Tax considerations associated with the new leasing standard

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In brief

In an effort to improve transparency and provide more meaningful information to users of financial statements, the FASB issued an Accounting Standards Update on Topic 842, *Leases*, on February 25, 2016. This new guidance will significantly impact the U.S. GAAP financial statement accounting for leases by lessees, eliminating the traditional concept of an operating lease. Under the new guidance, virtually all leases will be included on the balance sheet for lessees. The new lease accounting guidance will be effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 (one year later for annual periods for entities not meeting the FASB's definition of a public business entity). Early adoption is permitted. The new standard must be adopted using a modified retrospective transition. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

The changes in accounting guidance will not impact how leases are treated for U.S. federal income tax purposes; however, as companies transition to the new leasing standard for financial reporting, changes to lease accounting policies, lease terms and conditions, and processes and systems used to track and account for leases may impact several areas within the tax function, including U.S. tax accounting methods, deferred tax accounting, state taxes, transfer pricing, and tax processes and systems.

In detail

Background of the new lease accounting model

Leasing transactions are commonly used by many organizations to secure the use of property or equipment with payments typically made over time. Certain leasing transactions, such as sale-leaseback, also allow lessees to monetize the fair value of the property while continuing to use it.

The FASB and IASB issued new standards earlier this year to address concerns about the current accounting lease model, which included allowing lessees to achieve off-balance sheet financing.

The following provides an overview of the new standard, *Leases (ASC 842)*, from the perspective of both, a lessee and a lessor.

Lessee accounting model

Under the new accounting model under ASC 842, lessees will need to recognize a right-of-use asset and a lease liability on the balance sheet for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of the future lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs.

For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases), while finance leases will result in a front-loaded expense pattern (similar to current capital leases).

Classification will be based on criteria that are largely similar to those applied under current lease accounting, but without explicit bright lines.

Lessor accounting model

The model for lessor accounting in ASC 842 will be similar to the current model, but updated to align with certain changes to the lessee model (e.g., certain definitions, such as initial direct costs, have been updated) and the new revenue recognition standard. Similar to historical guidance, lessors will classify leases as operating, direct financing, or sales-type.

Lease accounting will continue to require significant judgments, including when making estimates related to the lease term, lease payments, and discount rate. Similar to today, the term of the lease will include the non-cancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor.

Leveraged leases

Leveraged lease accounting has been eliminated, although it has been grandfathered for existing arrangements.

PwC lease accounting resources

Included below are links to PwC lease accounting resources that provide a more expansive summary of the new lease accounting model:

- In brief: Lease accounting: The long-awaited FASB standard has arrived
- In depth: The leasing standard - A comprehensive look at the new model and its impact
- 10Minutes on the new US lease standard: How the new rules will bring changes to your financial statements
- Lessee accounting under the new leasing standard
- Lessor accounting under the new leasing standard
- PwC's comprehensive guide to the new US GAAP leases guidance

Tax considerations

The changes in accounting guidance will not impact how leases are treated for federal income tax purposes; however, as companies transition to the new leasing standard, changes to lease accounting policies, lease terms and conditions, and processes and systems used to track and account for leases may impact several areas within the tax function, including U.S. tax accounting methods, deferred tax accounting, state taxes, transfer pricing, and tax processes and systems.

Included below is a summary of several potential tax considerations when transitioning to the new leasing standard.

U.S. tax accounting methods

As part of companies' efforts in transitioning towards the adoption of the new leasing standard, additional leasing information may become available to tax departments. During this process, tax departments may identify necessary changes, or more optimal methods, related to their historical tax treatment of leases and related items. Specifically, tax departments may need to review the following U.S. tax accounting method items in conjunction with the adoption of the new leasing standard: characterization of leases (i.e., sale, lease, or financing); timing of income or expense under IRC Section 467; treatment of tenant improvement allowances; and treatment of lease acquisition costs. A tax change in method of accounting may be available to provide more appropriate or beneficial tax reporting prospectively for leases.

Deferred tax accounting

The measurement of book basis amounts associated with lease assets and liabilities may change upon adopting the new accounting guidance. For example, for lessees with leases classified as operating leases under the current accounting model, a right-of-use asset and lease liability will now be recorded under the new standard. However, the tax basis amounts may not change as the U.S. federal tax law is not changing, thus creating a change to deferred taxes. Tax departments will need to understand and assess any changes to the book basis of the lease assets and liabilities to ensure book and tax basis amounts are appropriately reconciled and deferred taxes are accurately recorded. In addition, if lease terms and conditions or policies change as a result of the adoption of the new standard, the tax basis and method may be impacted, and deferred tax considerations will need to be assessed.

From an income statement perspective, similar to the treatment today, book expense may be reversed for tax purposes. To the extent any impairment for a right-of-use asset is recorded for book purposes under Topic ASC 360, *Property, Plant, and Equipment*, it will also be reversed for tax purposes. The tax deduction for lease expense will be based on current tax methods (for example, in accordance with IRC Sec. 467 accrual path). Such differences between book and tax accounting would impact deferred tax computations.

State taxes

Certain states levy franchise taxes for companies doing business within a particular jurisdiction. Franchise taxes are generally based upon the net worth (stockholder's equity) of a corporation; however, various adjustments may be required (e.g., treasury stock, liabilities, reserves, etc.) to arrive at the taxable base. Implementation of the new leasing standard may impact the computation of a company's franchise tax base due to the requirement to record essentially all leasing transactions on the balance sheet for financial accounting purposes. Moreover, the property factor utilized in the computation of many state apportionment factors (for both income and franchise tax purposes) is determined through the use of an average owned property (generally, valued at its original cost) and eight times the net annual rent. After the adoption of new guidance, companies may need to change their process to gather the information for property factor computations, particularly if the right-of-use asset is recorded in the same balance sheet account or line item as other owned property.

Other non-income based taxes

Companies should consider whether the adoption of the new lease accounting standard will impact any other non-income based taxes. For example, a company should consider whether its property tax liability (if based on its financial accounting balance sheet) will change as a result of the proposed standard.

Companies should also consider if there will be any sale and use tax impact resulting from the adoption of the new lease accounting standard. For example, companies should assess whether a state would consider a lease transaction as a purchase, since companies will have lease transactions on the balance sheet after adopting the new standard.

International tax and transfer pricing

For companies with a global lease portfolio, consideration should be given to any local jurisdictional tax impacts resulting from a company's policy changes when adopting the new standard.

Similar to the considerations discussed above with respect to U.S. tax, companies will need to consider tax accounting method and tax impacts of the leasing standard in each foreign jurisdiction around the globe in which they operate upon transition. Depending on the number of jurisdictions and differences in rules across those jurisdictions, companies may require resources and changes to existing processes.

Companies should also consider differences between US GAAP and IFRS. Under the new IFRS leasing rules, lessees will no longer be able to recognize straight-line expense for virtually all leases. Instead, under the new IFRS rules, lease expense will be replaced by interest expense on the lease liability and depreciation expense due to depreciation of the right-of-use asset for virtually all leases.

The new leasing standard may also impact transfer pricing arrangements. Many profit level indicators and financial ratios are used to evaluate the consistency of intercompany pricing with the arm's length standard. For example, it may be appropriate to use the profit level indicator of return on operating assets ("ROA") to test the results of certain intercompany arrangements. Typically, these calculations have been based on balance sheet data prepared pursuant to U.S. GAAP. To the extent that the total assets of a legal entity will be increased due to the new standards, the computation of this ratio may be affected when compared to periods prior to adoption of the new standard. Multinational companies with intercompany arrangements should carefully evaluate how the financial ratios and profit level indicators utilized to assess the validity of the transfer pricing arrangements could be impacted as a result of the new lease guidance.

Tax data, process, and system considerations

Lease data is generally collected for different purposes including finance, accounting, procurement, IT, and tax. These various data collections often use unique processes and mechanisms, creating a significant variation in the quality, integrity, and relevance of the data across multiple information sources. Upon adopting the new lease accounting standard, opportunities and challenges may arise in regards to the associated processes and systems used to track lease data.

As processes and systems are evaluated for the new lease accounting standard, tax departments should actively participate to determine the impact to any lease data used for tax reporting purposes and ensure key lease data used for tax purposes continues to be available to the tax department. Opportunities may arise as part of this evaluation to attain lease data for tax reporting purposes that was previously not available. Lease data management and collection process improvements ranging from enhanced spreadsheet-based models and home-grown software solutions to ERP customization and end-to-end lease management module add-ons could significantly improve the organization's (including the tax department's) ability to access lease data and the global leasing processes.

Effective dates and transition

The new accounting guidance will be effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For entities not meeting the FASB's definition of a public business entity, the new accounting guidance will be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

The takeaway

As companies prepare to adopt the new lease accounting standard, tax implications and opportunities should be considered at each step of the implementation process.

For tax departments, during the adoption of the new accounting model it is important to review the data repository of the organization's entire lease portfolio, inclusive of renewal options, lease terms, payment schedules, etc. from both a financial accounting and income tax perspective. This will enable companies to effectively (i) identify differences between the current standard and new standard, (ii) inventory all existing leases and deferred income tax items associated with the leases, (iii) assist in the computation and reconciliation of book/tax differences, (iv) assess federal, state, and international tax impacts, and (v) implement a process to properly characterize a lease transaction under the new standard on a go forward basis, while at the same time assessing the tax treatment of each lease transaction.

Let's talk

For a deeper discussion of tax implication of changes to lease accounting standard, please contact your PwC engagement team or individuals listed here:

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