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Accounting considerations of US tax reform
Summary of major provisions and potential effects

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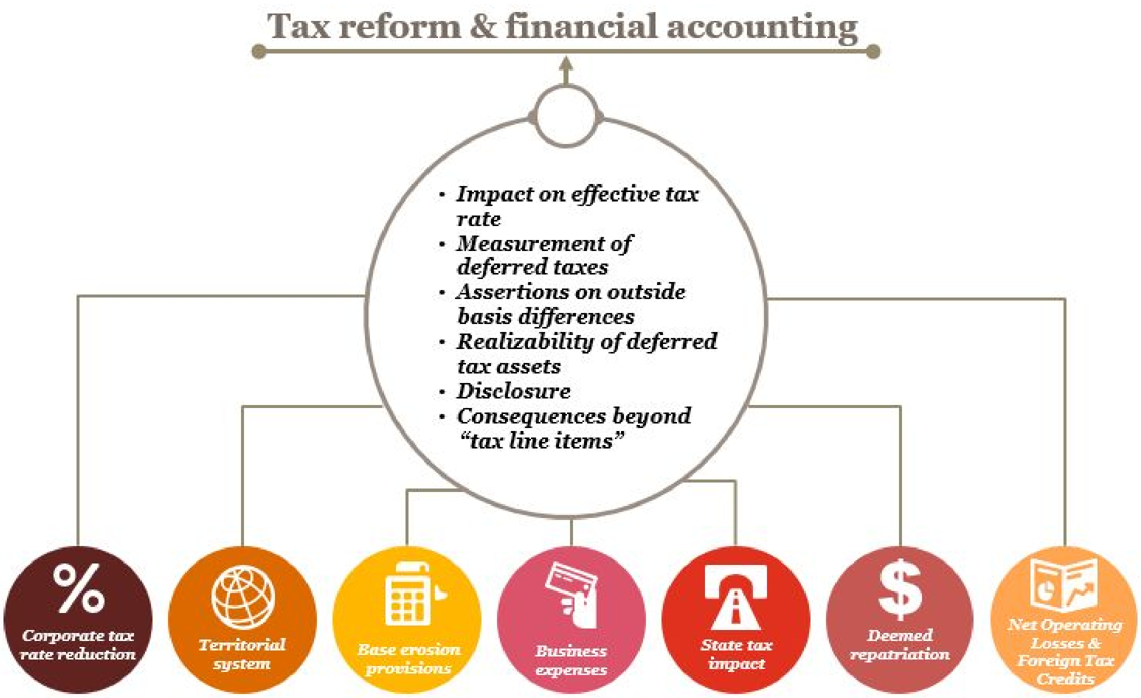
At a glance

On December 22, 2017, President Trump signed tax reform legislation (the 2017 Act), which includes a broad range of tax reform proposals affecting businesses, including corporate tax rates, business deductions, and international tax provisions. Many of these provisions significantly differ from current US tax law, resulting in pervasive financial reporting implications. Considering that the tax effects of changes in tax laws or rates need to be recognized in the period in which the law is enacted, this *In depth* includes an overview of accounting for tax law changes, key provisions of the 2017 Act, and details regarding how it will impact the financial statements.

Overview of accounting for US tax reform

The enactment of US tax reform represents a fundamental and dramatic shift in US taxation, which will have pervasive financial reporting implications for all companies with US operations. Companies will undoubtedly face challenges in accounting for the impact of tax reform. The speed with which the law was passed and the proximity to the end of the calendar year means that companies will need to understand the law, including a large number of anticipated Treasury interpretations, assess how to apply it to their facts and circumstances, gather data, and calculate the impact all in a very compressed timeframe.

Highlights of the financial reporting issues and significant provisions of reform include:



When to account for tax law changes

Under US GAAP, changes in tax rates and tax law are accounted for in the period of enactment. For US federal purposes, the enactment date for US GAAP is the date the President signs the bill into law.

Under IFRS, changes in tax rates and tax law are reflected when enacted or substantively enacted. While in some jurisdictions this could result in differences in the enactment date, there is not a difference for changes in US federal law.

How to account for tax law changes

Under US GAAP, the effect of a change in tax law is recorded discretely as a component of the income tax provision related to continuing operations in the period of enactment. This is true even if the deferred taxes being remeasured were established through a financial statement component other than continuing operations (e.g., other comprehensive income (OCI) or acquisition accounting). Adjusting temporary differences originally recorded to OCI through continuing operations may result in a disproportionate effect lodged in OCI. In other words, the original deferred tax amount recorded through OCI at the old rate will remain in OCI despite the fact that its related deferred tax asset/liability will be reduced through continuing operations to reflect the new rate. We believe that the disproportionate effect that remains in OCI should be eliminated when the circumstances upon which it is premised cease to exist (see PwC's *Income taxes* guide, Section 12.3.3.3). Changes in the valuation allowance assessment due to tax reform would also be recorded to continuing operations in the tax provision.

PwC observation:

IFRS requires the remeasurement of deferred taxes to be recorded outside profit or loss if the deferred tax relates to items previously recognized in OCI or equity, commonly referred to as "backwards tracing." It might sometimes be difficult to determine how to allocate the remeasurement. For example, a change in tax rate may affect a deferred tax balance that was previously recognized partly outside profit or loss (e.g., in connection with an employee benefit liability). In such cases, a pro rata or other more suitable method can be used to achieve an appropriate allocation.

Potential differences between US GAAP and IFRS

While the tax accounting analysis under US GAAP and IFRS is largely similar, there are some key differences in addition to those noted above. For example, certain provisions of the 2017 Act may be accounted for as a special deduction under US GAAP, but the concept of "special deductions" does not exist under IFRS. Therefore, it is possible that certain provisions may be evaluated differently under US GAAP versus IFRS. Differences between the two standards in the areas of financial statement disclosures, discounting, accounting for outside basis differences, and uncertain tax positions may result in different accounting conclusions with regard to the 2017 Act as compared to US GAAP.

Tax accounting implications of domestic provisions

Applicable tax rate

The 2017 Act reduces the corporate tax rate from 35% to 21% for tax years beginning after December 31, 2017. A blended tax rate would apply for non-calendar year-end companies for their fiscal periods that include the effective date of rate change. For example, a June 30, 2018 year end (FY18) taxpayer would apply a blended rate of 28% (6 months at 35% and 6 months of 21%) to its FY18 taxable income. The reduced 21% rate would then apply to all future years.

Tax accounting implications

ASC 740, *Income Taxes*, requires deferred tax assets and liabilities to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. Thus, at the date of enactment, deferred taxes will need to be remeasured based upon the new 21% tax rate. For non-calendar year-end companies, scheduling will be necessary to determine which deferred taxes will reverse at which rate.

The timing of reversals of temporary differences may not be the only consideration in determining the applicable tax rate. The applicable rate is determined by reference to the rate expected to apply when the reversal affects the amount of taxes payable or refundable. For example, consider a June 30 fiscal year company measuring an existing tax deductible temporary difference. In their June 30, 2018 fiscal year, the company expects to generate tax losses and for the existing temporary difference to reverse. Because the company is expecting to generate a loss, no taxes would be due and the reversal of the deductible temporary difference would have no impact on taxes payable. As a result, it should be measured at 21%, which is the rate expected to be in effect when the reversal will affect taxes payable or refundable. The blended rate would not be utilized since the reversal of the temporary difference does not impact taxes payable. Conversely, if the company expected to be profitable, the measurement of the reversing temporary difference would be at the applicable blended tax rate (the rate at which the temporary difference affected the payable).

Another common question arises regarding the applicable rate for fiscal year end companies when an existing temporary difference is expected to reverse during the year, but a new, similar temporary difference will be created by year end. For example, consider a company with a temporary difference at its June 30, 2017 year end date for a bonus accrual that is not tax deductible until paid. The bonus accrual is paid in fiscal 2018 and a new, similar bonus accrual arises. In scheduling, companies should only consider the reversal of the existing differences. In this scenario, the existing temporary difference would reverse at the blended rate and be replaced by a new deferred balance at a 21% rate.

PwC observation:

When the statutory tax rate is constant between periods, so-called "return-to-provision" adjustments for temporary differences do not generally impact the overall reported tax rate. This may change with tax reform. For example, calendar year return-to-provision adjustments would impact the current provision at a 35% rate but impact the deferred provision at 21%.

Repeal of AMT tax

The 2017 Act repeals the AMT regime for tax years beginning after December 31, 2017. For tax years beginning in 2018, 2019, and 2020, the AMT credit carryforward can be utilized to offset regular tax with any remaining AMT carryforwards eligible for a refund of 50%. Any remaining AMT credit carryforwards will become fully refundable beginning in the 2021 tax year.

Tax accounting implications

Any existing valuation allowances on AMT credit carryforwards should be released as part of accounting for tax reform since the asset is fully refundable. While an argument can be made that any AMT credit carryforwards should be reclassified as a receivable at the time of enactment, we believe the interaction with ongoing tax liabilities provides support for continuing to treat the AMT as a deferred tax asset.

Changes in NOL deduction

For net operating losses (NOLs) arising after December 31, 2017, the 2017 Act limits a taxpayer's ability to utilize NOL carryforwards to 80% of taxable income. In addition, NOLs arising after 2017 can be carried forward indefinitely, but carryback is generally prohibited. NOLs generated in tax years beginning before January 1, 2018 will not be subject to the taxable income limitation and will continue to have a two year carryback and 20 year carryforward period.

Tax accounting implications

Deferred tax assets for NOLs will need to be measured at the applicable tax rate in effect when the NOL is expected to be utilized. The changes in the carryforward/carryback periods as well as the new limitation on use of NOLs may significantly impact valuation allowance assessments for NOLs generated after December 31, 2017.

ASC 740 identifies four sources of taxable income to support realization of deferred tax assets. The changes in US tax law will limit two of those sources in future periods with regard to NOLs. One source, taxable income in prior carryback years, is eliminated for NOLs arising after 2017. Another source, tax-planning strategies, is limited. This is because tax-planning strategies, as defined in ASC 740, are actions an entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. Since NOLs generated after December 31, 2017 will not expire, a tax-planning strategy, by definition, would not provide a source of future taxable income.

However, tax actions that management has already implemented, are in the process of implementing, or committed to implementing in the near term may be reflected in estimates of future taxable income if they are supported by objectively verifiable evidence (see PwC's *Income taxes* guide, Section 5.6).

As companies schedule deferred taxes at the new rate and also consider the realizability of deferred tax assets, they should consider how deferred tax assets other than NOLs will reverse. If the reversal is expected to generate an indefinite carryforward NOL, this may impact the valuation allowance assessment. Some deferred tax assets, such as those relating to capital losses, may be subject to other limitations. The indefinite carryforward period for NOLs may also mean that deferred tax liabilities related to indefinite-lived intangibles, commonly referred to as "naked credits," can be considered as support for realization.

PwC observation:

As the naked credits may provide an income source for the indefinite lived NOLs, companies with a full valuation allowance and naked credits could have a valuation allowance release upon enactment.

The mere existence of deferred tax liabilities, however, does not make them a dollar-for-dollar source of taxable income. The limitation on NOL usage to 80% of taxable income for future NOLs may shift loss utilization into later years or suggest that deferred tax liabilities in future periods are insufficient to support realization. For example, consider a company with a $100 NOL and a $100 deferred tax liability. The $100 deferred tax liability would provide an income source to utilize $80 of the NOL. Thus, due to the limitations on NOL usage, and in the absence of other sources of taxable income, a valuation allowance of $20 would be necessary.

Cost recovery (full expensing)

The 2017 Act would allow companies to expense 100% of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023 (an additional year is provided for certain property with longer production periods). The 100% expense provision is phased down by 20% per calendar year beginning in 2023 (i.e., 80%, 60%, 40%, and 20% for calendar years 2023 through 2026, respectively), with normal depreciation rules applicable after that. The phase out begins in 2024 for certain property with longer production periods. Companies can elect not to immediately expense qualified assets.

Tax accounting implications

Companies planning to fully expense qualified property would need to consider the fact that it can be elected for property placed in service in 2017. The current tax benefit in 2017 would be at a higher rate than the reversal of the temporary difference in later years. Additionally, many states decouple from or modify federal bonus depreciation rules. Companies may face complexities in measuring state current and deferred taxes, especially for states that do not conform to federal tax rules.

Full expensing of certain expenditures would likely result in additional taxable temporary differences for fixed assets and may result in additional deferred tax assets for operating loss carryforwards to the extent there is a taxable loss. Companies will need to consider the implications of full expensing with regard to the realizability of any resulting NOL deferred tax assets.

> **PwC observation:**
>
> The creation of NOLs in 2017 through the full expensing provisions may be beneficial. NOLs arising before January 1, 2018 will not be subject to the 80% taxable income limitation and may be carried back for two years.

Interest expense limitation

Deductions for net interest expense are limited to 30% of adjusted taxable income, which is defined similar to EBITDA (earnings before interest, taxes, depreciation, and amortization). For tax years beginning after December 31, 2021, the calculation of adjusted taxable income is defined similar to EBIT (earnings before interest and taxes).

Unlike current law, this limitation applies to interest generated on both related-party and unrelated-party debt. Any disallowed interest can be carried forward indefinitely. Any carryforwards would be subject to change in ownership limitations under Section 382.

Tax accounting implications

In future periods, more companies may have interest limitations and an additional deferred tax asset for interest carryforwards. The new interest limitation rules under the 2017 Act are generally more broadly applicable than existing interest limitations. These interest carryforwards would need to be assessed for realizability. While it may take many years, due to the indefinite carryforward period for interest carryforwards, a valuation allowance may not be needed in situations when a company is currently profitable. Additionally, any existing interest limitation carryforwards would need to be assessed for realizability. The transition rules for these attributes are currently unclear.

When companies experience volatility in EBITDA, there may be added complexity in both projecting the annual interest limitation and assessing the realizability of deferred tax assets for interest carryforwards.

Executive compensation and other provisions

The 2017 Act retains the $1 million limitation on deductible compensation to covered employees. However, it eliminates the current exception for performance-based compensation and expands the definition of covered employees to include the chief financial officer. The limitation is extended to apply to a broader population of SEC filers and not just to those whose securities are traded on an exchange.

The expansion of executive compensation limitations are effective in 2018, but transition rules apply. The modifications do not apply to remuneration paid pursuant to a written binding contract in effect on November 2, 2017 if it was not materially modified on or after that date.

Other provisions of the 2017 Act may be relevant to particular industries and companies. Some provisions that may have a financial statement impact include the following:

- Certain specified research or experimentation expenditures would be capitalized and amortized over a five-year period (15 years for research outside the US) beginning in tax years after December 31, 2022. Currently, taxpayers can deduct these expenditures immediately or elect to amortize them over five years.

- The IRC Section 199 deduction for qualified domestic production activities is repealed.
- The following expenses are not deductible under the 2017 Act: entertainment, amusement, or recreation expenses, membership dues for clubs, and expenses incurred for the use of facilities in connection with these items.

Tax accounting implications

Companies will need to carefully evaluate the impact that these and other changes in law will have on their existing financial statement positions and disclosures in order to appropriately account for US tax reform. For example, existing deferred tax assets for stock-based compensation may be impacted, depending on application of the transition rules. The financial reporting impact will vary depending on specific facts.

Tax accounting implications of international provisions

Territorial regime

The 2017 Act introduces international tax provisions that fundamentally change the US approach to the taxation of foreign earnings, including the implementation of a territorial system (or partial territorial system in some instances) by providing a 100% dividend received deduction (DRD) on certain qualified dividends from foreign subsidiaries. Domestic corporations will continue to apply existing subpart F rules.

Tax accounting implications

This provision, coupled with other international provisions discussed below, significantly impacts the accounting for outside basis differences. The change to a territorial system may reduce the significance of evaluating outside basis differences and the indefinite reinvestment assertion as the US tax cost of dividend remittances will generally be reduced. However, the outside basis accounting model has not changed. Companies will need to continue to assess and evaluate their intentions with respect to outside basis differences. Companies can continue to assert that some or all of their undistributed earnings are indefinitely reinvested provided they have the ability and intent to do so, along with specific plans for reinvestment of those earnings. Those that do not assert indefinite reinvestment need to account for any potential costs, such as any future foreign taxes that would be withheld on distributions.

PwC observation:

It may be more difficult to overcome the presumption that undistributed earnings will be transferred to a US parent entity. This is because, as a result of the DRD, the incremental tax on remittance may be relatively minimal (i.e., it will consist of only foreign withholding taxes, state tax, and foreign currency translation effects). It may also be difficult to overcome the presumption if overseas cash is needed to fund significant liabilities in the US, such as the toll charge liability, discussed below. However, the ability to assert indefinite reinvestment remains. For example, it may not be appropriate to remove an assertion in jurisdictions where an entity is prevented from remitting earnings, has reserve requirements, or has projected working capital and other capital needs in the country where the earnings were generated.

New judgments on the indefinite reversal criteria are required as of each balance sheet date at each level of an organization. Companies still need to declare their intentions with respect to their outside basis differences. Companies that do not assert indefinite reinvestment may need to record deferred tax liabilities for the potential tax consequences of recovering the outside basis difference at the date of enactment of the new law, and reassess their assertion on an ongoing basis. Enactment of a territorial system along with the deemed repatriation provision discussed below could result in changes in management's intentions. To the extent a company changes its indefinite reinvestment assertion, the impact is reflected in tax expense in the period of change and appropriate financial statement disclosure should be made.

In order to calculate or measure the tax effect of an outside basis difference, a realistic and reasonable expectation as to the time and manner of the expected recovery must be determined. Taxes provided should reflect the expected form of recovery (e.g., dividend, sale, liquidation) and the character of taxable income that the repatriation will generate (e.g., ordinary versus capital gain). Outside basis differences will need to continue to be considered at every level of an entity's legal structure.

The deemed repatriation provisions of the 2017 Act result in an increase in the tax basis of foreign subsidiaries. This could result in excess tax over book basis for certain subsidiaries. Recognition of a deferred tax asset on an outside basis difference is prohibited unless it is apparent that the basis difference will reverse in the foreseeable future.

PwC observation:

The IFRS guidance on the accounting for outside basis differences is different from US GAAP and might lead to differences in when a deferred tax liability is recognized. A deferred liability is recognized under IFRS unless the entity controls the reversal of the temporary difference and reversal is not expected in the foreseeable future. The considerations described above would apply equally to the assessment of whether reversal is expected in the foreseeable future and to the measurement of the deferred tax liability.

Repatriation - toll charge

The 2017 Act will require a mandatory deemed repatriation of post-1986 undistributed foreign earnings and profits (E&P). The rate applied varies depending on whether the E&P is held in liquid (as defined in the 2017 Act) or non-liquid assets. A proportional deduction on the deemed repatriation will result in a repatriation toll charge of 15.5% for cash and liquid assets and 8% for non-liquid assets. The toll charge will be assessed regardless of whether or not the company has cash in its foreign subsidiaries and regardless of whether the company brings back the earnings. The toll charge is determined on the greater of E&P as of two measurement dates (November 2, 2017 or December 31, 2017). The amount of cash and liquid assets is determined based on the greater of the amounts calculated using two alternative measurement periods. At the election of the taxpayer, the toll charge can be paid in installments over eight years.

Companies can utilize existing foreign tax credit (FTC) and NOL carryforwards to settle the toll charge. Alternatively, companies can elect to not apply NOL carryforwards if they wish to utilize existing FTCs. Companies can claim a credit for foreign taxes deemed paid on foreign earnings subject to the mandatory inclusion, however these credits are subject to a "haircut."

Tax accounting implications

In the period of enactment, companies will need to record a tax payable for the toll tax irrespective of any actual remittances or their historical financial statement assertions. The tax payable would need to be allocated between current and non-current depending on payment expectations. The financial statement impact of recording the toll tax liability may be significant and will vary depending on a number of factors, including previous assertions. Historically, many companies have not recorded (or disclosed) a liability for their outside basis differences. In other cases, liabilities may have been recorded or disclosed, but enactment of the reform provisions may drastically change that amount.

Measurement of the toll tax liability may require extensive effort. E&P is determined on a cumulative basis and historical practices in calculating and tracking both E&P and tax pools should be revisited. Adding to the complexity is the need to compute E&P as of two separate measurement dates and the determination of the amount of earnings that are held in cash/liquid assets or other assets using two measurement periods. Furthermore, the determination of E&P balances, foreign tax pools, and the amount of cash and liquid assets may be impacted by the existence of uncertain tax positions.

Some have inquired as to whether the toll tax payable should be discounted given that it can be paid over an extended period of time. ASC 740 prohibits the discounting of deferred taxes. Taxes receivable and payable are generally considered either currently payable or currently refundable and, therefore, are not subject to discounting. However, ASC 835, *Interest*, provides for discounting of non-interest bearing payables and receivables with maturities in excess of one year when the aggregate amount of the liability and the timing of cash payments are fixed or reliably determinable.

Some believe discounting the toll tax payable would be appropriate as, once calculated and included as income on the tax return, the amount and timing of the toll tax payable is fixed and determinable. Others believe the toll tax charge should not be discounted because it does not arise from a contractual arrangement in which a financing element was negotiated. The applicability of discounting to this liability remains fluid.

Companies should also consider what impact the one-time toll charge and enactment of a territorial system will have on their valuation allowance assessments. Additional taxable income from the toll charge could support realization of existing deferred tax assets. Alternatively, existing deferred tax assets, such as FTCs, may have been supported by future repatriations and any remaining FTCs post toll charge would need to be assessed for realizability. Future realization of deferred tax assets is dependent on availability of an income source, which could be impacted by tax reform. A holistic evaluation of how tax reform impacts the valuation allowance assessment will be needed.

Additionally, similar to other aspects of tax reform, the toll charge will need to be assessed from a state income tax perspective, with the impact depending on existing rules and enacted state law changes in response to federal changes.

PwC observation:

On a prospective basis, unremitted earnings of foreign subsidiaries will include both earnings that have previously been taxed through the deemed repatriation provisions (but not distributed) as well as future earnings that generally would not be taxed in the US as a result of the 100% DRD. Understanding these amounts will be important as the resulting tax effects of repatriation, including potential FTCs, foreign currency gains or losses, and future basis adjustments, vary. For example, companies may expect the repatriation of foreign earnings that have been subjected to the toll tax to be free of additional US tax consequences; however, foreign withholding taxes as well as taxes on foreign currency gains and losses that arise from exchange rate movement between the deemed and actual distribution dates should not be overlooked.

Anti-base erosion – taxation of foreign earnings

For tax years beginning after December 31, 2017, the 2017 Act introduces new provisions intended to prevent the erosion of the US tax base. This is achieved, in part, through US taxation of certain global intangible low-taxed income (GILTI). In short, GILTI inclusions will impact companies that have foreign earnings generated without a large aggregate foreign fixed asset base and whose earnings have been taxed at a low tax rate.

Determining the impact of this provision will be a complex endeavor. The GILTI inclusion is based on the relationship between two concepts: the company's aggregate share of the tested income of foreign subsidiaries, and a specified return. Tested income is the total foreign subsidiary income, reduced by certain exceptions and allocable deductions. Thus, the GILTI provisions are applicable regardless of whether intangible income exists. The specified return is equal to 10% of the shareholder's aggregate share of qualified business asset investments (QBAI), which is generally defined as the company's basis in tangible depreciable business property.

If the aggregate share of net foreign subsidiary tested income exceeds the specified return, that excess amount is the amount of GILTI.

The full amount of GILTI is includible in taxable income. The GILTI inclusion is then reduced by 50% (reduced to 37.5% for tax years beginning after December 31, 2025). However, that reduction in the GILTI inclusion may be limited based on the level of US taxable income. A limited allowance for FTCs is allowed that would reduce the US tax cost. GILTI FTCs can only reduce US taxes owed on GILTI and are not eligible for carryforward.

Tax accounting implications

Some have questioned whether US deferred taxes should be recognized for GILTI if there are temporary differences that, upon reversal, would impact the calculation of GILTI. This concept is similar to US deferred taxes that may be recorded on foreign temporary differences that will result in a subpart F income inclusion when they reverse (see PwC's *Income taxes* guide, Section 11.10.2). Others have questioned whether GILTI should be included as part of the outside basis analysis.

Some believe that it would not be appropriate to recognize deferred taxes for the future effects of GILTI because the calculation includes aspects that are contingent or based on future events. Thus, this view would result in GILTI being accounted for as a period cost. However, others believe it would be appropriate to recognize deferred taxes for the future effects of GILTI as there may be existing basis differences that, upon reversal, will result in a GILTI inclusion. Due to the uniqueness of these provisions, which may also be subject to further interpretations of the tax law, the tax accounting for GILTI remains fluid.

Anti-base erosion – minimum tax on certain related party payments

The 2017 Act introduces a new minimum tax on international payments as a means to reduce the ability of multi-national companies to erode the US tax base through deductible related-party payments. The minimum tax, known as the base erosion and anti-abuse tax (BEAT), is imposed when the tax calculated under BEAT exceeds the corporation's regular tax liability determined after the application of certain credits allowed against the regular tax. BEAT is measured based on modified taxable income (i.e., taxable income after adding back base erosion payments). With certain exceptions, base erosion payments are payments to related foreign persons that result in a US tax deduction generally excluding payments for cost of goods sold.

A 5% BEAT rate applies for the year beginning after December 31, 2017. After that, the BEAT rate increases to 10%, and for years ending after December 31, 2025 the rate increases to 12.5%. Different rates apply to banks and securities dealers.

The BEAT applies to corporate taxpayers with average annual gross receipts over the preceding three years of at least $500 million and that have base erosion payments of more than 3% of the corporation's deductible expenses (2% for banks and securities dealers). The minimum tax paid does not reduce future regular income tax liabilities (i.e., unlike AMT, the BEAT is not creditable).

Tax accounting implications

We believe the BEAT should be accounted for as an income tax under ASC 740 as it is a tax assessed on a net income amount. Also, because the minimum tax effectively operates as a parallel but separate income tax system, we believe that companies should, for purposes of both current and deferred income tax accounting under ASC 740, determine whether they expect to be subject to regular income tax in all periods, the BEAT in all periods, or a combination of the two, depending on the tax year in question.

For companies that expect to be subject to the BEAT in all periods, we believe they should determine their current and deferred taxes based on the BEAT regime. Conversely, companies that expect to be subject to the regular tax in all periods would determine their current and deferred taxes based on the regular tax regime. Alternatively, if a company expects to alternate between the regular income tax regime and the BEAT from year-to-year, a hybrid approach may be unavoidable. In this case, the company should schedule the reversals of its temporary differences and use the tax rate expected to apply to each particular year.

Incentive for US production

The 2017 Act includes a new incentive for US companies to produce goods and services domestically and sell them abroad by allowing a 37.5% deduction (reduced to 21.875% for taxable years starting after December 31, 2025) for foreign-derived intangible income (FDII). FDII is generally calculated as a portion of the foreign-derived income of a US corporation determined by calculating the excess of total income over a set return on QBAI. When factoring in the reduced corporate rate of 21%, income eligible for the deduction would effectively be taxed at a 13.1% effective tax rate. This provision would generally be effective for tax years beginning after 2017.

Tax accounting implications

We believe that FDII will likely be accounted for as a special deduction (vs. being reflected in the measurement of deferred taxes). Under US GAAP, special deductions are generally recognized in the year they are included in the tax return. While ASC 740 does not define a special deduction, it does provide examples, including the Section 199 deduction. In general, special deductions have tax law requirements or limitations that are based upon future performance of specific activities. For instance, the Section 199 deduction is contingent upon the performance of qualified production activities and the amount of wages paid in the tax year. Likewise, the deduction for FDII is dependent upon the creation of certain eligible income.

PwC observation:

The concept of special deductions does not exist under IFRS. We believe the approach described above would be an acceptable way of accounting for the FDII provisions under IFRS.

Foreign tax credits

The 2017 Act significantly alters multiple FTC provisions and repeals certain indirect FTC provisions. Effectively, FTCs or deductions for taxes paid or accrued are eliminated on dividends to which the 100% DRD applies. FTCs or deductions for foreign taxes would generally be allowable for foreign income that is taxable to the US shareholder.

The availability to utilize FTCs against differing sources of foreign income is restricted. For example, GILTI inclusion FTCs can only be applied to reduce GILTI inclusions, while FTCs related to foreign branch operations can only be utilized against foreign branch income.

Tax accounting implications

In light of these changes and the overall changes to the international tax system, companies will need to evaluate the realizability of existing FTC carryforwards, excess FTCs generated with respect to earnings subject to mandatory inclusion, as well as FTCs generated in future periods.

PwC observation:

The 2017 Act does not generally impact the US taxation of branch operations, with the exception of the new FTC limitation rules related to foreign branch income from a qualified business unit. Accordingly, the accounting for branches generally is not expected to change. Nevertheless, there may be instances when a company has historically recorded a “mirror image” US deferred tax asset or liability for the related or anticipated deferred tax impact of foreign branch deferred tax liabilities or assets. With a reduced US tax rate of 21%, there may be situations when the foreign taxes that will be paid as the deferred taxes reverse are no longer expected to be fully creditable (e.g., when the foreign tax rate exceeds the reduced US tax rate and the company does not have other foreign source income to utilize the FTC). Further analysis may be necessary in these circumstances. For example, it may be appropriate to reduce the “mirror image” US deferred tax asset (or record a valuation allowance) for the portion of any net foreign deferred taxes that, when paid, are expected to generate FTCs that will expire unutilized.

State taxes

US tax reform may have significant state and local tax effects. The threshold state income tax question is whether and how a state conforms to the US tax code. How a particular state adopts the US tax code directly affects the application of enacted federal changes to its taxable income computation. Companies will need to evaluate the conformity rules for each state in order to determine the state tax effect and relevant tax accounting. The state tax implications of cost recovery (full expensing), the repatriation toll charge, and interest deductibility limitations may be particularly significant.

Other financial reporting considerations

Such significant changes in US tax law may have financial reporting consequences beyond the typical tax line items in the financial statements. For example, accounting for the effects of tax reform may impact financial statement reporting and ratios such as liquidity, cash flow needs, working capital, earnings per share, etc. Changes in financial ratios may impact existing debt covenants and dividend distributions that require certain ratios. Additionally, some of these effects may have pre-tax implications. Several are discussed below, but this is not an exhaustive list.

Long-lived asset and goodwill impairment considerations

A company tests its asset groups for recoverability whenever events occur or circumstances change that indicate its long-lived assets may not be recoverable. The company forecasts future cash flows directly associated with an asset group to determine if the net cash flows of the group exceed its carrying amount. While the cash flows are usually forecasted on a pre-tax basis, the company should consider whether the 2017 Act will affect expected cash inflows (e.g., revenues) and outflows (e.g., cost of revenues) of its asset groups at a level that would constitute a triggering event to test for recoverability.

Goodwill is tested annually for impairment and in the interim if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Depending on how the 2017 Act affects the fair value and carrying amount of a reporting unit, it may result in a triggering event to test goodwill for impairment.

The fair value of a reporting unit is the price the selling entity would receive in an orderly transaction with a market participant at the impairment test date. If an entity is testing a reporting unit for impairment at December 31, 2017, we would expect the effects of the 2017 Act to be considered by market participants and reflected in the determination of fair value.

The carrying amount of a reporting unit should be based on the carrying amounts of the assets and liabilities comprising the reporting unit as reflected in the company's balance sheet on the impairment test date. Deferred taxes originating from temporary differences related to the reporting unit's assets and liabilities should be included in the carrying amount of the reporting unit. Deferred tax assets generated from net operating loss carryforwards and tax credits may be included in the reporting unit depending on facts and circumstances. The impact of the 2017 Act on a company's deferred tax balances should not be adjusted for the purpose of conducting a goodwill impairment test unless the entity has recorded such changes as of the impairment testing date.

Hedging

Companies may designate forecasted transactions as the hedged item in a cash flow hedge. This may include things like forecasted sales, forecasted purchases, or forecasted interest payments. In order to qualify for hedge accounting, the forecasted transactions must be probable of occurring. Companies should assess whether aspects of tax reform may change the probability of forecasted transactions occurring. If a hedged forecasted transaction is no longer probable of occurring, hedge accounting must be discontinued. If a hedged forecasted transaction becomes probable of not occurring, then hedge accounting must be discontinued and amounts reported in accumulated other comprehensive income must be immediately reclassified into current earnings.

In addition, companies that employ after-tax hedging strategies should also consider the impact of the legislation on their hedging relationships. A change in the tax rate used to determine the tax effect of gains and losses on the hedging instrument can impact the hedging relationship and may require a company to change the hedge ratio through a dedesignation and redesignation of the hedging relationship. Companies that engage in after-tax net investment hedging should evaluate the impact of the change in tax rate in determining: (1) whether there is sufficient net investment in the hedged foreign operation after consideration of the tax effects, (2) whether the hedge is highly effective after consideration of the tax effects, and (3) if the company has not yet adopted the new hedging guidance (ASU 2017-12), the amount of ineffectiveness in the hedging relationship.

Companies that engage in after-tax net investment hedging should also consider the impact of the tax law change on the balance of their net investment (the hedged item). Companies designate the opening net investment balance in a net investment hedge. The impacts of the tax legislation on the hedged investment should be considered for any hedging relationships designated after enactment, including both new hedges and any cases when the hedging instrument is dedesignated and redesignated. Companies also need to evaluate the impact in determining the opening net investment balances (e.g., as of January 1, 2018 for a calendar year company) in hedged foreign subsidiaries for all net investment hedges.

Equity method investments for the benefit of tax credits

Companies may own equity method investments in flow-through entities in order to receive tax credit benefits earned by the investee. Common examples of these credits include qualified affordable housing credits, solar credits, and wind credits. Companies should consider whether aspects of tax reform may indicate that the value of their equity method investment could be impaired. This would generally be assessed under ASC 323, *Investments -- equity method and joint ventures*.

Equity method investments in qualified affordable housing projects that are accounted for using the proportional amortization method should be assessed for impairment under ASC 323-740. Because the investment balance in a qualified affordable housing projects essentially represents the collection of future tax benefits the company expects to receive (via credits and tax deductions associated with losses flowing through to the investor), companies electing the proportional amortization method under ASC 323-740 are required to amortize the investment balance each period. The amortization amount is determined by multiplying the investment balance by a ratio of the current year tax benefits divided by the total expected tax benefits over the life of the investment.

Tax reform will change the expected tax benefits due to the flow-through losses providing less of a benefit at a 21% tax rate than they would have at a 35% tax rate. We believe that it is appropriate for companies to adjust the proportional amortization calculation to reflect the expected tax benefits at the new rate, which will result in a “catch up” in amortization of the investment balance. Consistent with the annual amortization charge, we believe this “catch up” should be reflected in income tax expense. If there is any indicator that it is more likely than not that the new carrying value will not be realized (e.g., if the carrying value exceeds the remaining balance of tax credits and expected future deductions), companies should assess the investment for impairment using the guidance in ASC 323-740.

Disclosures

The enactment of the 2017 Act should be considered for disclosure as a subsequent event in financial statements when the enactment happens between the company’s year end date and the date that the financial statements are issued or available for issuance. Since the law was enacted on December 22, 2017, consideration of a subsequent events disclosure is relevant for companies with a fiscal year end that ends before that date. Per ASC 855, *Subsequent Events*, the disclosure should include a description of the 2017 Act, an estimate of its financial effect, or a statement that an estimate cannot be made.

SEC registrants should consider disclosure in Management's Discussion & Analysis of known trends or uncertainties that are reasonably likely to have a material impact on financial conditions or results of operations. The discussion should generally address the potential effects of the 2017 Act on the variability of earnings, financial condition, and liquidity. For example, the toll charge liability could result in significant cash requirements, driving the need for enhanced liquidity disclosures. It is important that the disclosures are balanced between impacts of the 2017 Act that potentially result in a tax benefit and those impacts that potentially increase tax expense. The SEC provided guidance about disclosure of the effects of the Tax Reform Act of 1986 in Financial Reporting Codification 501.11 that could assist companies in evaluating the disclosures that should be provided.

For SEC registrants, current guidance requires disclosure in the effective tax rate reconciliation footnote of individual reconciling items that are more than 5% of the amount computed by multiplying pre-tax income by the statutory tax rate. A US-based entity subject to a 35% statutory tax rate would disclose any item that increases or decreases the tax rate by 1.75% or more. This would decrease to approximately 1% with a 21% statutory rate. As a result, more items in the effective tax rate reconciliation may need to be separately disclosed, and companies may need to adjust the disclosure for prior periods presented in the financial statement for comparison purposes. For tax rate reconciliation purposes, a calendar US-based entity will utilize a 35% statutory rate for 2017 and a 21% statutory rate in 2018.

Many companies today disclose that it is not practicable to determine the amount of unrecognized deferred tax liabilities related to investments in foreign subsidiaries and foreign corporate joint ventures. Tax reform may impact a company's continued usage of the 'impracticability' exception or may render it no longer applicable once a liability has been measured/recorded for the entire outside basis difference.

Systems, processes, and controls

Given the 2018 effective date for many of the provisions, it will be critical that companies work expeditiously to evaluate necessary changes to systems and processes to comply with new US tax laws. Companies should assess necessary changes in their income tax accounting systems that will be impacted by tax reform legislation. Companies will need to consider changes in processes, controls, data needs, and systems. In addition, companies should ensure they have processes in place to monitor tax law and accounting developments in these areas.

The potential changes in systems and processes may result in changes in internal controls. Companies should revisit the controls they have in place to: identify tax law and accounting developments, assess the reliability of data used in the provision process, identify and monitor new deferred taxes, consider the realizability of deferred taxes, evaluate needed disclosures, and assess tax positions taken, among other items.

What’s next

Enactment of US tax reform is one of the most comprehensive policy developments in many years and will bring with it complex, wide-ranging impacts to financial reporting. While the effect will vary significantly between companies, it is expected that implementing and accounting for reform will be a challenging exercise. Notwithstanding the difficulty involved, the accounting guidance requires recognition of the tax effects of tax law changes in the period in which the law is enacted. As a result, while many difficulties exist, companies will need to determine the potential implications in financial reporting to ensure they account for these changes in the period of enactment.

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