capitalize costs incurred to purchase from a third party a priority review voucher (PRV) issued by the U.S. Food & Drug Administration (FDA). A PRV is a voucher entitling its holder to prioritized FDA review of a new medical treatment the applicant seeks to offer to the public. PRVs are considered valuable assets because their use can significantly reduce the time it would otherwise take to bring a new drug to market. A PRV can be held for use with a future FDA drug application or sold without restriction to another company for their use. PRVs have no expiration date and can be transferred an unlimited number of times.

In CCA 2023040009, the IRS concluded that a taxpayer must capitalize the amount spent to purchase a PRV either as a cost incurred to facilitate obtaining a franchise right or as a cost incurred to acquire a new intangible asset, depending on the intended use of the voucher. The IRS also provided guidance on how the capitalized costs should be recovered.

While CCA 202304009 discusses costs to acquire PRVs, the guidance might help forecast the tax accounting treatment of various other non-tax government incentives as well. For further information and analysis, see IRS Provides Insight Into Treatment of Transferable Incentives.

Proactive tax planning and seamless tax compliance are essential components of financial success. At FustCharles, we are dedicated to providing year-round support, ensuring you stay informed about emerging opportunities, evolving tax laws, and optimal strategies. Our commitment is to guide you towards the most advantageous course of action aligned with your objectives, ultimately contributing to your business's financial well-being.

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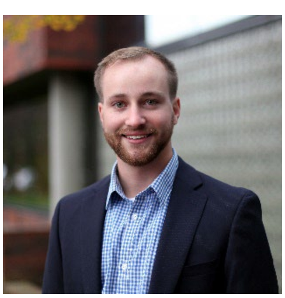

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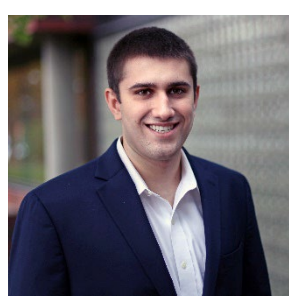

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