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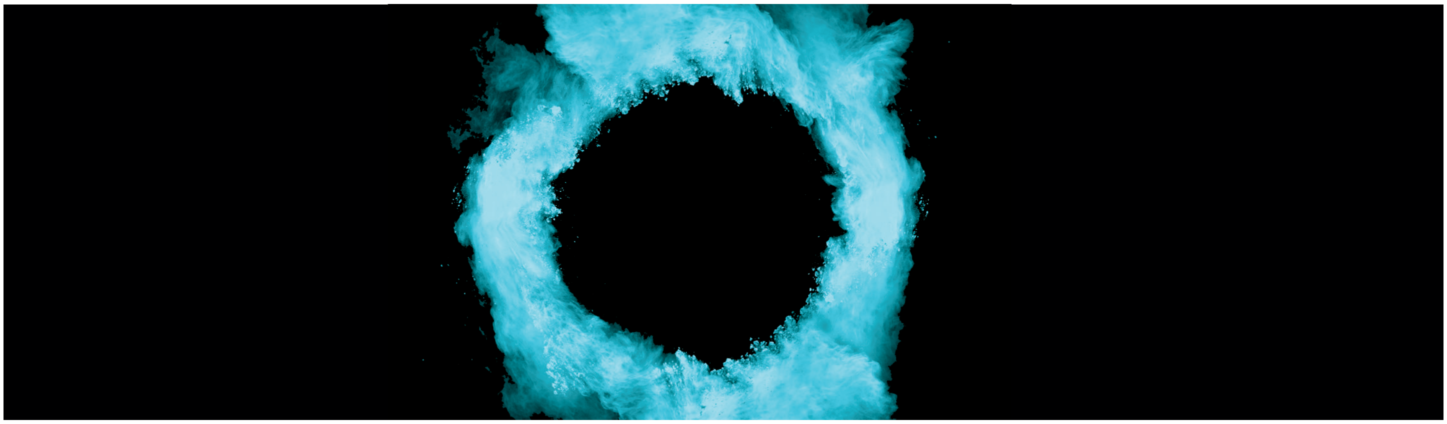

Addressing tax implications of the new ASC 842 lease accounting standard

The new lease accounting standard, ASC 842, has been on the minds of many CFOs in recent months. Compliance is demanding. Implementation is exacting. Systems are complex.

Preparing for day one is naturally a primary objective for nonpublic entities looking ahead at a 2022 implementation. But thinking beyond that first day of new lease accounting processes is equally important.

You might have processes in place to account for all your leases, but those processes will likely have ripple effects throughout your organization that may not be apparent until well after day one. The implications of the new requirements from the tax perspective will likely be among one of the most significant areas of impact.

While US generally accepted accounting principles (GAAP) rules around lease accounting are changing, the rules governing the accounting for income taxes for leases are not. Whether a nonpublic entity preparing for implementation or a postadoption public entity facing this challenge on a business-as-usual basis, it's crucial that an organization's tax team adapts to new lease accounting systems and develops new processes to perform the same data extraction they did before the new standard.

It is critical for CFOs to bring their tax teams to the table during implementation of the new lease accounting standard. If implementation is already underway without the tax team's involvement, CFOs may need to push for having well-documented implementation procedures that tax leaders and other stakeholders outside of accounting can effectively leverage. At the same time, the tax leaders within the organization should be ready to communicate their needs in the new environment and how their work can best be accomplished.

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New accounting processes, same tax requirements

The new lease accounting standard has increased visibility into the data used to reflect leases in the financial statements. Even so, companies may find it more challenging to identify and track book-tax differences because the data needed to apply the tax requirements may now be obscured as a result of applying to new lease accounting guidance.

What are the big changes?

- Because the right-of-use (ROU) asset is composed of different components, each with unique tax implications, the traditional change-in-balance approach to identifying book-tax differences may no longer apply.
- Since certain lease-related balances, such as initial direct costs and lease incentives, are tracked separately for tax reporting purposes, the tax practitioner's ability to identify each of these relevant components may be more challenging, as these balances are collapsed into the ROU asset under the new lease accounting standard.

With the new lease accounting standard comes new processes and software—and new hurdles for tax teams to gather the data they need. Many calendar-year-end public companies that had to address the new standard in their financial statements for 2019 found it difficult to obtain the information required to maintain certain tax methods. Private companies can learn from these challenges.

Three challenges CFOs can expect

To reduce last-minute scrambling and costly mistakes, CFOs should understand key challenges of the tax implications for leases that the new lease accounting standard has created. What does the intersection of new accounting practices and existing tax rules have in store for the finance function? These are the leading three key areas that may be affected:

Assessing the impact on deferred tax balances within financial statements

Determining the deferred tax balances specific to the ROU asset and lease liability is unavoidable under the new lease accounting standard. The biggest surprise for many public companies was that their deferred tax asset and liability balances needed to be adjusted for the impact of the new requirements.

A primary challenge companies have faced is the inability to use the book value of the recorded ROU assets and lease liabilities to record the new deferred balances. To avoid inaccurate tax expense, companies should perform further analysis of these accounts.

Identifying methods of tax accounting for leases that may be impermissible

The change in how leases are accounted for under the new lease accounting standard is revealing impermissible methods of tax accounting for leases that need to be corrected going forward.

The movement of existing accounts, such as deferred rent, lease incentives, and prepaid rent, into the single ROU asset is forcing tax departments to evaluate the existing treatment of legacy lease accounting methods. Many taxpayers have historically defaulted to the US GAAP accounting treatment for leasing tax methods, which is often impermissible. Impermissible methods are considered uncertain tax positions in the financial statements and can affect the effective tax rate of a company.

Responding to changes in accounting lease treatment

When applying the new lease accounting guidance, tax should also take the new data into consideration and determine if it warrants a corresponding change from the tax perspective.

A change in the definition of initial direct costs under the new lease accounting standard has pushed some companies to change the capitalization of these costs. Tax should evaluate if the new accounting treatment is permissible to follow or if the change in accounting results in a new book-tax difference.

Act early

With ASC 842 taking effect for nonpublic, calendar-year-end entities on January 1, 2022, it may seem like there's plenty of time for CFOs to address the implications pertaining to tax accounting for leases, but starting early is advised.

While tax teams still need the same data they needed before ASC 842, where and how that data is housed might have changed. Companies that decide to cross that bridge when they get to it could find themselves under the bridge and swimming against the current when tax time 2022 arrives. Tax teams scrambling at the 11th hour are more likely to spend extra time digging for the relevant data they need. That could lead to mistakes in the rush to complete work and the potential submission of incorrect financial statements that could catch the attention of the financial statement users, the board, or the IRS.

Addressing the tax implications of the new ASC 842 lease accounting standard will require collaboration that CFOs need to foster. As accounting functions dive deep into their lease population, tax professionals should be right there with them, identifying potential tax reporting issues in real time as the company's lease portfolio is inventoried and reorganized. The sooner CFOs bring tax to the table as a key stakeholder in ASC 842 implementation planning, the more confident they'll likely be that their new lease accounting processes are in line with existing tax rules.

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Let's talk

Whether you need help keeping track of deferred tax assets, impermissible tax accounting methods, or changes to accounting lease treatments, Deloitte has services that may support CFOs as they lead implementation of the new lease accounting standard and bring tax to the table. Don't let the tax implications of ASC 842 take a back seat. Start focusing on what you need today.

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