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# Converting to a Roth IRA? Read This First

*Financial magazines, newspapers, and business news channels are abuzz with stories reporting the new opportunity for high income individuals to convert their traditional individual retirement account ('IRA') into a Roth IRA starting in 2010.*

Up until now, high-income earners were not allowed to convert traditional IRA's into Roth IRA's. However, there is no hard and fast rule that can fit into a sound bite for determining when, or if, a conversion is suitable. Instead an in-depth analysis of an individual's specific facts and circumstances must be done.

Assuming that a conversion has been deemed desirable, there are strategies, based on the ability to have a 'do-over' on a conversion, which can be implemented to minimize the income taxes due. These strategies are particularly useful during volatile markets, such as those we have recently experienced.

## Some Background

Generally, when an individual converts a traditional IRA funded solely with deductible contributions, he or she is required to include in gross income the value of the assets transferred at the date of conversion. In essence, the individual will forego the income tax deferral and pay the tax now on the current account value, so that all future distributions are income tax free.

## Conversion Example

Assume an individual converts a traditional IRA comprised of diverse asset classes and investments with a total value of $1,000,000 to a Roth on January 1, 2010. Further, assume that in October of 2011, the Roth is worth only

$925,000 in total. Despite the 7.5% decline in market value, the individual is required to pay tax based on the much higher conversion date value of $1,000,000. The tax law, however, provides relief for just this situation.

The Internal Revenue Code allows individuals to undo a conversion from a traditional IRA to a Roth by what is known as a recharacterization. Once a Roth conversion has been recharacterized, the individual can then reconvert to a Roth after waiting at least 30 days from the date of recharacterization. Recharacterizations must be completed by the due date of the tax return, including the allowed period of extension, for the year the conversion took place. However, an individual cannot convert, recharacterize, and reconvert in the same calendar year.

In our example, the individual has until October 15, 2011 to elect to recharacterize the Roth conversion done on January 1, 2010. Even if an individual files their tax return for the conversion year by April 15, 2011, the IRS allows an additional six months to recharacterize a Roth conversion. Assuming that the individual elects to recharacterize, he or she will be able to reconvert the traditional IRA back to a Roth after waiting 30 days, at a value much closer to $925,000 (unless of course, the markets rebound dramatically in the 30 days following the recharacterization). Also, it is important to factor into the analysis that income tax rates in 2011 may be higher than in 2010, which could offset some of the benefit of a potential recharacterization.

## Account Segregation Strategy

Let's revisit the previous example to see how using this recharacterization provision can generate additional tax savings for conversions that are implemented using segregated accounts. Instead of converting the entire account as one sum on January 1, 2010, the individual could instead elect to split the IRA into 4 separate accounts and execute four conversions of $250,000 each. This allows the individual to track the performance of the converted Roth IRAs in separate buckets and only recharacterize the poorly performing account (or accounts). Although the combined accounts can be diversified across various uncorrelated asset classes, ideally each individual account should only contain assets that are highly correlated. Isolating the correlated assets in separate accounts, reduces the risk that the gain from an unusually high performing asset class will be offset by a poor performing asset class in the same converted account.

For instance, assume that by October of 2011, one subaccount grew 30% to $325,000, whereas the other three declined in value such that they more than offset this growth (see table below). In total, the individual still has a 7.5% loss and ends up with total portfolio worth $925,000 in October 2011. However, since the conversion was performed using segregated accounts, the individual can elect to recharacterize only the poorly performing Roth IRAs.

| **Account** | | | **Year 1** | **Re-Convert** | | **Year 2** |
|---|---|---|---|---|---|---|
| | 1/1/2010 | Gain/Loss | 10/15/2011 | 11/15/2011 | Gain/Loss | 10/15/2012 |
| 1 | 250,000 | 30.0% | 325,000 | | | |
| 2 | 250,000 | -10.0% | 225,000 | 225,000 | 12.0% | 252,000 |
| 3 | 250,000 | -20.0% | 200,000 | 200,000 | 25.0% | 250,000 |
| 4 | 250,000 | -30.0% | 175,000 | 175,000 | 30.0% | 227,500 |
| | **1,000,000** | **-7.5%** | **925,000** | **600,000** | **21.6%** | **729,500** |
| | | **(75,000)** | | | **129,500** | |

*Converted $250,000 in year 1 and $600,000 in year 2. Over two years, paid tax on the conversion of $850,000 in traditional IRA funds.*

The account that grew 30% to $325,000 can remain a Roth, and the individual can lock in the conversion date value of $250,000 for income tax purposes. The individual will elect to recharacterize the three poorly performing IRA's

that dropped in value and attempt a re-conversion 30 days later. The individual can repeat this process of recharacterizing the 'losers' and converting the 'winners' in subsequent tax years until the entire traditional IRA has been converted to a Roth. In the hypothetical example above, the three IRA's re-converted in November 2011 bounced back in 2012, in which case the individual would not recharacterize any of the accounts.

## Summary

As this example illustrates, segregating traditional IRA accounts and taking advantage of the opportunity to 're-do' the conversion can result in significant tax savings on a Roth conversion. Even though the original conversion value was $1,000,000, the individual only had to pick up $850,000 in income. WTAS is prepared to assist you in determining whether a Roth conversion is appropriate based on your individual situation and goals, as well as help develop strategies for minimizing income taxes should you decide to convert.

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# New Law - NOL Carrybacks

*Legislation enacted on November 6, 2009 (H.R. 3548, the Worker, Homeownership, and Business Assistance Act of 2009 (the "Act") significantly enhances the net operating loss ("NOL") carryback provisions to include an elective, longer carryback period for nearly all individual and corporate taxpayers.*

The American Recovery and Reinvestment Act (the so-called Stimulus Bill) enacted earlier this year had also included a temporary measure to allow certain small businesses (i.e., those with average gross receipts of less than $15 million), to elect a longer carryback period, but denied relief to many individuals and to larger corporate taxpayers. As explained later, the Act creates significant opportunities for many more taxpayers to obtain immediate cash refunds from NOLs generated in taxable years beginning after December 31, 2007 and before January 1, 2010 (i.e., NOLs generated in 2008 or 2009 for calendar year taxpayers). IRS issued Revenue Procedure 2009-52 on November 20, 2009 providing detailed guidance on how to elect a longer carryback period.

## Key NOL Provisions of the Act

The key provisions of the Act concerning net operating losses may be summarized as follows:

1. Taxpayers may elect (the "Election") to increase the general two-year NOL carryback period for losses generated in taxable years beginning after December 31, 2007, and before January 1, 2010 to a three-, four-, or five-year carryback period. Except as noted later in Item 3, only one Election may be made (i.e., a calendar-year taxpayer generating an NOL in 2008 and 2009 may elect a longer carry back period for either 2008, or for 2009). If a five-year carryback period is elected, only 50 percent of the

taxable income in that fifth prior year may be offset by the loss carried back from 2008 or 2009. Any remaining NOL is available for carryover to subsequent years. Thus, for example, if a calendar year taxpayer incurred a $1,000,000 NOL in 2008, an Election can be made to carryback that NOL to 2003. If taxable income in 2003 was $500,000, only $250,000 of the 2008 NOL could be used to offset 2003 income. The balance of the NOL from 2008 ($750,000) remains as a carryover to 2004 and later years. Note: This limitation does not apply to a small-business taxpayer that elected (or elects) the five-year carryback period for a 2008 NOL under the provisions of the Stimulus Bill.

2. As explained in detail in Revenue Procedure 2009-52, the Election must be made by the date, including extensions, of the taxpayer's return for its year beginning in 2009, and can file a refund in the form of a tentative carryback adjustment or a claim for refund. Thus, taxpayers need not decide before all information is available how best to maximize the benefit of this new provision. A taxpayer who has already filed its return showing an NOL for its year beginning in 2008 can elect a longer carryback period via an amended return even if it has already filed a carryback claim for the 2008 NOL. In addition, a taxpayer who elected to forego the carryback period for a 2008 loss, for example, because that was more advantageous than a two-year carryback, may revoke that election anytime before the due date, including extensions, of the taxpayer's return for its year beginning in 2009.
3. A small-business taxpayer that elected a longer NOL carryback period under the provisions of the Stimulus Bill for a 2008 NOL, may also make the Election under the Act for a 2009 NOL, and is not limited to electing a longer carryback period in only one year. It would, however, be subject to the 50-percent limitation noted earlier on offsetting income in the fifth taxable year preceding the 2009 loss year.
4. Taxpayers that have previously undergone a so-called corporate equity reduction transaction ("CERT"), incurred a significant additional level of indebtedness (e.g., in a leveraged buyout transaction) and have a significant interest expense component as part of an NOL, are subject to special rules and limitations under the normal NOL carryback rules for a defined CERT application period. A special rule extends the application period for CERT interest deductions for taxpayers making the Election. Interest deductions attributed to the CERT cannot be carried back as part of the NOL to a tax year preceding the year of the CERT.
5. Taxpayers making an Election are not eligible to use the special three-year carryback period for the portion of the NOL due to certain casualty and thefts, losses for certain taxpayers in federal disaster areas, and certain farming losses.
6. The 90-percent limitation on use of any alternative minimum tax ("AMT") NOL is suspended for any NOL to which the Election applies.
7. A modified version of the Election applies to life insurance companies. Additionally, taxpayers who received so-called TARP funds under the Emergency Economic Stabilization Act of 2008 are not eligible to make the Election.

## Opportunities Under the Act

The election to extend the loss carryback period for up to five years for a 2008 or 2009 NOL creates opportunities to reach incremental taxable income in prior profitable taxable years and thus generate significant cash refunds. Taxpayers with a complex tax attribute profile (e.g., taxpayers with significant business tax credits, foreign tax credits, or AMT credits) may need to undertake multi-year analyses to determine (a) whether the Election for a 2008 or 2009 NOL year should be made (if there is an NOL in both years), and/or (b) whether the Election should be of a three-, four-, or five-year carryback period. In addition, taxpayers generating NOLs during the 2008 or 2009

years whose component parts are treated under one of the other special NOL categories (e.g., taxpayers with so-called specified liability losses), will also need to undertake a multi-level analysis to optimize their tax refunds in combination with the Election.

Taxpayers filing consolidated income tax returns that have been involved in merger and acquisition activity in prior years may need to review applicable purchase and sale agreements ("Agreement") to determine the contractual implications (i.e., which party is entitled to the refund attributable to an NOL carryback) of making the Election. For example, if a subsidiary in the consolidated group was acquired from another consolidated group during the five-year period before generating an NOL in 2008 or 2009, the subsidiary's share of any consolidated NOL may have to be carried to the prior group's consolidated income tax return, with any related refund being potentially for the account of the prior consolidated group, depending on the terms of the Agreement. Revenue Procedure 2009-52 indicates that pending further guidance, a consolidated group cannot make or revoke a so-called "split" waiver of the NOL carryback period under the consolidated return regulations for a subsidiary acquired by the group.

The Election should be available to individual taxpayers that generate an NOL in 2008 or 2009, calculated with the existing required statutory adjustments applicable to individual taxpayers. Moreover, the Election should also be available to foreign corporations with income effectively connected to a trade or business within the United States that file Form 1120 F and generate an NOL in 2008 or 2009.

## Tax Planning Under the Act

Before making an irrevocable Election to carry back an NOL to 2003, or later, taxpayers should consider the entire impact of such an election. Failure to analyze all the implications of the Election could result in unexpected and unpleasant surprises. For instance, multinational companies that elect to take advantage of the extended NOL carryback provision must consider the effect this could have on their foreign tax credits (FTCs) taking into account the changes made to the credit carryback/carryover rules starting in 2005. Companies also need to determine the impact on financial statements, financial statement disclosures and potential adjustments to valuation allowances.

Taxpayers should consider taking traditional tax planning steps to maximize an NOL eligible for the Election. For example, planning to accelerate deductions/defer income, accounting method elections or changes, bonus depreciation, other beneficial elections (e.g. the Stimulus Bill election to defer certain cancellation of indebtedness income), should be considered to maximize opportunities to benefit from the Election. Additionally, taxpayers should be alert to, and clearly analyze whether and to what extent, the various states adopt the provisions of the Act for income tax purposes (e.g., New York is reportedly following the Election; California is not).

It is important to note that Congress, having previously identified tax-planning signals developing in the marketplace in or around the passage of the Stimulus Bill, has specifically given "anti-abuse" authority to the Treasury to prescribe regulations that will serve to chill tax planning under the Election that is perceived as overly-aggressive. This authority specifically includes identifying "anti-stuffing" rules and "anti-churning" rules. In particular, the "anti-churning" rules are targeted toward certain sale-leaseback transactions, where, for example, an asset with a built-in economic loss (thus, potentially increasing an applicable NOL) is sold to a third party, and leased back to the taxpayer. Presumably, some guidance in this area is forthcoming from Treasury.

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# Multi-State Unemployment Tax Compliance: Are You Paying Too Much?

*For many employers the determination of state unemployment insurance tax ("SUI") liability is straightforward.*

The employer multiplies the SUI rate provided from the state by the employee's wages up to the state's wage base. The employer generally remits the SUI to the state where the employee performs services. However, complexities arise when an employee performs services in more than one of the 53 jurisdictions (all 50 states plus the District of Columbia, Puerto Rico and the Virgin Islands) with SUI provisions. Many multi-state employers pay SUI in every state where an employee performs services. This may result in an overpayment of an employer's total SUI expense. Quite often these overpayments create refund opportunities for an employer.

Although states have considerable freedom in drafting and administering SUI laws, the federal government must approve such laws before employers can receive credit (up to 5.4 percent) against the tax imposed under the Federal Unemployment Tax Act ("FUTA") for contributions made under state law. Fortunately for employers, the U.S. Department of Labor ("DOL") has promulgated rules and regulations that provide guidelines for determining the jurisdictions to which multi-state employers must remit SUI. The DOL, through the Employment and Training Administration division, has created a uniform definition of employment in terms of localization of work. This definition consists of four factors applied in successive order to a multi-state employee's fact pattern to determine the single jurisdiction to which an employer must remit SUI. These factors are summarized from the DOL's *Manual of State Employment Security Legislation*.

## Services Localized

The first factor looks to see if the services are "localized" within a state. Services are considered localized within a state if the service is performed entirely within such state. If the service is performed both inside and outside the state, but the service performed outside of the state is incidental to the individual's service within the state, then the service is treated as localized within such state. If it is determined that the employee's services are localized within a state, the SUI for that employee is reported to that state and the additional factors need not be considered. If the employee's services are not considered localized then the employer should look to one of the following three factors.

## Base of Operations

If the service is not localized in any state but the base of operations and some of the service is performed within the state then the employee's entire service should be reported to this state. A base of operation can be the place where an employee reports to work has an office, receives instructions, mail and supplies, or keeps business records. If the employee's services are not localized and the employee doesn't have a base of operations the employer should look to one of the following two factors.

## Direction and Control

If the employee's work is not localized and there is no base of operations, but there is direction or control in one of the states where the employee performs services then the entire service should be reported to this state. A place of direction or control refers to a facility from which the employer can exercise immediate control over the employee's services. If there is no place of direction or control, localized services, or base of operations, then the employer should look to the following factor.

## Residence

In rare instances where none of the three previous factors can be applied, the state of the employee's residence will have jurisdiction.

When an employer misapplies the four factors, the result may be an overpayment of state unemployment tax. For example, assume an employee performs services in four states within a single calendar year and the employee earns approximately $15,000 in each state. If an employer pays SUI in each state in which the employee performs services, the employer could pay four times the required SUI liability.

Many states have provisional arrangements contained in their statutes allowing employers who have multistate employees performing services in multiple states to pay unemployment taxes to one state where the employees have met one of the four factors. Generally, these arrangements cover services that are typically performed by employees who contract by the job and whose various jobs are located in different states. For example, a construction worker who works for an Illinois firm on a six-month assignment in Minnesota and then goes to Indiana for a six-month assignment, might be covered under Minnesota and Indiana laws for the services performed in each state. Under the provisional arrangement, the Illinois employer could elect to have all the services performed by the construction worker covered under the Illinois unemployment act. Therefore, the employees who meet one of the four factors in any one state may not be required to pay SUI in multiple states. Employers who have multistate employees and meet one of the four factors for more than one state may be entitled to a refund from states in which the employees have worked and SUI was paid.

During an employee's term of employment the factor used to determine the state in which unemployment tax is due may change (e.g., when an employee is permanently transferred to another state). If the factor is such that the employee is now subject to unemployment tax of another state, the employer may have the option to take advantage

of the taxes already paid in a previous state. This will result in SUI savings because the additional SUI paid will only be to the extent of the current state's unemployment wage base. It is typical for a company that transfers employees to work on projects in different states within the same calendar year to restart the state unemployment taxable wage base when the employee is transferred to the new state. However, the employer may be able to take credit for taxes paid under another state unemployment compensation law.

For example, an employer has 1,000 employees that provide services in Illinois where the employer's Illinois Unemployment Insurance Rate is 3.1 percent and the SUI wage base is $9,000. On July 1st of the current calendar year the employer transfers all 1,000 employees to Minnesota where the employer's Minnesota unemployment insurance rate is 5.4 percent and the SUI wage base is $22,000. The employer computes and pays the Minnesota unemployment tax for each employee on $22,000 of wages. Under these facts, the company overpays tax as follows:

| | |
|---|---|
| Minnesota Unemployment Insurance Tax Paid (1,000 X 22,000) X .054 | $1,188,000 |
| Correct Minnesota Unemployment Insurance Tax | 702,000 |
| Amount of Over Payment | **$486,000** |

As a best practice, employers should review their SUI filings at least annually. Situations such as employees working in multiple jurisdictions and changes in employment related to acquisitions, expansions, or relocations can be managed for tax savings.

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# A Season to Harvest

*As we enter the holiday season, we are reminded that the first Thanksgiving was a celebration of new opportunities, new freedoms, and a bountiful harvest.*

For wise investors, thoughts of the "harvest" may quickly lead to a conversation with their advisors regarding potential tax-loss harvesting and other year-end planning techniques. The advisor will then most likely scan through their taxable accounts looking for holdings that have decreased in value since their purchase date. Disposing of these positions can generate capital losses to offset against any capital gains they may have been lucky enough to generate over the year. For the last few years, finding loss positions to harvest has not been a very difficult task, and many investors are likely to have generated excess capital losses, of which $3,000 can be used to offset ordinary income in the current year with the rest being carried forward to offset future year gains. While most perceive this simple strategy as a relatively routine year-end tax saving task, we encourage our clients to give this annual process strong consideration and work with their tax and investment advisors to more appropriately weigh any investment implications of the loss harvesting as well as the potential tax benefits of any year-end planning. The items addressed below present a brief snapshot of issues that frequently arise during the year-end investment planning process, but should be addressed with your advisors throughout the year.

## Be Aware of Wash Sale Rules

Before implementing any loss harvesting, investors should be careful to avoid the tax trap known as the "wash sale" rules. In short, this set of rules prohibits claiming a loss on the sale of a capital asset if the same or a substantially similar asset is purchased within 30 days (before or after) of the transaction. Any loss disallowed under these rules increases the basis of the newly acquired asset, effectively putting the taxpayer back in the same tax position as before the sale. For investors with multiple accounts and multiple managers, these rules can quickly erode any

expected current-year tax benefit of the loss harvesting in the absence of diligent planning.

One alternative for investors looking to effectively harvest some tax losses while maintaining their investment strategy is to "double-up" on the investment position they anticipate selling for a loss by acquiring an equal number of shares or units outside of the wash sale window (31 or more days prior to the planned sale). Clearly, this requires advance planning and carries some risk that the price of the security could continue to deteriorate, compounding the loss position to the investor. On the other hand, if the price of the stock or fund remains level or appreciates, the loss positions can be sold and the loss taken without concern of the wash sale rule limitation. This strategy is frequently engaged in by investors with a great deal of conviction or emotional attachment to a particular position who do not want to reduce their position in the underlying investment.

In contrast, investors who are not as particular about the specific security can plan around the wash sale rules by identifying and acquiring a position considered to be closely correlated with, but not "substantially identical" to, the position that was (or will be) sold. This option also allows the investor to capture more of any favorable price movement of the asset that was (or will be) sold. However, like the strategy described above, this approach is not without risk. Specifically, due to the IRS' ambiguity and inconsistency on the definition of "substantially identical", consulting both competent tax and investment professionals on this matter is highly recommended.

## Mutual Fund Distributions

Whenever rebalancing a portfolio includes plans to purchase a mutual fund, it is important to consider the timing of the purchase. Each year at year end, a mutual fund is required to distribute to its shareholders all net capital gains created by the sale of securities within the fund. This may result in a higher tax liability for the mutual fund owner who is required to pay tax on this capital gain distribution even if the proceeds are reinvested in the mutual fund. If purchasing a mutual fund in the fourth quarter in a taxable account, investors should consider postponing the purchase until after the distribution is made to avoid incurring tax on the distribution.

## Tax Rate Considerations

Minimizing overall tax liability is the purpose of tax loss harvesting, but another consideration especially important right now is what is likely to occur to tax rates in the coming years. The Obama Administration has recommended that the current top 33 and 35 percent tax brackets be increased to 36 and 39 percent respectively. Long-term capital gains rates are also expected to increase from the current 15 percent to 20 percent, which is still a historically conservative level for long-term capital gains rates. Accordingly, it is even more important for investors to consider changes in tax rates as part of the year-end investment planning. Rather than harvesting the loss this year, it may be more prudent to wait if the loss position can be used against gains that may be taxed at higher rates.

## Gifting (Charitable or Otherwise)

Finally, for investors considering a disposition of a concentrated position in low basis stock, gifting or donating portions of those positions is another effective way to hedge against potentially escalating future capital gains rates. Consultation with a tax advisor regarding the income tax and gift tax implications of gifting or donating significant assets is crucial and should be done prior to making the gift. However, if diversification is the principal objective of the disposition, donating low basis stock in appropriate taxable years can help to both lower your taxable income as well as reduce the unsystemic risk associated with the concentrated holding.

As 2009 comes to a close, year-end investment and tax planning may prove to be anything but straightforward due to the erratic behavior the capital markets have exhibited during the last 24 months and the forthcoming political landscape. The extreme downturn in the stock market from late 2007 through early 2009 and the acute rebound to

date combine with the uncertainty of future tax rates to provide a more challenging decision for investors who are just now planning year-end investment analyses and considering rebalancing their investment portfolios. However, as we have certainly noted before, the recent volatility creates an ideal time for investors to re-evaluate their investment strategies and examine what role tax strategy will have on their plans.

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# Exploring Accounting Method Changes

*On November 6, 2009, Congress enacted the Worker, Homeownership, and Business Act of 2009 ("the Act") that allows all businesses a five-year period for carrying back net operating losses.*

In 2008 and 2009, IRS issued two revenue procedures (Rev. Proc. 2008-52 and Rev. Proc. 2009-39) that add to an already lengthy list of automatic tax accounting method changes. What do these two disparate developments have to do with one another? In short, a great deal. Because many of the automatic tax accounting method changes would typically increase tax deductions, they may provide opportunities to create or increase a net operating loss in 2009 that may now be carried back up to five years to create a cash refund opportunity.

The Act provides taxpayers an election to carryback an applicable net operating loss for either (but not both) 2008 or 2009 for a period of three, four, or five years. The Act expands legislation enacted earlier in 2009 in the American Recovery and Reinvestment Tax Act that permits an eligible small business to carryback a 2008 applicable net operating loss for a period of three, four, or five years. The Act also eliminates the 90 percent limitation that applies for alternative minimum tax purposes to the use of a net operating loss for which the Election was made. Consequently, a net operating loss sustained in 2008 or 2009 is potentially more valuable than a loss sustained in other years.

Careful analysis is necessary to determine whether a five-year carryback of a 2008 or 2009 loss provides the greatest refund opportunity. Taxpayers who might create or increase a 2009 net operating loss through automatic accounting method changes made in 2009 should consider the impact of those potential accounting method changes when deciding whether to carryback a 2008 or 2009 loss. Revenue Procedure 2009-39 is particularly relevant to this analysis because it permits taxpayers to deduct repair and maintenance costs that were previously

capitalized as well as abandoned property—two method changes that may produce substantial tax deductions for capital intensive enterprises.

In addition to increasing a net operating loss, automatic accounting method changes may also reduce current-year estimated tax payments, affect the tax provision and disclosures in financial statements, and provide back-year audit protection against potential penalties and interest for erroneous tax positions. These other aspects must be weighed in determining whether to change a tax accounting method.

An automatic accounting method change may be taken into account for purposes of determining estimated tax payments as soon as the intent is formed to file the application to change method (Form 3115). The application does not actually have to be filed for the benefit to be taken into account. For purposes of determining estimated tax payments, a taxpayer generally treats the "catch-up adjustment" (Sec. 481(a) adjustment) as an extraordinary item arising on the first day of the tax year in which the item is taken into account in determining taxable income. Alternatively, the taxpayer may choose to treat a Sec. 481(a) adjustment as an extraordinary item arising on the date the application to change a method is filed with the IRS National Office. As a consequence, there is no need to wait to benefit from a favorable method change for tax purposes if the company has decided it will definitely file Form 3115.

Realization of the impact of an accounting method change for financial statement purposes varies depending on whether the method change is automatic and whether the present method is proper. A company may be permitted to realize the financial statement impact of an automatic accounting method change from a permissible method to another permissible method at the time the decision is made to file the application, assuming the taxpayer is qualified to make the change. If the present method is an improper method, the financial statement impact is usually taken into account after the automatic accounting method change is filed. If substantial favorable method changes are being filed, careful consideration should be given to the financial reporting impact on tax contingencies and disclosures.

A taxpayer is eligible for back-year audit protection with respect to an erroneous method once the Form 3115 is properly filed with the IRS National Office. The IRS National Office copy of the automatic method-change application can be files as late as the due date of the tax return for the year of change; however, there is no need to delay this filing until the return is filed – the application may be filed anytime during the year of change. Often these applications are filed as soon as possible to ensure that the taxpayer is not contacted by IRS to schedule an examination before the Form 3115 is filed.

A few of the often overlooked favorable accounting method changes that are now automatic include those for: rental income or expense; overhead capitalized under Sec. 263A to inventory or construction; repair and maintenance costs; abandonments; materials and supplies; trade discounts; vendor allowances; the tax treatment of workers' compensation; prepaids, and other intangibles, including capitalized marketing expenses. Almost every taxpayer can reduce taxable income or increase a tax loss through appropriate tax accounting method planning focused solely on method changes that are automatic and that can still be made for the 2009 tax year.

In light of the enhanced carryback provision, taxpayers should take a close look at the availability of opportunities to change accounting methods.