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Planning in Advance for the Biden Administration's Proposed Increased Tax Rates

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Companies anticipating the possibility of higher tax rates should consider "reverse" planning—accelerating income and deferring deductions through accounting method changes, elections, and transactional planning.

I. Introduction

The new Biden Administration has made their proposal to increase the corporate tax rate, as well as numerous other domestic and international tax reform proposals, a high profile priority. President Biden's proposed increase in the top corporate rate from 21 percent to 28 percent has garnered much attention. As outlined in Treasury's Green Book, released on May 28, 2021, the administration proposed that their requested corporate rate increase become effective for tax years beginning after December 31, 2021 (note that the Green Book provides that for fiscal year corporations with a tax year that straddles January 1, 2022—i.e., a tax year beginning in 2021 and ending in 2022—the proposal would apply a tax rate equal to (i) 21 percent plus (ii) 7 percent multiplied by the portion of the tax year that occurs in 2022).

Companies should consider planning for the possibility of increased tax rates. An increase in tax rates would present a transition opportunity for "reverse" planning by accelerating income and deferring deductions through accounting method changes, elections, or transactional planning—to yield a permanent economic benefit that may be recognized in the financial statements. This benefit may be enhanced further to the extent that the increase in taxable income in 2020 and/or 2021 may increase foreign tax credit utilization or increase the foreign derived intangible income ("FDII") deduction, the latter of which was proposed to be repealed in the Green Book. *Companies should carefully review the due dates for implementing these opportunities as some will have to be implemented in 2021, prior to the possible effective date of a potential tax increase.*

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This planning may also be relevant for foreign corporations as the Biden tax plan also includes a proposal to raise the rate at which “global intangible low-taxed income” (“GILTI”) is taxed from 10.5 percent to 21 percent. Thus, the opportunities discussed below may provide a 10.5 percent permanent tax benefit to the extent they are implemented before the potential increases become effective. Furthermore, the Green Book proposed an increase in the top marginal income tax rate from its current level of 37 percent to 39.6 percent for tax years beginning after December 31, 2021. If enacted, such an increase in individual marginal rates could make this planning potentially relevant for passthrough entities, such as partnerships, that have individual partners.

This article summarizes the more common accounting method planning opportunities (including for controlled foreign corporations (“CFCs”)), as well as the elections and transactional planning that may be made and undertaken, respectively, in planning for the possibility of increased tax rates.

II. Accounting Method Changes

To change a method of accounting, the IRS requires a taxpayer to file Form 3115, *Application for Change in Accounting Method*, under one of two procedures. The taxpayer must use the automatic consent procedures if the change is one of several hundred method changes described in Revenue Procedure 2019-43. If the change is not described in Revenue Procedure 2019-43 (or in some cases, if a change was filed/made for the same item in the last five years), the taxpayer must file the Form 3115 under the non-automatic procedures with the IRS National Office by the end of the year of change.

Under either procedure, the taxpayer must compute a section 481(a)[1] adjustment, which is the cumulative difference between the present and proposed methods of accounting as of the beginning of the year of change. For a taxpayer favorable adjustment, the deduction must be taken entirely in the year of change. For a taxpayer unfavorable adjustment, the income inclusion must be spread over four years. The spread periods are generally mandatory with a few limited exceptions. For planning purposes, taxpayers should consider filing an unfavorable change in 2020 to include two years of the four year adjustment in income at the lower tax rate, versus filing the change in 2021 and only including one year of the four year adjustment at the lower tax rate.

A taxpayer must generally apply an accounting method consistently from year to year after the Form 3115 has been filed and the method implemented on the return. This generally means that once a method is changed, the taxpayer is required to continue using that method unless an exception applies that would permit a change to be made to a different method before the end of the five-year period. The following is a summary of the more common automatic and non-automatic method changes that may be used to plan for the proposed rate increase.

Most automatic accounting method changes have a scope limitation. While reviewing the tax planning opportunities detailed below, taxpayers must consider all procedural rules as well as all other ancillary planning considerations (i.e., state taxes, estimated tax payments) to determine which, if any, to apply.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

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A. Automatic Changes

1. Expense Deferrals

a. Discontinuation of the Recurring Item Exception

Taxpayers may discontinue using the recurring item exception under the automatic consent procedure (and defer the deduction to the year of payment) for certain types of payment liabilities including real property taxes, personal property taxes, state income taxes, and state franchise taxes.

b. Capitalization of Research Expenditures—Section 174b

Taxpayers that incur research and experimental costs can change methods (on a project by project basis) to treat the costs as capitalized and recovered over a period of not less than 60 months under section 174(b). Taxpayers can also treat section 174 costs as chargeable to a capital account to recover the costs over the associated asset's recovery period.

c. Capitalization of Software Development Costs

Taxpayers that incur costs to develop or customize software applications for specific use in their businesses can change methods to treat the costs as capitalized and recovered in several different ways: Over three or five years under Revenue Procedure 2000-50; under section 174, on a project by project basis to treat the costs as capitalized and recovered over a period of not less than 60 months; under section 174(b), as section 174 costs chargeable to a capital account and recover the costs over the associated asset's recovery period (section 167 as bonus, 36 months, or ratably over 10 years under section 59(e)).

d. Related Party Payments—Section 267

Taxpayers that owe amounts to related parties, including foreign related parties, may, under section 267(a), be required to defer accruing those liabilities to the year the liabilities are paid, instead of when accrued (e.g., interest generally, amounts for services or royalties payable to a foreign related party that is not a CFC, or that are payable to a CFC where the payment does not result in an inclusion for the U.S. shareholder).

2. Income Acceleration

a. Full Inclusion of Advance Payments

Taxpayers are permitted to recognize advance payments as income in the year the payments are received or due, where most taxpayers defer advance payments one tax year.

b. Prepayment for Related Party Arrangements

Taxpayers may consider modifying an arrangement with a related party outside of the taxpayer's consolidated group to agree to a binding and non-refundable prepayment of future income, which may consist of royalties for the use of an intangible, inventory purchases, management fees, and other

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services, etc. Under U.S. tax principles, the payor of a prepayment would not be required to accelerate the timing of the offsetting deduction for the prepayment, and in most cases would be required to take the deduction into account in the same year the deduction would have been allowable absent a prepayment.

c. Long-Term Contracts

Taxpayers may consider evaluating their current accounting method for long-term contracts for an alternative permissible method under section 460 to accelerate the recognition of income.

3. Inventory

a. Section 263A UNICAP Cost Capitalization to Inventory

Taxpayers can increase capitalized costs to inventory by considering all methods of allocating section 263A costs to inventory including the simplified methods (and sub-methods), burden rates, specific identification, or a standard cost method. Taxpayers should also consider the optimal method for the capitalization of mixed service departments, including the discontinuation of using the de minimis rule or changing to use the direct reallocation method.

b. Changing from the LCM or Subnormal Goods Method

Taxpayers’ ending inventory may be valued at cost or at cost or market value, whichever is lower. A taxpayer may change from taking inventory write-downs under either the LCM or subnormal goods rules.

c. Taxpayers Using the LIFO method

Discontinue LIFO - Taxpayers no longer wanting the complexity of maintaining LIFO computations each year may find it advantageous to change from the LIFO method to another permissible method in 2021.

Change within LIFO - Taxpayers currently using the LIFO method and wanting to stay on LIFO should review their calculations to determine whether all sub-LIFO methods are computed correctly including pooling methods, index calculations, LIFO conformity, and others.

4. Fixed Assets

a. UNICAP for Self-Constructed Assets and Software Development

Taxpayers can increase capitalized costs to self-constructed assets and software development by considering UNICAP methodologies to capitalize direct and indirect costs allocable to the asset including purchasing, storage and handling, and mixed service department (“G&A”) costs

b. Revision of Certain Depreciation Elections

Taxpayers have a limited opportunity to revise specified depreciation elections for assets placed in service in 2017-2020. This includes the ability to retroactively make, or revoke, an election out of bonus depreciation.

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c. Interest Capitalization

Taxpayers can change to comply with the avoided cost method to capitalize interest to designated property, including all real property (land, the unsevered natural products of land, buildings, and inherently permanent structures), and the production of some tangible personal property).

d. Capitalization of Materials and Supplies

Taxpayers that may be improperly deducting nonincidental materials and supplies immediately upon purchase may change their method of accounting to expense nonincidental materials and supplies as consumed. Incidental materials and supplies may be deducted in the year of purchase if no record of consumption is kept or no physical inventories at the beginning and end of the year are taken.

B. Non-Automatic Changes

1. Discontinuation of the Recurring Item Exception for Expenses other than State and Local Taxes

Taxpayers may change from a method of applying the recurring item exception for certain types of payments liabilities, such as rebates and insurance, under the non-automatic consent procedures.

2. Deferred Compensation

Taxpayers often follow their financial accounting method for compensation that is deferred in a nonqualified deferred compensation plan, which results in a deduction being claimed before the tax requirements are met. Deferred compensation is generally not deductible until the year in which the amounts are includible in the employees' income (e.g., when distributed from the plan).

III. Elections

A. Elect to Capitalize Employee Compensation, Overhead, and De Minimis Costs

Taxpayers can elect to capitalize employee compensation, overhead, and de minimis costs (i.e., costs not exceeding $5,000 applied on a transaction-by-transaction basis) paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction. Amounts that facilitate the acquisition or creation of an intangible can be capitalized into the basis of the intangible asset and are subject to amortization over the applicable life.

B. Section 59(e) Election

Taxpayers that incur research and experimental costs (including software development costs) and use the current expense method under section 174(a) can make an election under section 59(e) to amortize the expenses ratably over a 10-year period, beginning in the year the expenditure is made.

C. Elect Out of the 12-Month Rule for Prepaid Assets

Taxpayers may choose to capitalize and amortize certain prepaid payment liabilities (such as insurance premiums and warranty and service contracts) rather than currently deduct such costs under the "12-month rule."

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D. Fixed Assets—Depreciation

Taxpayers have the option to elect out of the generally required MACRS method and recovery period, including bonus depreciation for the year that assets are placed in service.

- Taxpayers can elect to depreciate assets placed in service in the current year under the alternative depreciation system
- Taxpayers using the general depreciation system can elect to depreciate certain assets using the 150 percent declining balance method or the straight-line method
- Taxpayers can elect out of bonus depreciation on a recovery class-by-class basis
- Taxpayers can elect to forego recognition of partial dispositions

De minimis Expensing –Taxpayers can use the de minimis safe harbor to follow their book policy of expensing amounts paid for property with an economic useful life of 12 months or less as long as the amount per invoice (or item) does not exceed $5,000.

E. Section 266—Election to Capitalize Interest and Carrying Charges

Taxpayers can elect to capitalize certain taxes, carrying charges, and interest on a loan to purchase personal property or to pay for transporting or installing the same, and to treat them as chargeable to capital account, notwithstanding that they are otherwise expressly deductible.

F. Fixed Assets—Repairs and Maintenance

Book conformity for repairs— Taxpayers may elect to treat amounts paid during the tax year for repair and maintenance expenses to tangible property as amounts paid to improve that property if the taxpayer treats these amounts as capital expenditures on its books and records. The capitalized repairs and maintenance expenses would be recovered over the life of the underlying asset.

IV. Transactional Planning

A. Defer Year-End Bonus Accruals

Taxpayers may defer the deduction for bonus accruals by delaying the payout until more than 2½ months after year-end. Alternatively, a taxpayer may defer the accrual of a bonus payment by changing the terms of its bonus plan such that (1) management has discretion to reduce or eliminate the bonus after the year the service are provided or (2) the employee must be employed on the payment date to receive the bonus. In that case, the terms of the bonus plan should be changed during the year of change rather than after the year the services were provided.

Also, many taxpayers issue bonus resolutions fixing a minimum bonus compensation amount payable to a pool of employees (if the liability is not fixed under the terms of the current bonus plan).

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B. Designate Pension Payments for the Year Paid

Taxpayers interested in increasing taxable income for the preceding tax year can shift pension payment deductions into a subsequent year by designating payments made after year-end for the year paid rather than the year in which services were rendered.

V. Summary

Taxpayers wanting to plan for potentially increased U.S. and GILTI tax rates may want to consider engaging in reverse planning to recognize a permanent tax benefit by accelerating taxable income into a lower tax rate year. Taxpayers should carefully consider the factual and procedural aspects, as well as the impact on estimated tax payments and state taxes, in determining whether to implement these strategies.

Contacts

Please contact a member of your local Accounting Methods and Credit Services team or one of the contacts below for more information on how these planning strategies may affect your company.

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