Tax readiness: Accounting methods — tax planning after tax reform

August 8, 2019

In brief

The 2017 tax reform (the Act) enacted or amended a number of provisions relating to accounting methods, most notably for revenue recognition and bonus depreciation. Accounting methods can be an important tool in strategies for reducing exposure from tax reform provisions that are not specifically accounting methods, such as the base erosion and anti-abuse tax (BEAT) and the Section 163(j) business interest deduction limitation. PwC on August 6 hosted a webcast featuring specialists who discussed these issues. This Insight highlights those discussions.

The next Tax Readiness webcast — California: Key Developments in the Golden State — is scheduled for August 14, 2019, from 2:00 PM - 3:00 PM (EDT).

In detail

Revenue recognition

Section 451(b) amendment
A taxpayer using an accrual method of accounting includes an item in income under the all-events test. Before tax reform, a taxpayer accrued income when an item was due, earned, or paid, whichever occurred earliest. Rev. Proc. 2004-34 and Reg. sec. 1.451-5 allowed limited deferral of advance payments.

The Act added new Section 451(b), requiring accrual of income no later than the earliest of when an item is due, earned, paid, or recognized in a taxpayer’s applicable financial statement (AFS). Certain special methods of accounting, such as for installment sales and long-term contracts, are excepted. Section 451(b) is effective for tax years beginning after 2017.

Observation: This limitation to the all-events test has a significant effect on unbilled receivables (e.g., licenses, interrelated services) tax planning.

The IRS and Treasury have not yet published regulations under Section 451. Although there are open issues and a lack of regulatory guidance, accrual-method taxpayers with an AFS likely will need to change their method of accounting to the modified all-events test. Rev. Proc. 2018-60 allows taxpayers to make the change using the automatic procedures under Rev. Proc. 2015-13. The 2018 revenue procedure generally provides audit protection for past years, but the IRS may review whether the new method is proper.

Section 451(c) amendment
New Section 451(c), added by the Act, allows limited deferral for certain advance payments beyond the tax year received, effective for tax years beginning after 2017. A taxpayer recognizes income under Section 451(c) in the year of receipt to the extent revenue is recognized in the taxpayer’s
AFS. Any remaining income is recognized in the next tax year.

Congressional intent in enacting Section 451(c) was to codify Rev. Proc. 2004-34, but some disparity between Section 451(c) and Rev. Proc. 2004-34 exists. However, Notice 2018-35 allows taxpayers to continue to rely on Rev. Proc. 2004-34 until regulations under Section 451(c) are published. Reg. sec. 1.451-5, providing a two-year deferral, has been removed.

Taxpayers may change their method of accounting to obtain the one-year deferral benefit using the automatic procedures under Rev. Proc. 2015-13.

ASC 606
ASC 606 is a new mandatory financial accounting standard, based on expected consideration, for recognizing revenue from contracts with customers to provide goods, services, or nonfinancial assets. It is effective for years beginning after December 15, 2017 (an additional year is provided for nonpublic entities).

The adoption of ASC 606 may result in acceleration of revenue, a change in deferral of advance payments, or a change in allocating transaction price among performance obligations.

Rev. Proc. 2018-29 provides automatic consent for taxpayers to change their tax accounting methods to conform to ASC 606. However, the revenue procedure allows only partial conformity and generally excludes method changes for advance payments (changes for advance payments may be made automatically under Rev. Proc. 2018-31).

Because new Section 451(b) requires revenue to be recognized for tax purposes no later than when it is recognized in the AFS, taxpayers may be required to accelerate recognition of income compared to under pre-tax reform law. Further, adoption of ASC 606 may accelerate the recognition of revenue for financial statement purposes. However, new Section 451(c) allows deferral of certain advance payments for up to one year, potentially alleviating some of the burden taxpayers may face.

Observation: Taxpayers should assess the impact of book changes on current tax methods and determine if one or more method changes, such as for unbilled receivables or advance payments, are necessary.

Observation: When participants in the August 6 webinar were asked whether their company made, or plans to make, changes in their tax methods of accounting as a result of the recent changes in rules for revenue recognition, 56% said no; 18% said yes, changes related to ASC 606 but not Section 451(b); 7% said yes, changes related to Section 451(c) but not ASC 606; and 20% said yes, changes related to both ASC 606 and Section 451(b).

Accounting methods and tax reform planning

Bonus depreciation: Qualified Improvement property
The Act renewed 100% bonus depreciation for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for certain property). Due to what has been acknowledged as a drafting error, qualified improvement property (QIP) placed in service on or after January 1, 2018, is not qualified property. QIP is eligible for 100% bonus depreciation if acquired after September 27, 2017, and placed in service in a tax year beginning before January 1, 2018. The IRS and Treasury have taken the position that a technical correction is required for QIP placed in service after December 31, 2017 to qualify for 100% bonus depreciation.

Bonus depreciation: Self-constructed property
Before tax reform, a taxpayer was treated as acquiring property constructed for its own use when construction began, whether the taxpayer constructed it or another party constructed it under a written binding contract.

Following tax reform, self-constructed property is treated as being acquired when construction begins for property a taxpayer constructs itself. When another party constructs the property for the taxpayer, the property is treated as being acquired when a written binding contract is entered into for the property. Accordingly, self-constructed property is not treated as being acquired after September 27, 2017, and hence is not eligible for 100% bonus depreciation, if the taxpayer entered into a written binding contract before September 28, 2017, even if construction begins after September 27, 2017. Property is not treated as being acquired before September 28, 2017, however, if the contract was not binding before that date.

Observation: Taxpayers may want to analyze whether a construction contract was binding before September 28, 2017.

A component of self-constructed property has a separate acquisition date than the larger property. A component acquired before September 27, 2018, is not eligible for 100% bonus depreciation if the larger property was acquired after September 27, 2017, but the larger property, except the component, is eligible for 100% bonus depreciation. If the larger property was acquired...
before September 28, 2017, and the component was acquired after September 27, 2017, neither is eligible for 100% bonus depreciation. Relief under Rev. Proc. 2011-26 that applied to components acquired after the relevant date under earlier bonus depreciation provisions is not available for post-tax reform bonus depreciation.

**Bonus depreciation: Used property**

Property is qualified property eligible for bonus depreciation only if its original use begins with the taxpayer or the taxpayer acquires previously used property under certain conditions:

- The taxpayer or a predecessor did not use the property at any time before the acquisition (what constitutes a predecessor is not clear).
- The taxpayer did not acquire the property from a related person under Section 267 or 707(b); special rules apply to the timing of testing the relation between parties.
- The taxpayer did not acquire the property from a member of the same controlled group; special rules test membership in a controlled group.
- The taxpayer’s basis is not determined by reference to the adjusted basis of the property in the hands of the transferor or as property acquired from a decedent.
- The cost of the property does not include any basis determined by reference to the basis of other property the taxpayer held at any time.

**Bonus depreciation: Elections**

The Act retained an annual election out of bonus depreciation on a class-by-class basis, which applies to all property in a class placed in service during that tax year. The Act provides a new election to claim 50% instead of 100% bonus depreciation for qualified property acquired after September 27, 2017, and placed in service during the tax year that includes September 28, 2017. This election applies to all qualified property placed in service during that tax year.

These elections must be made by the due date, including extensions, of a taxpayer’s federal income tax return for the tax year that the property is placed in service. Rev. Proc. 2019-33 allows a taxpayer to make either election late for qualified property acquired after September 27, 2017, and placed in service in the taxpayer’s 2016 or 2017 tax year by filing either (1) an amended federal income tax return before filing the tax return for the next tax year, or (2) Form 3115, Application for Change in Accounting Method, for the first, second, or third tax year after the taxpayer’s 2016 or 2017 tax year (as defined in Rev Proc 2019-33). Taxpayers may obtain consent to revoke a previously made election by filing an amended return or Form 3115 within the same time frame.

These elections are made as described in the instructions to Form 4562, Depreciation and Amortization.

**BEAT planning**

The Act added the BEAT as new Section 59A. The BEAT is a 10% minimum tax (5% for a tax year beginning in 2018), computed as the excess of the applicable rate multiplied by modified taxable income (MTI) over regular tax. MTI is taxable income increased by base erosion tax benefits with respect to any base erosion payment and the base erosion percentage of any net operating loss deduction allowed under Section 172 for the tax year.

A base erosion payment, in general, is an amount paid or accrued to a foreign related party in tax years after December 31, 2017, that is allowable as a deduction.

The BEAT generally is imposed on certain corporations with a base erosion percentage of 3% or more and average annual gross receipts for the three-tax-year period ending with the preceding tax year of at least $500 million.

Amounts included in cost of goods sold (COGS) are reductions to gross income rather than deductions, and accordingly are not base erosion payments. A Section 263A (UNICAP) study may identify costs that currently are treated as deductions but must be capitalized into inventory and recovered through COGS. Examples of capitalizable (or partially capitalizable) costs include royalty/license fees related to production, commissions paid for inventory procurement, fees paid for inventory warehousing, and management fees. Changes from treating a cost as a deduction to treating a cost as capitalized to inventory generally must be implemented through method changes.

Taxpayers also may elect to capitalize and amortize research and development (R&D) costs instead of currently expensing them. This strategy would reduce the current-year base erosion tax benefit and affect the computation of the taxpayer’s base erosion percentage. While this strategy may yield a benefit for BEAT purposes, it would increase a taxpayer’s regular taxable income and thus its regular tax in the year of the election.

**Observation:** Elections under Sections 59(e) or 174 have different characteristics and requirements. A study may identify whether expensing or capitalizing R&D costs provides a
greater benefit and whether applying Sections 59(e) or 174 is more appropriate, given company attributes.

Taxpayers also may consider ‘inverse accounting methods planning’ to increase regular taxable income and reduce BEAT liability. Because the BEAT amount is reduced by regular tax, increasing taxable income and regular tax liability may reduce the BEAT amount and transform a permanent BEAT liability into a temporary item.

**Observation:** The foregoing approach could provide a useful one-year strategy while a taxpayer is restructuring or planning a longer-term solution to reduce BEAT.

**Observation:** When participants in the August 6 webcast were asked whether their company has made, or plans to make, accounting method changes in response to the BEAT, 53% said no; 13% said yes, accounting method changes to decrease deductions, such as including costs in inventory or capitalizing R&D expenses; 5% said yes, accounting methods changes to increase taxable income; and 29% said their company is not subject to BEAT.

**Section 163(j)**

As amended under tax reform, Section 163(j) limits a taxpayer’s deduction for business interest to (1) business interest income, (2) 30% of adjusted taxable income (ATI), and (3) floor plan financing interest.

ATI is taxable income adjusted by disregarding certain income and deductions, such as depreciation, depletion, and amortization (DD&A) for tax years beginning before 2022. Thus, DD&A is added back to taxable income to determine ATI. However, under proposed regulations, DD&A capitalized to inventory under Section 263A and recovered through COGS is not a DD&A deduction for purposes of Section 163(j) and does not increase ATI.

Interest and other costs, such as general and administrative expenses, capitalized to self-constructed property under Section 263A are recovered through depreciation, thus increasing ATI and the Section 163(j) limitation. Capitalized interest loses its character as interest and is not subject to the Section 163(j) limitation, reducing the amount of business interest that may be disallowed. Thus, methods planning may help to reduce the amount of disallowed interest by both increasing DD&A and ATI, and decreasing the amount of business interest subject to disallowance.

**GILTI**

Section 951A, added by the Act, taxes global intangible low-taxed income (GILTI) of US shareholders of controlled foreign corporations (CFCs), effective for CFC tax years beginning after December 31, 2017. GILTI generally is the excess of net CFC tested income over net deemed tangible income return. The return generally must be 10% of a pro rata share of the qualified business asset investment (QBAI) of each CFC over interest expense. QBAI is the adjusted basis of depreciable tangible property under Section 168(g).

Taxpayers are allowed a 50% deduction against GILTI tax through December 31, 2025 (37.5% thereafter). The GILTI inclusion net of the deduction is then taxed at 21% to arrive at tentative GILTI tax. Taxpayers are allowed a deemed-paid foreign tax credit to arrive at US tax liability.

**Observation:** Methods planning may reduce GILTI liability, but taxpayers should note that uncertainty will continue regarding transition and methods rules until additional IRS guidance is issued.

Planning could include strategies to (1) reduce CFC tested income using traditional methods planning to accelerate deductions and defer income to reduce tested income, (2) increase QBAI, such as capitalizing more costs (e.g., repairs, UNICAP costs) to the basis of tangible property, and (3) in lieu of ADS depreciation (which generally is required to compute QBAI), electing an exception (if eligible) for assets placed in service before the GILTI regime became effective.

Transition issues related to GILTI include:

- That tested income is a new concept from subpart F
- How tested income methods are adopted and changed
- Whether taxpayers use E&P methods for tested income
- Whether taxpayers adopt (rather than change to) new methods, considering that--
  - Preamble language indicates tested income or tested loss is not limited to E&P for that tax year, and
  - Changing to use ADS for depreciation for tested income purposes is a change in method of accounting.

**Observation:** When participants in the August 6 webcast were asked whether their company has implemented, or plans to implement, accounting method strategies in response to GILTI, 49% said no; 10% said yes, only for depreciation; 21% said yes, for depreciation and/or other items; and 19% said their company is not subject to GILTI.

**Earnings and profits (E&P)**

Method change considerations for E&P include:
Accounting method rules for CFC E&P for what are permissible methods, elections, and adopting or changing methods are similar to rules for domestic corporations.

Method changes may reduce E&P by accelerating deductions or deferring income (or vice versa).

Method changes provide possible audit protection for improper methods in earlier years.

Exceptions for E&P to the general method change rules include:

- No audit protection is provided if the issue is under consideration, which is broadly defined for CFCs.
- The 120-day window does not apply for CFCs.
- The spread for positive Section 481(a) adjustments is two years instead of four years if the taxpayer is under examination (unless the taxpayer is in a three-month window).
- No audit protection applies for earlier years when deemed paid taxes are 150% more than the average of the prior three years (see Section 8.02(5) of Rev. Proc. 2015-13), even if the taxpayer is not under examination. For example, for a method change in 2018, the taxpayer receives no audit protection for 2017 when the Section 965 toll charge substantially increased taxes.

Other tax reform planning

Section 1341 mitigation

Section 1341 provides relief from changes in tax rates or tax attributes — e.g., when a taxpayer includes an item in gross income in one tax year and repays it in a later tax year when the tax rate is lower (thus getting less benefit from the deduction).

Section 1341 applies if all of the following apply:

- A taxpayer includes an item in gross income in an earlier tax year because the taxpayer appeared to have an unrestricted right to the item,
- The taxpayer must repay the item in a later tax year because the taxpayer did not have an unrestricted right to it,
- The repayment is allowable as a deduction, and
- The deduction is greater than $3,000.

Observation: Interest in Section 1341 planning has increased following the corporate rate reduction from 35% to 21% under the Act. Thus, Section 1341 may compensate for the disparity when a taxpayer included an item in income at a 35% tax rate and deducts a repayment at a 21% tax rate.

Section 118 contributions to capital

Contributions to capital are excluded from the gross income of a corporation. The exclusion does not apply to contributions from a customer or potential customer. The Act also exempts from the exclusion contributions from a governmental entity or civic group made after December 22, 2017, unless the contributing group or entity is a shareholder.

Under a transition rule, a contribution from a governmental entity under a master development plan approved by a governmental entity before December 22, 2017, may be evaluated under pre-Act Section 118 to determine whether it is a contribution to capital and eligible for exclusion from the recipient corporation’s income.

Compliance issues

Reporting for the Section 199A qualified business income deduction

Under Section 199A, each individual taxpayer/owner applies the applicable limitations on, and computes and claims, the Section 199A deduction.

A relevant pass-through entity (RPE) must report the necessary information to the owner on Schedule K-1 for each trade or business (ToB) the RPE operates. The information includes:

- The owner’s allocated share of qualified business income (QBI), W-2 wages, and unadjusted basis immediately before acquisition (UBIA) of property, including amounts from specified service trades or businesses (SSTB) (because the SSTB limitation is applied at the owner level)
- Whether any ToB is an SSTB (determined at the entity level)
- QBI, W-2 wages, UBIA, and SSTB determinations reported to the RPE by lower-tier entities
- The owner’s allocated share of qualified REIT dividends and qualified publicly traded partnership income or loss received by the RPE, including those reported by lower-tier entities
- Whether the RPE or a lower-tier entity has aggregated ToBs and information about each ToB aggregated.

If the RPE does not report this information, then the owner has no QBI from that RPE.

Observation: Individual taxpayer/owners may have taxable income below the applicable threshold, allowing them to benefit from income from an otherwise disqualified SSTB. Thus, even if an...
RPE determines that its trade or business is an SSTB, it still should report the SSTB’s QBI, W-2 wages, and UBI on Form K-1.

Note: The IRS may accept private letter ruling requests on Section 199A issues.

UNICAP final regulations
Final regulations make significant changes to Section 263A rules, including a new, complex definition of Section 471 costs, for most producers and resellers using a simplified method to allocate Section 263A costs to ending inventory.

Under the previous regulations, Section 471 costs for UNICAP generally were costs a taxpayer treated as Section 471 costs for book purposes, with increases to additional Section 263A costs for costs not in Section 471 costs that were capitalizable for Section 263A, and decreases to additional Section 263A costs for costs capitalized in Section 471 costs but not required or allowed as Section 263A costs.

The new rules provide two definitions of (i.e., accounting methods for determining) Section 471 costs. The default definition is that Section 471 costs are the types of costs used for book. A taxpayer must change its Section 471 costs to include the correct amounts for tax rather than treating the difference in amount as additional Section 263A costs. Under the AFS definition, Section 471 costs are the types and amounts of costs used for book purposes. Under either definition, a taxpayer generally must include all direct costs (labor and materials) in Section 471 costs.

Whether a taxpayer must change its Section 471 method to include the types or amounts of costs that must be capitalized under Section 263A, or may (or must) adjust Section 471 costs for these differences by using negative or positive amounts to determine additional Section 263A costs, depends on whether the taxpayer is a large or small producer or a reseller, and which Section 471 method (default or AFS) the taxpayer uses.

Regardless of its Section 471 method, a large producer using the simplified production method may not use negative adjustments to determine additional Section 263A costs. These taxpayers may change to the new modified simplified production method (MSPM), which uses two formulas (for pre-production costs and production costs) and allows negative adjustments.

Compliance with the new regulations is not optional. Most producers and resellers using a simplified method will have to change one or more of their methods of accounting.

The regulations are effective for tax years beginning on or after November 20, 2018. Taxpayers may benefit from early adoption in 2018, as (1) the MSPM may reduce amounts capitalized to ending inventory, increasing COGS, and (2) the method changes generally will provide audit protection for improper UNICAP methods used in earlier, higher-rate tax years.

Observation: When participants in the August 6 webcast were asked whether their company plans to change one or more methods of accounting to comply with the new UNICAP regulations, 14% said yes, they plan to change their method for Section 471 costs; 10% said yes, they plan to change to the modified simplified production method; 6% said yes, they plan to change both Section 471 costs and their simplified method; 35% said they do not plan to change a UNICAP method of accounting; and 35% said they are not subject to UNICAP.

The takeaway
In light of tax reform, tax accounting methods currently have a heightened importance and will continue to be relevant going forward. In addition to analyzing the substantial changes to tax accounting provisions such as Section 451 and bonus depreciation, taxpayers should consider tax accounting methods in complying with, and planning for, new provisions such as the BEAT, Section 163(j), and GILTI. Section 1341 provides a unique opportunity and should be considered in light of rate reduction. While Section 118 has been repealed, it still may provide companies a benefit under the Act’s transition rule. Finally, RPEs should consider their need to comply with reporting requirements under Section 199A, and taxpayers should consider whether to early adopt the new UNICAP regulations in 2018.
Let’s talk

If you would like to discuss how these developments may affect your business, please contact:

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