Taxpayers should review tax reform and other guidance as year-end approaches

December 18, 2019

In brief

2019 was an eventful year that saw the IRS and Treasury issue a number of important regulations and other published guidance under the 2017 tax reform act (the Act). This Insight summarizes many of those developments and other tax issues and provisions. It also discusses approaches that taxpayers may consider to help maximize (in the case of positive provisions such as bonus depreciation) or minimize the impact of tax reform. With year-end approaching, taxpayers may want to review how these developments and approaches may affect their businesses.

In detail

Section 451/revenue recognition

Section 451 governs the timing of including an item in gross income. A taxpayer using an accrual method of accounting includes an item in gross income when all the events have occurred that fix the right to receive the income and the amount is determinable with reasonable accuracy (the all-events test). Before tax reform, a taxpayer satisfied the all-events test at the earliest of when an item was due, paid, or earned. The Act added Section 451(b), which modifies the all-events test by providing generally that an accrual-method taxpayer meets the all-events test no later than when an item of gross income is taken into account as revenue in the taxpayer's applicable financial statement (AFS). Section 451(b) generally excludes special methods of accounting from this AFS inclusion rule. Accrual-method taxpayers that do not have an AFS continue to include an item in gross income under the pre-tax reform all-events test.

The Act also added Section 451(c), which provides rules for a taxpayer using an accrual method of accounting to elect to defer including certain advance payments in gross income consistent with treatment in an AFS, but for no more than one tax year. An advance payment is a payment (1) for which full inclusion in income for the year of receipt is a permissible method of accounting, (2) any part of which is included in revenue in a taxpayer's AFS in a later tax year, and (3) for goods or services or other items Treasury identifies.

Sections 451(b) and Section 451(c) also require a taxpayer to allocate transaction price to performance obligations under a contract consistently with the allocation in the taxpayer's AFS.

The Section 451 amendments apply for tax years beginning after December 31, 2017.

The IRS and Treasury issued proposed regulations under Sections 451(b) and 451(c) and Rev. Proc. 2019-37 providing change in accounting method procedures (since incorporated into Rev. Proc. 2019-43). The regulations are proposed to apply to tax years beginning on or after the date final regulations are published in the Federal Register, but allow taxpayers to rely on them for tax years beginning after December 31, 2017, under certain conditions. Taxpayers also may choose to continue to apply Rev. Proc. 2004-34 instead of the Section 451(c) proposed regulations.

Section 451(b) proposed regulations

The Section 451(b) proposed regulations define special method of accounting, expand the definition of an AFS for foreign corporations, include special rules for debt instruments, and provide rules for issues relating to contracts covering more than one tax year and taxpayers with different financial accounting and tax years. The proposed regulations clarify that the AFS inclusion rule (1) does not apply to different characterizations of a transaction for AFS and federal income tax (tax) purposes, for example whether a transaction is a sale, lease, or license, and (2) does not change an item's exclusion from income or nonrecognition treatment for tax as a result of AFS treatment as revenue.

The AFS inclusion rule requires a taxpayer to include an item in gross income no later than when recognized as revenue in an AFS. The proposed regulations define 'revenue' recognized in an AFS as all transaction price amounts includible in gross income under Section 61. 'Transaction price' is the gross amount of consideration a taxpayer expects to be entitled to for AFS purposes for transferring goods, services, or property (including specified fees on debt instruments). Transaction price is not adjusted for amounts subject to Section 461 such as refunds, rebates, rewards, chargebacks, and amounts included in cost of goods sold (COGS).

Observation: The definition of transaction price in the proposed regulations prohibits a taxpayer from offsetting gross income for anticipated adjustments for related items such as refunds, rebates, and COGS, although these amounts reduce or offset revenue recognized in the AFS. As a result, this controversial rule may result in less tax and book conformity.

Note: New financial accounting standard ASC 606 applies to revenue from contracts with customers to provide goods, services, or nonfinancial assets based on expected consideration (transaction price). This new standard may result in accelerating revenue recognition in an AFS and therefore accelerate inclusion in gross income for tax.

Section 451(c) proposed regulations

The conference report to the Act indicates that Section 451(c) is modelled on Rev. Proc. 2004-34, which generally allows a taxpayer with an AFS to defer an advance payment for up to one tax year to the extent the payment is deferred in the taxpayer's AFS. However, the statutory language of Section 451(c) fails to reflect several provisions of Rev. Proc. 2004-34. The Section 451(c) proposed regulations reflect the intent behind Section 451(c) by adopting a number of additional provisions from Rev. Proc. 2004-34, including the definition of advance payments, a non-AFS deferral method for taxpayers without an AFS, and rules for short tax years.

Former Reg. sec. 1.451-5 required taxpayers to offset certain advance payments for inventoriable goods required to be included in gross income by costs included in inventory costs. The proposed regulations do not include a similar rule.

For an in-depth discussion of the Section 451(b) and Section 451(c) proposed regulations and revenue recognition issues, see:

Proposed regulations interpret the all-events test under Section 451(b)

Guidance issued on Section 451(c) advance payments, Section 451(b) and (c) method changes

IRS authorizes making certain automatic method changes consistent with financial accounting standard ASC 606

IRS revises effective date for automatic method change to comply with ASC 606

Bonus depreciation

The Act amended Section 168(k) to allow 100% bonus depreciation for qualified property placed in service in certain tax years with percentages declining by 20% per year in later years. Property is qualified property eligible for bonus depreciation only if it is (1) of a certain type, (2) acquired after September 27, 2017, (3) placed in service after September 27, 2017 and before January 1, 2026 (January 1, 2027, for longer term production property and certain aircraft), and (4) new property or property not previously used by a taxpayer or related party.

The IRS and Treasury published final and proposed regulations in 2019 (2019 regulations) on the expanded depreciation provisions. The regulations apply generally to qualified property placed in service in or after a tax year that includes September 24, 2019. The regulations provide rules allowing taxpayers to apply the final regulations, 2019 proposed regulations, or original (2018) proposed regulations for certain periods and with certain conditions.

Used property

A taxpayer may be allowed bonus depreciation if neither the taxpayer nor a related party had a previous depreciable interest in the property. The 2019 regulations (1) provide a five-year lookback period for this determination, (2) provide a de minimis rule, (3) re-propose rules applying the used property rules to transfers between members of a consolidated group and related parties generally, and (4) clarify and re-propose certain used property rules in the context of Section 743(b) adjustments.

Date of acquisition

Under the regulations, a taxpayer acquires property on the date the taxpayer enters into a written binding contract for acquisition.

Note: Property constructed by a taxpayer for its own use (self-constructed property) and components of that property may have different acquisition dates. Generally, self-constructed property is acquired when construction begins.

The 2018 proposed regulations limited bonus depreciation for self-constructed property and components of self-constructed property by providing that (1) a taxpayer acquires property constructed for the taxpayer by a third party when the parties enter into a written binding contract, and (2) a component of larger property is not eligible for 100% bonus depreciation if a taxpayer acquires the larger property before September 28, 2017, regardless of when the component is acquired.

Example. A taxpayer (1) entered into a written binding contract for a third party to construct property for the taxpayer before September 28, 2017, (2) began construction on that property after September 27, 2017, and (3) itself began construction on a component of that property after September 27, 2017. The 2018 proposed regulations did not allow the taxpayer 100% bonus depreciation for either the larger property or the component.

The 2019 regulations largely removed these limitations by providing that (1) property constructed for a taxpayer by a third party under a written binding contract entered into before construction begins is self-constructed property and the taxpayer aquires the property when construction begins, and (2) bonus depreciation for the larger property and the component is based on their individual acquisition dates. Thus, in the example, the taxpayer may claim bonus depreciation for (1) the larger property because the taxpayer entered into a written binding contract before construction began and construction began after September 17, 2017, and (2) the component because the taxpayer began construction after September 17, 2017.

For further information on bonus depreciation, see:

Final and proposed regulations expand bonus depreciation availability

Rev. Proc. 2019-33 provides procedures for changing bonus depreciation elections

Proposed regulations provide guidance on qualified property eligible for bonus depreciation

Section 263A/UNICAP

Final regulations under Section 263A substantially change the rules for taxpayers using a simplified method to capitalize additional costs to inventory. The final regulations generally apply for tax years beginning on or after November 20, 2018. Thus, calendar-year taxpayers must comply with the regulations for the 2019 tax year.

The regulations made significant changes that include (1) defining Section 471 costs to require certain direct costs and variances to be accounted for as Section 471 costs (rather than as additional Section 263A costs) unless de minimis and/or safe harbor rules apply, and (2) generally prohibiting large producers from including 'negative' additional Section 263A costs (i.e., types or amounts of costs capitalized for book not required or permitted to be capitalized for tax) in the UNICAP simplified formulas unless the taxpayer changes to the new modified simplified production method.

Section 471 costs

The regulations change the definition of Section 471 costs to provide for one of two methods, the default method or the applicable financial statement (AFS) method.

Under the default method, the *amount* of Section 471 costs must conform to the amount a taxpayer incurs for federal income tax purposes (i.e., book-tax differences in amount must be treated as Section 471 costs). A taxpayer using the AFS method generally may determine both the type and amount of Section 471 costs based on the taxpayer's AFS, but may not include financial statement write-downs, reserves, or valuation adjustments in Section 471 costs. Under either method, Section 471 costs must include all direct costs and variances or over/under-applied burden, unless certain de minimis and safe harbor rules apply.

Additional Section 263A costs

The final regulations generally prohibit taxpayers from including negative amounts in additional Section 263A costs under the simplified production method. The regulations allow taxpayers using the simplified resale method or modified simplified production method and small taxpayers using the simplified production method to account for certain costs as negative additional Section 263A costs, and even *require that treatment* for taxpayers using the AFS method to adjust certain Section 471 costs. Large producers using the simplified production method may not include negative amounts in additional Section 263A costs, but may change to the new modified simplified production method, which allows these adjustments.

Most taxpayers with inventory subject to UNICAP, including taxpayers that may include negative amounts in additional Section 263A costs under the final regulations, likely will have to make at least one accounting method change for 2019.

Approaches for using UNICAP to reduce BEAT liability and the Section 163(j) interest disallowance are discussed below.

For an in-depth discussion of the UNICAP regulations and issues, see:

Final regulations provide complex rules on negative additional Section 263A costs

Section 263A final regulations provide new modified simplified production method

Taxpayers should act now to timely implement Section 263A regulations

UNICAP taxpayers that claim bonus depreciation may benefit by using a historic absorption ratio

Section 1341 mitigation

Section 1341 is a relief provision that may apply when a taxpayer must repay an amount the taxpayer included in income in an earlier tax year when the rate was higher. For example, a taxpayer that includes $10,000 in income in 2017 at the 35% corporate rate and deducts a repayment of that amount in 2019 when the corporate rate is 21%, pays $3,500 in tax in 2017 and reduces tax resulting from the repayment by only $2,100 in 2019, $1,400 less than the tax paid.

Section 1341 provides an alternative computation of tax that is intended to place this taxpayer in roughly the same economic position it would have been in if it had not included the item in income in the earlier year or if the tax rates had remained the same. Given the change in tax rates under the Act, a taxpayer that included an item in income before 2018 and must repay it in 2018 or later should consider whether the repayment qualifies for relief under Section 1341.

For an expanded discussion, see:

Section 1341 and rate changes may provide opportunities for permanent tax savings

Section 199A

Section 199A provides individual taxpayers and some trusts and estates a deduction for combined qualified business income from a partnership, S corporation, sole proprietorship, trust, or estate. The deduction applies for tax years beginning after December 31, 2017, and before January 1, 2026.

Combined qualified business income is (1) qualified business income (QBI) plus (2) qualified REIT dividends and qualified publicly traded partnership (PTP) income. QBI is the net amount of qualified items of income, gain, loss, and deduction of each qualified trade or business of a taxpayer.

Relevant passthrough entities, such as partnerships and S corporations, must obtain and report to owners on Schedule K-1 certain information about their trades or businesses that are necessary for the owners to determine their Section 199A deductions.

In 2019 the IRS and Treasury issued a number of regulations and other published guidance under Section 199A:

- Final regulations generally apply for tax years ending after February 8, 2019. The preamble provides that taxpayers may rely on the proposed regulations or the final regulations in their entirety for tax years ending in calendar year 2018.
- Proposed regulations address the treatment of previously suspended losses as qualified business income and guidance on regulated investment companies, charitable remainder trusts, and split-interest trusts, which taxpayers may apply in their entirety pending publication of final regulations.
- Rev. Proc. 2019-11 finalizes a revenue procedure proposed in Notice 2018-64 on methods for calculating W-2 wages, and applies for tax years ending after December 31, 2017.
- Notice 2019-7 proposes a revenue procedure providing a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of Section 199A, to apply to tax years ending after December 31, 2017. Taxpayers may apply the safe harbor pending publication of the final revenue procedure.
- Proposed regulations under Section 199A(g) provide rules for specified agricultural or horticultural cooperatives and their patrons, to apply to tax years ending after the date of publication of final regulations in the Federal Register, on which taxpayers may rely until finalization.
- Notice 2019-27 proposes a revenue procedure providing methods for specified agricultural or horticultural cooperatives to calculate W-2 wages for purposes of Section 199A, to apply generally to tax years ending after 2017. Specified cooperatives may use the methods described in the notice until the revenue procedure is published.
- Rev. Proc. 2019-38 finalizes the safe harbor for rental real estate enterprises proposed in Notice 2019-07 and generally applies to tax years ending after December 31, 2017. Taxpayers may rely on the safe harbor provided in Notice 2019-07 for their tax year ending in 2018.

For additional information on Section 199A, see:

Final regulations provide guidance on the Section 199A passthrough deduction

Impact of the final Section 199A rules and the Notice 2019-07 safe harbor on the real estate industry

IRS finalizes safe harbor for rental real estate

Reasonable compensation in light of Section 199A

Proposed regulations under Section 199A(g) provide special rules for cooperatives

Proposed regulations provide guidance on computing the Section 199A deduction

Proposed regulations under Section 199A provide guidance on specified service trades or businesses

Tax reform readiness: Deeper dive on Section 199A proposed regulations

Accounting method planning for BEAT, GILTI, and Section 163(j)

The Act added Section 59A on the base erosion and anti-abuse tax (BEAT) and Section 951A on global intangible low-taxed income (GILTI), and amended Section 163(j) to limit the allowable deduction for business interest. Accounting methods provide planning opportunities in each of these areas.

BEAT

In general, the BEAT is a tax on base erosion payments an applicable taxpayer pays or accrues in tax years beginning after December 31, 2017. A base erosion payment includes an amount a taxpayer pays or accrues to a related foreign person for which a deduction is allowable. An applicable taxpayer is a corporation (other than a RIC, REIT, or S corporation) with average annual gross receipts for the three preceding tax years of at least $500 million and a base erosion percentage of at least 3% (2% in the case of certain banks and registered securities dealers).

The BEAT is equal to the excess of (1) the BEAT applicable rate for the tax year multiplied by the taxpayer's modified taxable income over (2) the taxpayer's regular tax liability. The BEAT applicable rate is 5% for tax years beginning in 2018, 10% for tax years beginning on or before December 31, 2025, and 12.5% for tax years beginning after December 31, 2025 (one percentage point higher for banks and securities dealers).

Note: Section 15 provides a blended tax rate to a tax year when a portion of the year is subject to one tax rate and another portion of the year is subject to another tax rate. BEAT proposed regulations provided that Section 15 applies to a fiscal tax year beginning after January 1, 2018, resulting in a blended tax rate between 5% and 10%, instead of 5%, for the first BEAT year for taxpayers with fiscal tax years beginning in calendar year 2018 and ending in calendar year 2019. Recently released final regulations provide that Section 15 does not apply to BEAT for a tax year that includes January 1, 2018, or January 1, 2019, but applies to the change in the BEAT rate from 10% to 12.5%.

A taxpayer may reduce its BEAT liability by adopting or changing accounting methods to reduce deductible payments and/or increase regular taxable income. A taxpayer also may be able to reduce its base erosion percentage below 3% and eliminate its BEAT liability for a tax year through these accounting methods planning approaches.

Cost of goods sold. Taxpayers that maintain inventories recover many costs as COGS under Sections 471 and 263A instead of as deductions. Accordingly, a taxpayer may reduce base erosion payments and BEAT liability by capitalizing to inventory costs the taxpayer currently deducts. Sales-based royalties and management fees are two types of costs that may be capitalizable under Section 263A that taxpayers often improperly deduct. A taxpayer that currently is not capitalizing sales-based royalties, management fees, or other costs may be eligible to change its method of accounting to capitalize these costs using the automatic procedures.

Capitalizing expensible costs. A taxpayer may choose to capitalize certain costs that the taxpayer otherwise may expense, for example research and development costs under Section 59(e) or 174. Capitalizing these costs resulting from payments to related foreign parties may reduce a taxpayer's BEAT liability by deferring the amount of deductible base erosion payments.

Waiving deductions. Newly released proposed regulations allow a taxpayer to waive all or a portion of an otherwise allowable deduction. A waived deduction is not a base erosion payment. The taxpayer makes the election under IRS procedures on an originally filed or amended federal income tax return or during an IRS examination of the taxpayer's tax return. The taxpayer may increase, but not decrease, the amount of a waived deduction on an amended return or during an examination.

Observation: Modelling should be conducted to determine if the reduction in BEAT liability is sufficient to compensate for the increase in taxable income resulting from these approaches.

Taxpayers may structure contracts with related foreign parties and third parties to reduce BEAT liability. This approach may apply when a US taxpayer subject to BEAT receives an amount from a third party and remits that amount to a foreign

related party, or the taxpayer pays an amount to a foreign related party that the foreign related party remits to a third party. In certain situations, the amount received is not taxable to the recipient and, correspondingly, not deductible when remitted to the ultimate payee. Thus, a payment from a taxpayer to a foreign related party in one of these situations is not deductible and not a base erosion payment.

In the following types of arrangements, the payments to foreign related parties may not be base erosion payments.

- Agency: The taxpayer receives payment from a third party and remits the payment to the foreign related party as an agent, or the foreign related party receives an amount from the taxpayer and remits it to a third party as the taxpayer's agent (in which case the taxpayer's deduction is for the payment to the third party).
- Conduit: The taxpayer acts as a conduit in receiving a payment from a third party and remitting the payment to the foreign related party, or the foreign related party acts as a conduit in receiving a payment from the taxpayer and remitting it to a third party.
- Cost reimbursement: The taxpayer pays an amount to a foreign related party and is entitled to reimbursement from another party, or the foreign related party pays an amount to a third party and is entitled to reimbursement from the taxpayer (characterized as a loan or advance between the parties).
- Revenue sharing: The taxpayer pays the foreign related party its share of revenue from a bona-fide revenue sharing agreement, which the foreign related party receives as its right under the agreement.

Note: The final regulations do not provide any guidance on these transactions and note that existing federal income tax principles determine the character of the payments.

GILTI

Section 951A taxes the GILTI of US shareholders of controlled foreign corporations (CFC), 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).

Accounting methods planning may reduce GILTI liability by (1) accelerating deductions and deferring income to reduce tested income, (2) capitalizing additional costs (e.g., repairs, Section 263A costs) to the basis of tangible property to increase QBAI, or (3) electing an exception to ADS depreciation to compute QBAI for assets placed in service before the GILTI regime became effective.

Section 163(j)

Amended Section 163(j) limits a taxpayer's deduction for business interest to the sum of (1) business interest income, (2) 30% of adjusted taxable income, and (3) floor plan financing interest. Adjusted taxable income is taxable income adjusted by disregarding certain income and deductions, notably depreciation, amortization, or depletion (DAD) deductions incurred in tax years beginning before January 1, 2022. Thus, recovering costs as DAD instead of as a current deduction increases adjusted taxable income and the Section 163(j) limitation and reduces disallowed interest.

Section 263A requires or permits taxpayers to capitalize certain costs into the basis of self-constructed property (as well as inventory). A taxpayer may increase adjusted taxable income and the Section 163(j) deduction limitation by optionally capitalizing costs to self-constructed property, which then are recovered through depreciation.

For example, a taxpayer may increase capitalized costs by using the direct reallocation method to allocate all mixed service costs to capitalizable production activities that relate to departments that impact production activities in any way. A taxpayer using another allocation method may change to the direct allocation method, increase adjusted taxable income by the amount of the additionally capitalized mixed service costs, and recover capitalized costs when the property is placed in service (the full amount if the property is eligible for 100% bonus depreciation).

Taxpayers that produce self-constructed property that is designated property also may reduce disallowed interest by capitalizing interest to the property. Designated property generally is real or tangible personal property that has (1) a class life of 20 years or more, (2) an estimated production period exceeding two years, or (3) an estimated production period exceeding one year and an estimated cost of production exceeding $1 million. Capitalized interest is added to the

basis of the property produced and recovered through depreciation, but also loses its character as interest and thus is not subject to disallowance under Section 163(j).

For more information on these topics, see:

Tax readiness: Accounting method planning after tax reform

Taxpayers may be able to reduce BEAT liability by increasing cost of goods sold

PLR concludes that reimbursement of pharma fee is not includible in income

Preliminary highlights from the final and proposed BEAT regulations

Capitalizing costs under UNICAP may reduce interest disallowance

The takeaway

Although some issues and uncertainties remain, the IRS and Treasury issued a multitude of guidance in 2019 that contributed to road maps for taxpayers to comply with tax reform and other tax provisions. With year-end approaching, taxpayers should review their methods of accounting both for compliance and to consider approaches that may result in positive tax benefits.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact one of the PwC professionals listed below, or your local Accounting Method Services contact:

Annette Smith
Washington, DC
(703) 405-8775
annette.smith@pwc.com

Brad White
Los Angeles, CA
(206) 484-6587
brad.white@pwc.com

Our insights. Your choices.

Make your preference selections to receive more content like this.

Set your preferences today

© 2019 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 157 countries with over 276,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.