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Tax Accounting Perspectives

New accounting update requires changes to accounting for leases
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As Accounting Standard Update ("ASU") No. 2016-02, Leases (Topic 842), becomes effective for public business entities in fiscal years beginning after December 15, 2018, companies should consider how to implement the necessary changes to book and tax accounting methods and calculations to prepare appropriately for adoption.

What's new?

New ASU requires changes to accounting for leases

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-02, which amended the accounting for leases and replaced ASC 840 with ASC 842.

ASC 842 applies to leases of property, plant, or equipment, but does not apply to leases of intangible or biological assets, inventory, or assets under construction. It is effective for years beginning after December 15, 2018 for public entities and December 15, 2019 for private entities, and early adoption is permitted.

Highlights

Operating leases are recorded on the balance sheet with an offsetting asset and liability

Under ASC 840, leases are classified as either operating or capital. Capital leases are generally arrangements in which the lessor only finances the leased asset, and all other rights of ownership and obligations transfer to the lessee. Operating leases allow the use of an asset but do not involve a change in ownership.

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What does this mean for you
- Adjustments to deferred taxes
- Transition rules
- Potential changes to state or local taxes

Deloitte perspective
Don't wait to assess the impact of implementation

Before the adoption of ASC 842, operating leases were considered “off-balance sheet” liabilities, as no liability was recorded for expected future rent payments. Similarly, no asset was recorded on the balance sheet for leased assets.

Under the new guidance, a lessee will be required to recognize a right-of-use (“ROU”) asset and lease liability for contracts with a term of more than 12 months. Any unamortized lease balances from ASC 840 (e.g., prepaid or deferred rent) will also be included in the ROU asset.

Once adopted, a lease will be classified as either an operating lease or finance lease by the lessee, based on the lease arrangement. For finance leases, interest and amortization expense are recognized. Operating leases result in a lease expense, typically expensed on a straight-line basis.

The accounting for lessors remains relatively unchanged under the ASU. See Deloitte’s Heads Up, Volume 23, Issue 25, for further discussion of the standard

What does this mean for you

Adjustments to deferred taxes

While the income tax treatment of the lease remains unchanged, a change in the book accounting for leases necessitates an analysis of the related deferred tax implications of the standard once adopted.

For operating leases, a lessee generally records a deferred tax asset or liability under current U.S. Generally Accepted Accounting Principles.

Once adopted, ASU 842 results in the recognition of a lease asset and a lease liability which would generally result in a change in lease related book/tax basis differences and corresponding deferred taxes.

Transition rules

ASC 842 currently requires entities to use a “modified retrospective” transition approach that is intended to maximize comparability and be less complex than a full retrospective approach.

However, on January 5, 2018, the FASB issued a proposed ASU amendment that will allow entities to elect not to restate their comparative periods in transition. Effectively, the amendment would allow entities to change their date of initial application to the beginning of the period of adoption. Comments on the proposed ASU were due by February 5, 2018.

Potential changes to state and local taxes

Certain state and local tax apportionment formulas include property and rent payments in the calculation of income allocated to the jurisdiction. Therefore, the changes to recognition of leases under ASC 842 could cause a change to the state income tax rate utilized in a company’s tax provision and measurement of deferred tax assets and liabilities.

Deloitte perspective

Don’t wait to assess the impact of implementation

As the effective date of the ASU approaches, entities should anticipate the potential changes to the recognition of income and expense as well as the balance sheet presentation for financial reporting purposes, including the related deferred tax implications.

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