Tax Reform:
Accounting Methods and Cost Recovery Considerations

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Published on www.lorman.com - November 2019

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On December 22, 2017, President Trump signed into law the tax reform legislation known simply as "H.R. 1" – informally called the "Tax Cuts and Jobs Act (the "Act")." The Act represents the most significant overhaul of our tax laws in over 30 years and contains substantial changes to the taxation of businesses, individuals, multi-national companies, tax-exempt organizations and others.

Now, businesses large and small are considering the numerous changes that may affect them. This discussion will focus on the accounting method and cost recovery changes made by the Act and the issues and opportunities raised by these provisions.

Full Expensing Provisions

The Act expanded and extended the bonus depreciation provisions available under Section 168(k). The Act provides 100% bonus depreciation for qualifying assets acquired and placed in service after September 27, 2017 and prior to December 31, 2022. The bonus depreciation deduction then phases out over the next 4 years with each year reduced by 20%. Taxpayers may also elect to claim 50% bonus depreciation in lieu of 100% for assets placed in service in the first tax year ending after September 27, 2017.

The Act also made some significant changes to the types of property qualifying for bonus depreciation under Section 168(k). As under prior law, qualifying property includes property with a recovery period of 20-years or less as well as computer software, water utility property, qualified film or television production and qualified live theatrical production. However, the prior qualifying categories of qualified leasehold improvement property, qualified retail improvement property and qualified restaurant property are eliminated and qualified improvement property is not identified as a separately qualifying category of property.

Most significantly, the Act removes the requirement that qualifying property be original use property (i.e., new property). The Act allows taxpayers to claim bonus depreciation on both new and used property as long as the property was acquired by purchase and not previously used by the taxpayer. However, the Act exempts certain types of property used by dealerships and electing farming and real property businesses that are not subject to the new interest expense limitations under Section 163(j) from eligibility to claim bonus depreciation.

The Treasury Department and IRS have issued Proposed Regulations interpreting the bonus depreciation provisions and clarifying their application. Specifically, the Proposed Regulations outline the requirements that must be satisfied for used property to qualify for bonus depreciation as well as the applicability of the bonus depreciation provisions to certain asset transfers and transactions. Additionally, the Proposed Regulations outline the requirements regarding when property is considered acquired for purposes of qualifying for bonus depreciation.

The Act increases the dollar limitation and investment limitation for claiming the Section 179 deduction. The Section 179 dollar limitation is increased to $1 Million and the investment limitation is increased to $2.5 Million for tax years beginning after 2017. Both limitations are indexed for inflation for tax years beginning after 2018.

The Act also refines and expands the types of real property that the taxpayer can elect to treat as eligible for Section 179. "Qualified real property" for purposes of Section 179 is expanded to include qualified improvement property as well as certain improvements to nonresidential real property such as roofs, heating, ventilation and air conditioning property, fire protection and alarm systems and security systems. Finally, the Act removes the limitation on claiming the Section 179 deduction for property used primarily in providing lodging and now allows this property to be eligible for deduction under Section 179. The Act, however, did not change the taxpayers that are prohibited from claiming the Section 179 deduction such as noncorporate lessors and estates and trusts.

For property placed in service prior to 2023, taxpayers are eligible to fully expense the cost of qualifying property under either Section 179 or through bonus depreciation. To determine which provision to utilize, taxpayers should focus on the applicable restrictions for each deduction. For example, Section 179 is subject to both a dollar limitation and an overall investment limitation that do not apply for purposes of claiming bonus depreciation. However, certain types of improvements meet the requirements of qualifying real property for Section 179 purposes but are not eligible for bonus depreciation because the property does not meet the definition of qualified improvement property. Additionally, certain taxpayers that are exempt from the interest expense limitations in Section 163(j) are not eligible to claim bonus depreciation but continue to be eligible to use the Section 179 deduction.

Updates to Depreciation Recovery Periods

The Conference Report accompanying the Act indicated that Congress intended to provide a 15-year recovery period for qualified improvement property as defined under Section 168(e)(6). However, the language providing the 15-year recovery period was inadvertently omitted from the statutory language and the Proposed Regulations did not address this issue. As a result, until a correction is provided by Congress, qualified improvement property is subject to 39-year recovery. Additionally, due to the elimination of qualified improvement property as a separate category of property qualifying for bonus depreciation, qualified improvement property is not eligible for bonus depreciation until the recovery period is corrected to a life less than 20-years.

The Act also eliminated the categories of qualified leasehold improvement property, qualified retail improvement property and qualified restaurant property as eligible for 15-year recovery. As a result, for tax years beginning after January 1, 2018, the only category of property eligible for the shorter 15-year recovery was intended to be qualified improvement. Until a correction is issued, no property placed in service after 2017 is eligible for a 15-year recovery.

Under prior law, the recovery period for nonresidential real property and residential rental property for purposes of the Alternative Depreciation System (“ADS”) in Section 168(g) was 40-years. The Act reduced the recovery period for residential rental property to 30-years but did not revise the recovery period for nonresidential real property.

The Act also modified the depreciation recovery periods and methods for property used in a farming business. Under prior law, assets used in a farming business were required to be depreciated using the 150% declining balance method. The Act now allows these assets to be recovered using the 200% declining balance method. Additionally, the recovery period for certain machinery and equipment used in a farming business is reduced from 7-years under prior law to 5-years.

Real estate trades or businesses that elect not to be subject to the interest expense limitations in Section 163(j) are required to depreciate certain types of real property using the ADS recovery periods. These property categories include nonresidential real property, residential rental property and qualified improvement property. Similarly, farming businesses that elect not to be subject to the interest expense limitations under Section 163(j) are required to depreciate all property with a recovery period of 10-years or more using the ADS recovery periods and methods.

Accounting Methods

The Act provides an opportunity for taxpayers with gross receipts below $25 Million to use simplified methods of accounting for tax purposes for tax years beginning after December 31, 2017. Qualifying taxpayers are eligible to use the overall cash method of accounting, avoid the requirement to compute inventory balances for tax purposes, avoid the uniform capitalization rules under Section 263A and avoid long-term contract accounting rules under Section 460. Under prior law, the ability to take advantage of these safe harbors only applied to taxpayers with gross receipts of $10 Million or less and were also dependent on how the taxpayer's business was organized. For example, taxpayers that operated their businesses as C corporations were subject to lower thresholds.

The new safe harbors significantly broaden the group of taxpayers that are eligible for relief. The same $25 Million safe harbors apply regardless of the tax classification of the taxpayer's business, i.e., a partnership, S corporation, C corporation, etc. Additionally, the safe harbors are not affected by the taxpayer's business activities. However, in order to qualify as a "small business" with gross receipts below $25 Million, the taxpayer will be required to aggregate the receipts of all related businesses.

The IRS recently released Rev. Proc. 2018-40 which provides automatic accounting method changes for taxpayers to change their method of accounting to take advantage of the new small taxpayer safe harbors. The accounting method changes require the filing of a shortened Form 3115, *Applicant for Change in Accounting Method*. The accounting method changes for the overall cash method, inventory and uniform allow taxpayers to claim a Section 481(a) catch-up adjustment to account for the differences between their current methods of accounting and the new methods. However, changes in a taxpayer's method of accounting for long-term contracts are required to be applied on a cut-off basis and only apply to contracts entered on or after January 1, 2018.

Revenue Recognition

Several significant changes are occurring with respect to business' revenue recognition methods for both financial accounting and tax purposes. The FASB and IASB issued a new standard revising the rules for businesses across all industries to modify their accounting for revenue. The new standard, ASC 606 – *Revenue from Contracts with Customers*, outlines a 5-step process that all businesses must use to recognize revenue from their customer contracts. The new standard is effective for public entities for periods beginning after December 15, 2017 and for non-public entities for periods beginning after December 31, 2018.

The Act also made several modifications to Section 451 which sets out the general rules for recognizing revenue for tax purposes. Under Section 451(b) which was added by the Act, a taxpayer cannot recognize revenue for tax purposes after the date the revenue is recognized for financial statement purposes. In addition, Section 451(c) of the Act codifies the deferral method of accounting for advance payments received by taxpayers for goods and services to be provided in a later period. This method was previously outlined in Rev. Proc. 2004-34 and is similar, but not identical to, the revised provision in Section 451(c). We are anticipating additional guidance from the IRS in applying both Section 451(b) and Section 451(c).

The interaction of ASC 606 and the Act's amendments to Section 451 may have a significant impact on the tax revenue recognition methods of certain taxpayers. While we are not certain of all of the potential impacts these changes will have on taxpayer's revenue recognition methods, we are advising taxpayers to actively participate in their implementation of ASC 606 and consider the potential tax implications of the new provisions.

Deduction Limitations

In an effort to offset the revenue loss from other provisions of the Act, the Act reduced or eliminated several deductions and benefits available under prior law. Taxpayers impacted by these changes may need to consider what actions they should take to offset the potential increase in their tax liability.

One of the most significant limitations is the limitation on interest expense deductions under Section 163(j). Section 163(j) limits a taxpayer's allowable interest expense to the sum of their business interest income, 30% of their adjusted taxable income and floor plan financing for certain dealerships. The definition of "adjusted taxable income" for purposes of the limitation is not reduced by a taxpayer's depreciation, amortization or depletion for tax years beginning before January 1, 2022. As a result, a taxpayer's adjusted taxable income for purposes of computing its interest expense limitation is not reduced by bonus depreciation for the next few tax years.

Section 163(j) applies to all taxpayers with several exceptions. First, Section 163(j) does not apply to small taxpayers with average gross receipts below $25 Million. This threshold will be determined in the same manner as the small taxpayer threshold outlined above. Additionally, real estate and farming businesses may elect not to be subject to the limitation. In exchange, however, as discussed above, these businesses are required to use ADS recovery periods and methods to depreciate certain assets. Additionally, dealerships that deduct floor plan financing are not eligible to claim bonus depreciation.

The Act repealed the Domestic Production Activities Deduction ("DPAD") under Section 199 for tax years beginning after December 31, 2017. The DPAD provided a deduction for 9% of a taxpayer's income from qualified production activities undertaken in the United States. The Act did not directly provide a replacement provision but did add new Section 199A which provides a deduction of 20% for income of pass-through entities from certain businesses.

The Act also limited the like-kind exchange provisions under Section 1031 to real property for exchanges occurring after December 31, 2017. Many open questions remain regarding how these provisions will be implemented in cases where real property with imbedded personal property is exchanged.

The Act modified a taxpayer's ability to deduct meals, entertainment and commuting expenses. Most entertainment and commuting expenses are no longer deductible and certain meal expenses that were previously fully deductible are now subject to the 50% limitation under Section 274. Additionally, for tax years beginning after 2025, deductions for employer provided eating facilities are disallowed.

Finally, the Act limited the itemized deduction for state and local income and property taxes for individual taxpayers to $10,000. The state income tax for pass-through businesses is also subject to the limitation but the deduction for state and local property taxes incurred by a pass-through business is not.