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Could a Change in Accounting Method Save Taxes?

With the 2017 tax filing season at a close, taxpayers and their accountants are now shifting their focus to year-end planning. While most year-end planning conversations include a discussion about the timing of major purchases, the Tax Cuts and Jobs Act awards small businesses the opportunity to defer potentially significant taxes and simplify their accounting processes - all without opening their checkbook.

The TCJA changed two key areas that previously required certain small businesses to file their tax returns using the accrual method of accounting and keep a detailed accounting of their inventory. Under the old law, businesses that were required to maintain inventory under Section 471 and corporations failing to meet the $5 million gross receipts test (up to $10 million for certain businesses) were required to report using the accrual method. These broad categories caught many small businesses and accounting for accruals and inventories became a time-consuming process. Under the new rules, the Section 471 inventory requirements and the gross receipts test were essentially bundled together under a new threshold of $25 million in gross receipts.

What does this mean for taxpayers?

Most Businesses with gross receipts under $25 million are now eligible to report using the cash method, and they no longer have to account for their inventory. This change allows taxpayers to treat their inventories as non-incidental materials and supplies and deduct the costs when incurred, rather than carry the inventory on their balance sheet and deduct the cost when the product is sold. Switching to the cash method may also result in a tax benefit by deferring recognition of receivables and payables until the cash is ultimately collected or paid.

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Who should consider a change in accounting method to adopt these rules?

In general, qualifying companies carrying large amounts of inventory on their balance sheet should consider a change under the new rules. The result would be a one-time deduction for the entire cost of the inventory in the year of the change and a deferral of taxes. Also, if your business is like most and has more receivables than payables, changing to the cash method will generally defer more income than the accrual method. These changes also have the added benefit of better matching cash flow with taxable income reporting, making it easier for taxpayers to meet their tax obligations. Taxpayers should consult their tax advisor to discuss whether a change in accounting method could benefit them.

How do I make the change?

In August, the IRS released Rev. Proc. 2018-40, which updated the list of accounting method changes that receive automatic IRS consent. Included on that list were a number of taxpayer-favorable method changes, including the change to the overall cash method and the exception from the requirement to account for inventories under Section 471. This simplifies the process and allows taxpayers to make the change by filing Form 3115, Application for Change in Accounting Method, with their timely filed tax return.

Our team at RJI CPAs is available to help you navigate the evolving tax law and how recent changes may impact your business.

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