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THOUGHT LEADERSHIP FROM THE BDO NATIONAL TAX ASC 740 SPECIALTY SERVICES

BDO KNOWS: ASC 740

SUBJECT

Income Tax Accounting Question & Answer Series #3 –

ACCOUNTING IMPLICATIONS FROM THE TANGIBLE PROPERTY "REPAIR" REGULATIONS

PREFACE:

There are numerous tax compliance and financial accounting implications related to the Tangible Property "Repair" Regulations ("Regulations"). The implementation of these Regulations will likely require multiple, annual tax elections and tax accounting method changes. These Regulations affect capitalization procedures and policies related to acquisition, production, and improvement of tangible property and will affect the determination of current taxable income, deferred income taxes, and liabilities for uncertain tax benefits ("FIN 48"). This ASC 740 Q&A addresses the main tax compliance and reporting requirements for businesses and the United States Generally Acceptable Accounting Principles ("GAAP") implications (*i.e.*, financial reporting aspects).

BACKGROUND

In September 2013 the Treasury Department and the Internal Revenue Service completed a nearly ten-year process to study and propose rules related to acquisition, production, and improvement of tangible property by issuing the final Regulations (T.D. 9636). In 2014, the Service and Treasury issued complimentary final regulations for the disposition of tangible depreciable property (T.D. 9689). Prior to issuing the final Regulations, the guidance defining deductible repairs to tangible property consisted of numerous, often conflicting, court cases and complicated rulings. These Regulations establish requirements to

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determine when certain costs for the acquisition, production, and improvement of tangible property may be immediately deducted, capitalized and deducted in the future, depreciated, and the manner and accounting for disposition of tangible property.

The Regulations are effective for the first day of the taxable year that begins on or after January 1, 2014. For taxpayers with a calendar year as their taxable year, the effective date was January 1, 2014. For all other taxpayers, the effective date is the first day of the first taxable year that begins in 2014 (*e.g.*, April 1, 2014, effective date for a taxpayer with March 31, 2014, fiscal year-end).

For financial reporting purposes, these Regulations were enacted in the third quarter of fiscal calendar year 2013 and should have been initially considered in the third quarter of 2013 if they were expected to result in material adjustments to earnings and financial positions.[1]

Q&A 1: What are the key tax provisions covered by the Regulations?

- De minimis expensing "safe harbor" rule: An annual election adopting a minimum capitalization threshold which requires financial statement and taxable income conformity (the election allows expensing amounts beneath a specified dollar amount);

- Materials, supplies, and spare parts: New rules and accounting methods regarding the timing of deductions for consumable items (*e.g.*, fuel, lubricant, and similar items expected to be consumed within 12 months, property with an economic useful life of 12 months or less, items with an acquisition cost of $200 or less) and spare parts;

- Routine maintenance "safe harbor" rule: A new "safe harbor" accounting method which allows taxpayers to deduct expenditures for routine activities to maintain equipment and buildings;

- Acquisition of property: New rules and accounting methods require taxpayers to capitalize amounts that facilitate the acquisition of property;[2]

- Units of property: New accounting method guidelines for determining what is the asset that is being repaired or improved;

- Repair versus improvements: New accounting method rules to characterize expenditures as deductible repairs or capital improvements;

- Small taxpayers "safe harbor" rule: New annual election to simplify compliance with the "repair" and "improvement" rules for small taxpayers;[3]

- Election to capitalize repair and maintenance costs: New annual election to capitalize costs incurred for repair or maintenance if the costs are also capitalized for financial accounting; and

- Disposition of property: New accounting method rules to determine the timing of when property can be disposed of and an election to designate a "partial" disposition of an asset.

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[1] For ASC 740 purposes, these Regulations are considered enacted in September 2013. The effect of a change in tax law is recognized in the period that includes the enactment date (ASC 740-10-35-4).

[2] The Regulations also introduce a new election allowing taxpayers to capitalize certain internal labor and overhead as costs to acquire property and a special rule allowing taxpayers to not capitalize investigatory costs incurred to determine whether to purchase a building or investigating which building to purchase.

[3] The term "small taxpayer" is defined as those taxpayers whose average annual gross receipts for the three preceding taxable years is not more than $10,000,000.

Q&A 2: What are the tax requirements and financial reporting implications of the de minimis expensing "safe harbor" rule?

This new "safe harbor" rule provides taxpayers IRS examination protection for expensing de minimis tangible property by electing to follow a policy to expense the acquisition costs of tangible property up to a maximum amount (or a "ceiling" threshold). Said another way, taxpayers are now allowed to set a minimum threshold for capitalization of certain tangible property costs. The "safe harbor" rule must be elected annually and generally applies to 2014 taxable years and later.[4] However, to avail of this protection, the Regulations require **financial accounting and taxable income conformity**. That is, this new "safe harbor" rule, which allows taxpayers to set a minimum threshold for capitalization, must also be followed for financial accounting purposes (*i.e.*, must be reflected in book income). If a "safe harbor" election is made by an entity which is expensing such costs for financial accounting purposes, the Service will not question the practice of deducting the same amounts for taxable income purposes. If the de minimis expensing policy is not used for book accounting purposes, the deduction on the tax return may be disallowed upon IRS audit, and the costs incurred would have to be capitalized and depreciated.

The de minimis expensing threshold cannot exceed $5,000 for taxpayers with applicable financial statements[5] (generally, audited financial statements). The "ceiling" is compared to the acquisition cost of an asset, the "unit of property". That is, all costs to acquire and place an asset into service must be aggregated together and compared to the capitalization threshold to determine deductibility, if any single amount is less than the threshold. The policy must be in writing if followed on audited financial statements. The Regulations do not specify the extent and the format of a written de minimis expensing policy.

Taxpayers who do not have audited financial statements are limited to a maximum expensing threshold of $500, but the policy is not required to be in writing. However, conformity with the treatment of such costs for book accounting is still required (*e.g.*, compiled financial statements).

In determining whether certain costs fall within or outside the de minimis "safe harbor" threshold, multiple invoices for costs incurred to acquire the asset and place it into service must be aggregated. For example, invoices paid to purchase equipment, install the equipment, and purchase supplementary components of the asset must be aggregated for purposes of assessing whether the cost of the asset is beneath the de minimis threshold. The Service will treat attempts to subdivide the cost of an asset into multiple invoices, each beneath the de minimis threshold, as an abuse of the de minimis "safe harbor" rule. Taxpayers are permitted to compare the de minimis threshold to the per-item cost for "bulk" purchases if the per-item cost is detailed on the invoice, and the per-item cost is less than the de minimis threshold.

The de minimis expensing amount may be changed annually to reflect changing procurement decisions. However, the selected maximum expensing threshold policy should be consistent or in conformity with the treatment of the costs for book income and elected annually by filing an election statement to adopt the "safe harbor." The policy selected may also be influenced by existing covenants, performance and compensation, and other non-tax indicators.

The Regulations do not prevent taxpayers from adopting an expensing threshold greater than the $500 or $5,000 limits. However, the audit protections of the "safe harbor" rule will not apply, and the taxpayer will have to demonstrate that its expensing policy represents a "clear reflection of income" standard for taxable income purposes (see Q&A 3).

Establishing a fixed asset minimum capitalization threshold for United States GAAP (financial reporting) represents an administrative convention rather than the proper application of United States GAAP. This de minimis practice may be used if the effect of such a policy is immaterial to the financial statements. Therefore, the relevant consideration for financial accounting is whether the difference between expensing versus capitalizing and depreciating de minimis amounts results in

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[4] Taxpayers had the option to adopt the de minimis safe harbor for 2012 and 2013 taxable years.

[5] Applicable financial statements include, but are not limited to, financial statements prepared on a GAAP or International Financial Reporting Standards basis.

a material misstatement of income and financial position reported under United States GAAP. Reporting entities should consider whether setting a particular threshold or de minimis amount for expensing will result in a material misstatement to the financial statements and should also discuss the appropriateness of their de minimis expensing policies with their external auditors.

The requirement to maintain conformity between federal income tax treatment and the financial reporting treatment of costs incurred to acquire tangible property is a significant prerequisite to avail of the examination protection afforded by the "safe harbor" rule. Effective implementation of this "safe harbor" rule requires knowledge of financial reporting audit materiality and coordination with internal accounting. If the selected de minimis threshold cannot be followed for financial reporting purposes (presumably, because it would cause a material misstatement of earnings and financial position), but is nonetheless taken or expected to be taken on a tax return, a liability for an uncertain tax benefit ("UTB") might be required.[6] This difference in treatment will also affect measurement of deferred income tax related to tangible property.[7] Therefore, one accounting consequence might be a reclassification of deferred tax liability ("DTL") to FIN 48 liability and recognition of interest expense for a timing-related UTB.[8] A FIN 48 payable for tax accounting methods or/and the de minimis "safe harbor" rule would be included in the FIN 48 rollforward table required to be disclosed in financial statements' income tax footnotes (for public entities). The following example illustrates the accounting:

Example Facts:

Company A is a United States corporation which files a federal income tax return on Form 1120 and has a federal and state applicable tax rate of 40% (the company is profitable and pays current income taxes). In the current year, Company A adopts a de minimis expensing policy for costs incurred at the beginning of the year in connection with tangible property (the policy is to expense costs incurred up to $5,000). However, such policy is not followed in Company A's United States GAAP audited financial statements. During the current year, Company A incurred the following tangible property costs: (1) $4,000 for a large computerized system with a five-year useful life, (2) $3,000 for office equipment with a three-year useful life, and (3) $5,000 for commercial grade printing equipment with a five-year useful life. For book purpose, the costs are capitalized and amortized on a straight-line basis over the assets' respective useful life. Company A is preparing the current-year annual financial statements and is expected to file the current-year Form 1120 shortly after it issues its financial statements.

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[6] Uncertain tax benefits represent an entity's potential future obligations to the taxing authority for tax return positions, previously taken into taxable income or expected to be taken, whose benefit cannot be recognized (or may only be partially recognized) in the financial statements; tax return positions may affect both timing and amount of deduction or income (ASC740-10-25-16 through 25-17).

[7] Temporary differences are differences between book basis of assets and liabilities and their tax basis as determined under the recognition and measurement principles of ASC 740-10, *i.e.*, FIN 48 (ASC 740-10-45-12).

[8] An entity begins recognizing interest expense in the first period the interest would begin accruing according to the provision of the relevant tax law (ASC 740-10-25-56).

Example Analysis:

Assume the de minimis tax policy does not meet the "clear reflection of income" tax standard and therefore fails recognition on technical merits. Company A expects to reduce its current taxable income by $12,000, or a $4,800 reduction in federal and state current tax expense.

The company is proposing to book the following current and deferred tax journal entries:

Debit: Current Tax Payable	$4,800	
Credit: Current Tax Expense		$4,800

(journal entry to recognize reduction in current tax due to immediate expensing of $12,000 tangible property costs)

Debit: Deferred Tax Expense	$3,680	
Credit: Deferred Tax Liability		$3,680

(journal entry to recognize a taxable temporary difference due to book-tax basis difference arising from different expensing policies – for book, a combined $2,800[9] is depreciated for the three assets, while the entire $12,000 costs is expensed for tax – *i.e.*, basis difference of $9,200 times 40%)

However, Company A's tax return position does not meet the recognition requirement because this expensing policy is not followed in preparing the financial statements and a FIN 48 liability should be recognized and reflected in the measurement of deferred taxes related to the tangible assets. The following journal entries are required to reclassify the deferred tax liability to FIN 48 liability and the deferred tax expense into FIN 48 current tax expense (*i.e.*, the journal entries to put the tax balance sheet and income statement on "FIN 48" basis):

Debit: Deferred tax Liability	$3,680	
Credit: FIN 48 liability		$3,680

Debit: Current Tax expense (FIN 48)	$3,680	
Credit: Deferred Tax Expense		$3,680

The FIN 48 liability would be included in the UTB rollforward table required to be disclosed in public entities' income tax footnote disclosure. Company A would also have to comply with the accounting for interest and penalty as required by federal and state tax laws (*i.e.*, in the first period interest and penalty are required). The FIN 48 liability would be reduced and a tax benefit would be recognized as more depreciation is allowed to be claimed.

In "Year 2", Company A would make the following journal entry:

Debit: FIN 48 Liability	$1,120	
Credit: Current Tax Benefit		$1,120

(journal entry to recognize a tax benefit from $2,800 annual depreciation and reverse a commensurate amount of FIN 48 liability)

If interest and penalties are required starting in "Year 2" (which is when the tax return for the current-year is filed), the company would have to accrue and follow its accounting policy election for interest and penalties.[10]

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[9] Total depreciation (three assets combined): Year 1 - $2,800; Year 2 - $2,800; Year 3 - $2,800; Year 4 - $1,800; Year 5 - $1,800 (combined five-year depreciation of $12,000).

[10] ASC 740-10-25-56 through 25-57 and ASC 740-10-45-25.

Q&A 3: May a taxpayer expense amounts greater than the de minimis limits under the Regulations?

Yes. However, electing a policy to expense costs greater than $5,000 (or $500 without audited financial statements) to acquire property will likely face a higher level of IRS scrutiny because such policies would not benefit from the "safe harbor" policy's examination protection. Nonetheless, taxpayers may reach an agreement with the Service to use an expensing threshold amount higher than the de minimis "safe harbor" limits if the taxpayer can demonstrate that a higher expensing threshold is consistent with the "clear reflection of income" tax law standard. To demonstrate that an expensing policy higher than $5,000 (or $500 without audited financial statements) meets the "clear reflection of income" standard, industry practices and financial reporting of certain costs (*e.g.*, a consistent practice of expensing certain items) can be an indication that the practice results in a clear reflection of income. However, no method of accounting is acceptable unless, in the opinion of the Service, it clearly reflects income. Effective implementation (of a higher-than-$5,000 expensing policy) will also require knowledge of financial reporting audit materiality and coordination with internal accounting. If a policy elected and followed on tax returns does not result in a "clear reflection of income," the policy will fail recognition on tax technical merits. Consequently, a position to accelerate deductions would require recognition of a FIN 48 payable and will also affect the deferred tax measurement as discussed in Q&A 5 and illustrated in Q&A 2.

For example, assume a taxpayer has a de minimis policy to expense amounts of $7,000 or less and follows the policy on its audited financial statements because the amount is below the materiality threshold for these financial statements. The taxpayer purchases equipment A for $4,000 and equipment B for $7,000 and expenses both purchases on its applicable financial statements under its de minimis policy. The taxpayer has expensed costs related to equipment B in excess of the "safe harbor" maximum limit of $5,000. The taxpayer would need to determine whether the tax return position meets the requirement for recognition on the financial statements based on technical merits. Upon IRS examination, the taxpayer will have to prove that following its de minimis policy of $7,000 is a clear reflection of income. If the deduction is disallowed by an IRS examiner because it is not a clear reflection of income, the taxpayer will have to capitalize and depreciate such amounts for tax purposes.[11]

Q&A 4: How are other requirements of the Regulations implemented and what are their tax compliance implications?

The Regulations are implemented either through elections made on an original tax return or through requests for changes in accounting methods.

Certain requirements of the Regulations are implemented annually by elections with a formal statement included in a federal income tax return. Other elections are made simply by reporting a position on a tax return. Below is a table of various elections and the manner of electing:

[11] It is not clear at this time if the Service will allow the taxpayer in this example to revert to the $5,000 maximum de minimis threshold amount because the taxpayer will not have book and taxable income conformity for the de minimis expensing policy (*i.e.*, up to $7,000 is expensed for book accounting while a lesser "ceiling" is used for tax purposes).

Election	How Election Made
De minimis "safe harbor" rule (as discussed in Q&As 2 and 3)	Statement required; elect annually by filing paper statement with timely filed original federal tax return
Capitalize employee compensation and/or overhead as facilitating the acquisition of property[12]	No statement required; elect by capitalizing on timely filed original federal tax return
Capitalize and depreciate certain materials and supplies (spare parts)	No statement required; elect by capitalizing and depreciating on timely filed original federal tax return
General asset account[13]	Check box on Form 4562, Depreciation and Amortization, on timely filed original federal tax return
Optional termination of a general asset account	No statement required; elect on timely filed original federal tax return
Optional recognition of gain or loss for partial disposition[14]	No statement required; elect by reporting the disposition and gain or loss on timely filed original federal tax return
Capitalize repair and maintenance costs following book capitalization	Statement required; elect annually by filing paper statement with timely filed original federal tax return
"Safe harbor" for small taxpayers	Statement required; elect annually by filing paper statement with timely filed original federal tax return

Note: Timely filed original return includes extension

Additionally, the Regulations provide for certain changes in tax methods of accounting. Automatic changes are provided by the Service in Rev. Proc. 2011-14 or its successor, *i.e.*, certain changes in tax method of accounting are automatically granted ("automatic" changes) upon the Service's receipt of the request. The Service published additional automatic accounting method change guidance in Rev. Proc. 2014-16 for the Regulations and Rev. Proc. 2014-54 for the complimentary final regulations regarding the disposition of tangible property.

For automatic changes, a taxpayer obtains the Service's consent to change to the new method upon attaching the Form 3115, Application for Change in Accounting Method, to the timely filed (including extensions) federal income tax return for the taxable year of change and filing a copy of the Form 3115 with the Service in Ogden, Utah, on or before the filing date

[12] Taxpayers must capitalize amounts that facilitate the acquisition of real or personal property, unless such costs are deductible under the de minimis threshold. However, amounts paid for employee compensation and overhead to acquire property are treated as costs that do not facilitate the acquisition of real or personal property. This election allows taxpayers to capitalize employee compensation and overhead as costs that facilitate the acquisition of property.

[13] Where the general asset account is elected, a taxpayer capitalizes assets placed into service into "groups" of assets or a "general asset account(s)" ("GAA"). Assets are placed into a GAA with assets of the same depreciation method, convention, recovery period, and in-service period. When an asset in a GAA is disposed of, any proceeds received are recognized in taxable income. The basis of the asset remains in the GAA and continues to be depreciated unless the taxpayer elects to terminate the GAA upon the disposition of all assets or the last asset in the GAA or makes a qualifying disposition election.

[14] This election allows a taxpayer to recognize a gain or loss on the disposition of a portion of an asset. For example, assume a taxpayer replaces a roof on a building and capitalizes the new roof as an improvement. Now the taxpayer has two roofs capitalized (old and new) but only possesses one physical roof. The taxpayer has the option to make an election to claim a partial (part of the building structure, but not the entire building) disposition of the old roof and write off the undepreciated basis of the old roof.

of that return. No IRS user fee is required with an automatic change. While there are an increasing number of automatic changes each year, any accounting method change not specifically listed as an automatic change under Rev. Proc. 2011-14 or its successor is, by default, a non-automatic change.[15]

Unlike an automatic change, a non-automatic change entails a written submission of the legal authorities supporting the change in method, an IRS user fee, a higher level of review by the Service, and an accelerated due date. A non-automatic Form 3115 must be filed with the IRS National Office in Washington, D.C., on or before the last day of the taxable year of change. A taxpayer has secured consent from the Service to change to the new method when the Service provides a written consent agreement in response to the non-automatic Form 3115 and the taxpayer (1) timely signs and returns the consent agreement to the IRS National Office and (2) attaches a copy of the signed consent agreement statement to its federal tax return for the year of change.

Elections and requests for changes in tax accounting methods must be made on a timely-filed current-year income tax return. Therefore, the elections only apply to the year in which they are made (i.e., cannot be made for a taxable year where a tax return has already been filed). Further, some elections are annual elections, requiring taxpayers to decide every year whether to make a particular election.

An accounting method change generally results in a cumulative catch-up adjustment (a “section 481(a) adjustment”) which is calculated, as of the beginning of the year of change, as the difference between the deductions determined and claimed on the returns filed under the old method and the cumulative deduction that would have been claimed if the new accounting method were used from the initial period (this calculation is required even if the statute of limitation for the prior taxable year(s) is closed).

Certain method changes are implemented on a cut-off basis, which means the method change is made without a section 481(a) adjustment; only the items arising on or after the beginning of the year are accounted for under the new method of accounting, while costs in prior years are accounted under the former method. Certain method changes under these Regulations are calculated on a modified cut-off basis. Under this approach, the section 481(a) adjustment is calculated back to the beginning of 2014 but not earlier, an approach which will become more relevant to taxable years subsequent to 2014.

A cumulative adjustment that is an increase to taxable income (a “positive” or unfavorable adjustment) must be recognized in taxable income over four years; an adjustment that is a decrease (a “negative” or favorable adjustment) to taxable income reduces taxable income at once in the current year of change.

For example, a business entity incurred a cost for repairs in 2005 which was capitalized as an improvement to a building and is being depreciated over 39 years starting from 2005. The entity decides to file an automatic accounting method change in 2014 to deduct the expenditure as a repair. The entity expects to attach a Form 3115 to its 2014 tax return which will be filed on extension during the latter part of 2015 and include a section 481(a) “repair deduction” adjustment. The adjustment is determined as the difference between the gross repair costs incurred in 2005 and the depreciation claimed in all tax returns since 2005 through the beginning of 2014. The result is a section 481(a) “favorable” adjustment (equal to the undepreciated basis of the repair expenditure incurred in 2005) that reduces taxable income in 2014.

When an impermissible accounting method is used in a prior year, filing an accounting method change in 2014 to adopt the final Regulations will provide the taxpayer protection upon IRS examination and avoid payment of interest (and penalties) for all periods prior to the year of change for the method of accounting.

[15] Automatic accounting method changes are generally subject to scope limitations, or restrictions on their availability to all taxpayers, *e.g.*, same method change filed within the previous five years, under IRS examination, last year of a trade or business. The scope limitations applicable to the Regulations are waived for 2014 taxable year. Subsequent to 2014, taxpayers may be precluded from filing automatic accounting method changes under the Regulations because of the scope limitations. Such taxpayers will have to file non-automatic accounting method changes where the scope limitations prevent filing an automatic accounting method change.

A taxpayer under IRS examination may request an automatic accounting method change for an impermissible tax method if the taxpayer obtains written consent from the examining agent that the method of accounting is not an item under exam. However, this requirement to obtain written consent from an IRS examining agent is waived for accounting method changes filed for the 2014 taxable year solely for purposes of complying with these Regulations.

The financial reporting implications of tax accounting method changes are explained in Q&A 5.

Q&A 5: What are the financial reporting considerations and implications from the Regulations' tax elections and accounting method changes?

The Regulations may affect financial reporting in a number of ways:

- **Current provision for income taxes:** The Regulations may affect the determination of taxable income for the current period.

- **Deferred income taxes:** Implementing these Regulations will also affect recognition and measurement of deferred taxes related to tangible property and the balance sheet classification of these deferred taxes (refer to detailed discussion below).

- **Effective Tax Rate:** The Regulations affect the timing (as opposed to the amount) of deductions. While timing-related items generally should not change the effective rate, sometimes there are indirect effects on valuation allowance (*e.g.*, when reversal pattern of deferred tax assets and liabilities changes), interest expense, and special deductions (*e.g.*, section 199 for domestic production) which are tied to taxable income.

- **Uncertain Tax Positions:** Taxpayers may take or expect to take tax return positions which are not supported under these Regulations. As explained in Q&A 2, FIN 48 liabilities and interest may arise from timing-related uncertain positions (the FIN 48 liability would also be reported on IRS Form Schedule UTP).

The recognition and measurement of temporary differences related to assets and liabilities affected by changes in tax accounting methods are explained in ASC 740-10-55-58 through 55-63.

For financial reporting, a tax accounting method change could result in an initial catch-up adjustment (discussed in Q&A 4) which affects current income tax provision and two temporary differences which affect deferred tax provision. One temporary difference is related to amounts that were previously deducted or capitalized but are required to be capitalized or expensed under the new tax accounting method (*i.e.*, a temporary difference in the underlying asset or liability). Another temporary difference arises from the recognition of a positive cumulative catch-up adjustment (*i.e.*, deferred income for tax purposes) required to be included in taxable income over four years. A deferred tax liability is recognized in income tax expense for this deferred income (for tax purposes) and is released to income tax expense as deferred income is included in taxable income ratably over four periods (or a shorter period if required).

The recognition of a deferred tax liability for the cumulative catch-up adjustment would also affect the classification of the related deferred taxes in a classified balance sheet. The portion of the deferred tax liability (recognized for the catch-up adjustment) that is expected to be included in next year's taxable income would be classified as current. The deferred tax liability (or deferred tax asset) related to tangible property is classified based on the classification of the related asset for financial reporting, which typically results in noncurrent classification.[16]

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[16] ASC 740-10-45-7 Note: The FASB has proposed to eliminate "current" classification and require "noncurrent" classification for all deferred taxes (for more information on the FASB proposal, see BDO Knows ASC 740 alert issued in November 2014 *FASB Votes to Issue Exposure Draft on Tax Recognition for Intra-entity Asset Transfers and Balance Sheet Classification for Deferred Tax Items*).

The timing of recognition in the financial statements depends on whether the method change is required by a tax law change or is voluntary. Additional complexities arise when a change from an impermissible to a permissible tax accounting method is required to avoid interest and penalties.

If a tax accounting method change is required by a change in tax law, the effect of the method change would be reflected in the period that includes the enactment date (ASC 740-10-55-62).

When the filing of a method change is voluntary, the guidelines in ASC 740-10-25-33 related to changes in tax status serve as principles to determine the timing of recognition. Accordingly, the effect of an election for a voluntary change is recognized on the approval date or on the filing date if approval is not necessary. This means that no recognition should be given in the financial statements for the expected tax return effect from non-automatic tax accounting method change until the period in which the Service provides a written consent agreement. For automatic method changes, the timing of recognition should coincide with management's decision and expectation to file an automatic change because there are no administrative hurdles or approvals potentially preventing the acceptance of an automatic method change. For example, if management decides at year-end that a voluntary automatic method change is available and is beneficial and therefore will be filed with the current-year tax return, the anticipated effect should be accounted for at year-end even though the filing of the current-year return and Form 3115 is expected in the following year.[17]

When an impermissible method is used in prior years, a Form 3115 should be filed as of the last day of the current year to avoid accruing interest and penalties in the financial statements. However, if the Form 3115 is not filed as of the end of current fiscal year but is expected to be filed after year-end but before the issuance of the financial statements, there are conceptual arguments in support of (a) accruing interest and penalties in the current year's financial statements and then reversing them in the subsequent period when the form is filed, or (b) not accruing interest and penalties based on management's expectation and ability to effectuate the filing of a method change before the financial statements are issued. BDO does not object to either approach, depending on the facts & circumstances.

Q&A 6: What tax return compliance disclosures are necessary?

The Service expects most taxpayers to file accounting method changes with their 2014 tax returns. Taxpayers should identify current accounting methods not in conformity with the final Regulations and consider filing Forms 3115 in the current year to benefit from IRS audit protection afforded taxpayers that voluntarily file Forms 3115 to switch from impermissible methods.

Where an accounting method is contrary to the Regulations and a request for accounting method change is not filed, taxpayers should consider disclosing the position on Form 8275-R, Regulation Disclosure Statement, to mitigate certain tax penalties. Interest accrual is still required on any amount of tax owed. Taxpayers whose tax accounting methods are considered uncertain positions resulting in UTBs and whose gross assets exceed a specified threshold are also required to disclose the uncertain tax positions on Schedule UTP (Form 1120), Uncertain Tax Position Statement.

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[17] Applying an expectation-based accounting is consistent with other provisions in ASC 740: measurement of deferred income tax should reflect the effects of tax elections expected to be made in the future (ASC 740-10-55-23) or the expected type of taxable or deductible amounts in future years (ASC 740-10-55-24), and recognition of deferred tax assets is allowed based on expected tax filing of a combined entity resulting from a business combination (ASC 805-740-30-3).

ADDITIONAL INFORMATION

Please refer to the following resources for additional information:

BDO KNOWLEDGE Webinar - Tangible Property Regulations: New Rules Updates & Highlights – recording here.

BDO/CCH Special Report: Comprehensive Analysis of Final Repair/Capitalization Regulations – here.