Financial Statement Impacts of U.S. Tax Reform

January 2018

Instructors

Bob Fitzula
Partner, DHG Tax
704.367.5922
bob.fitzula@dhgllp.com

David Henderson
Partner, DHG Tax
704.367.5502
david.henderson@dhgllp.com

Dave Hinshaw
Partner, DHG Assurance
704.367.7095
dave.hinshaw@dhgllp.com

Phil Laminack
Sr. Manager, DHG Tax
404.215.7504
phil.laminack@dhgllp.com

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This guidance concerning ASC 740 is preliminary and based on our current understanding of the indicated tax law provisions. Certain tax law provisions may be clarified through issuance of guidance by Treasury, regulations or future technical corrections. We will update our views as such further information becomes available.

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Topics

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3. Re-measurement of Deferred Taxes
4. Interim Reporting Considerations
5. Selected Domestic Items of Tax Reform
6. One-time Transition Tax
7. Misc. International Items
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Introduction

Tax Reform Is Here!!!

Tax Reform Is Here!!!

- Legislation enacted on December 22, 2017
- Most comprehensive change to the U.S. federal tax code since 1986
- Immediate impact for most corporations' December 2017 financial statements
- Consider key internal controls over financial reporting for tax reform

"*The magnitude of the changes in the Act may give rise to certain operational challenges and constraints for entities when complying with the requirements under ASC Topic 740 upon issuance of an entity's financial statements for the reporting period in which the Act is enacted.*"
– SEC Staff

Are You Ready?

Enacted Date

vs.

Effective Date

Enacted vs. Effective

EXAMPLE:

"The President signed the bill into law on December 22, 2017. The new rates apply to tax years beginning on or after January 1, 2018."

Enacted Date: December 22, 2017

Effective Date: January 1, 2018

Enacted vs. Effective

"The effect of a change in tax laws or rates shall be recognized at the date of enactment."
- ASC 740-10-25-47

"*Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.*"
- ASC 740-10-35-4

"When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date."
- ASC 740-10-45-15

Enacted vs. Effective

If a law is enacted subsequent to the balance sheet date, but prior to issuance of the financial statements, it would be considered a non-recognized subsequent event. Companies should determine (based on materiality) whether to disclose the change in tax law and an estimate of its expected impact.

EXAMPLE: Legislation enacted December 22, 2017 would be a non-recognized subsequent event for a corporation with a November 30th fiscal year end.

Enacted vs. Effective

ENACTED: The date the legislation is signed into law (in the U.S., typically by the President or State Governor or by legislative override)

EFFECTIVE: The date the legislation takes effect

Polling Question #1

On what date was the tax law enacted?

A. January 1, 2018
B. December 22, 2017
C. December 31, 2017
D. September 27, 2017

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B. December 22, 2017
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Re-measurement of Deferred Taxes

Re-measuring of DTAs(DTLs)

Immediate Consideration

- Corporate Rate of 21% reflected for deferred tax assets and liabilities expected to reverse after 12/31/2017
  - Flat rate, no brackets
  - No special rate for Personal Service Corporations
- Blended statutory tax rate complexity for fiscal year taxpayers
  - Portion of year at 35%, portion at 21%. IRC §15 governs blending of rate
- Reduced "Federal Benefit of State" effect on state effective tax rates
- For U.S. GAAP purposes, all re-measurement effects of deferred tax balances should be recorded to income from continuing operations as of the enactment date. This includes deferred tax balances that were originally recorded to Other Comprehensive Income ("OCI") (U.S. GAAP prohibition against backwards tracing) *(rules differ for IFRS purposes on backwards tracing)*

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*Defined here (and hereafter) as an item that 2017 calendar year and fiscal year 2018 companies need to immediately evaluate in the current reporting period

Re-measuring of DTAs(DTLs)

Immediate Consideration

Summary of re-measuring mechanics (at date of enactment):

1. *Obtain U.S. deferred tax balances as of enactment date (note: In practice, one may expect to use 12/31/2017 balances as that could be the best information available)*
2. *For companies with market value driven assets (such as large AFS investment portfolios), consider change in market value from 12/22 through 12/31*
3. *Schedule the reversal of the deferred tax balances in the future*
4. *For companies in an NOL for 2017, consider any implications of the transition taxable income (Subpart F) with regard to realization of current year NOL*
5. *Compare current federal tax rate versus new future tax rate of 21%*
6. *Record all changes in the tax rate to continuing operations (discretely in the quarter of the tax law enactment)*
7. *Evaluate any impact to the federal effect of the state tax rate*
8. *Consider valuation allowance considerations due to change in NOL carryforward period (indefinite life of NOLs), foreign tax credit carryforwards, etc.*
9. *Consider any adjustments due to AMT credits law change (refundable)*
10. *Consider application of Base Erosion anti-abuse tax ("BEAT") in measuring future reversal of deferred taxes.*

Re-measuring of DTAs(DTLs)

Immediate Consideration

- Rate change may result in disproportionate tax effects being lodged in OCI
  - Will commonly apply to companies with portfolios of available-for-sale securities
  - Could apply to various other items that are accounted for through OCI, such as pensions, currency translation, etc.
- Affected companies should currently have/established an accounting policy for the disproportionate tax effects left behind in OCI. To the extent that a company does not have a historical accounting policy, the company should consult with its accounting group to adopt an accounting policy. The below methods represent the most common methods:
  - Item-by-Item method vs. Aggregate Portfolio method
- Disproportionate effect that remains lodged in OCI is not eliminated until the circumstances upon which it is premised cease to exist
  - **Example:** Disproportionate tax effect of pension lodged in OCI remains until pension plan is terminated

Interim Period Considerations

Interim Periods under ASC 740-270 (f/k/a FIN 18)

Immediate Consideration

- Impact of rate change will be a discrete item in the interim period in which the law is enacted (i.e. calendar year end companies: Q4)
- For fiscal year companies, this will be an interim reporting event
- For fiscal year companies, consider blended federal rate impact on EAETR calculation

Selected Domestic Items

Misc. Domestic Items - NOLs

Immediate Consideration

- NOL utilization limited to 80% of taxable income

  ** Note – Potential impact on valuation allowance considerations*

- NOL carrybacks eliminated

  ** Note – Loss of source of taxable income for valuation allowance analysis*

- NOL carryforward period is indefinite

  ** Note – This impacts ability to use tax planning strategy for mitigation of valuation allowance on NOL carryforwards*

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Misc. Domestic Items - AMT

Immediate Consideration

- Corporate AMT Repealed
- AMT Credit Carryforwards:
  - Fully offset regular tax liability beginning in 2018
  - Excess credits 50% partially refundable through 2020
  - Remaining credits fully refunded in 2021
  - Convert credit to receivable (current and/or non-current)
  - Release any current valuation allowance against AMT credits

Misc. Domestic Items

- 100% bonus depreciation through 2022
  - *Note –100% applies to assets acquired as of September 27, 2017*

  Immediate Consideration
- Limitation on interest expense (complex new set of rules)
- Repeal of Domestic Production Activities Deduction
- Dividends Received Deduction is reduced for domestic corporations owned less than 100%

Misc. Domestic Items

- Like-kind Exchange limited to real property
- Revenue limit for cash method of accounting increased from $5M to $25M
- Performance based exemption under IRC §162(m) is repealed
  ** Consider impact on realizability of existing DTAs for equity based compensation if 2017 and prior awards has not met the grandfathering requirements*
- Entertainment related expenses fully disallowed (no 50% deduction)
- Expansion of non-deductibility of fines and penalties

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Misc. Domestic Items

- Consider State conformity dates with IRC
- IRS Directive (LB&I-04-0917-005) on ASC 730 for R&D Costs
  ** Opportunity to release FIN 48 reserve on R&D positions*
- R&D costs under §174 to be amortized over 5 years rather than immediately expensed beginning in 2022

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Misc. Domestic Items

Immediate Consideration

- Companies that have elected ASU 2014-01, Accounting for Affordable Housing Projects, will need to recast proportional amortization, leading to a potential impairment charge included in tax expense
- Companies that have leveraged leases will need to recast effective interest yield calculations under ASC 840 (FAS 13), leading to financial statement impact
- FDIC premiums paid by banks may become nondeductible if consolidated assets are above $50 billion. A phaseout occurs between $10 billion and $50 billion.
- Retains tax credits for R&D, LIHTC, NMTC and energy
- Accrual basis taxpayers must recognize taxable income no later than the year the income is recognized in a financial statement.
  - Excludes mortgage servicing rights.

Polling Question #2

Which of the following is being repealed?

A. Domestic Production Activities Deduction under IRC §199
B. Corporate Alternative Minimum Tax
C. Performance based exemption under IRC §162(m)
D. All of the above

Polling Question #2

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A. Domestic Production Activities Deduction under IRC §199
B. Corporate Alternative Minimum Tax
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D. All of the above

One-time Transition Tax

ASC 740-10-25 (f/k/a APB 23)

General Rule:

- Record a DTL for the excess of book basis over tax basis in subsidiary
- DTA for excess of tax basis over book basis typically not recorded unless expected to be realized within the foreseeable future

  - DTL not required if investment is permanent in nature
    a) Permanently invested in initial investment and/or
    b) Earnings permanently reinvested

Outside Basis Differences

Components of Overall Outside Basis DTA(DTL)

- DTL for residual U.S. tax on unremitted foreign earnings
- DTL for local country withholding taxes on future repatriation
- DTA(DTL) for currency movement on initial and subsequent capital contributions
- DTA for unborn foreign tax credits
  - Withholding tax (§901)
  - Deemed paid tax (§902 or §960) – **Note: §902 repealed starting 2018**

Outside Basis Differences (Continued)

- "Unremitted Foreign Earnings" is a GAAP concept, based on book earnings
- Earnings and Profits ("E&P") is a tax concept, based on U.S. tax rules

Caution!

+ In practice, the two above measures often vary by only an immaterial amount (differences between the two often disregarded for ease of computation)
+ In certain situations, the two measures might materially diverge
+ Pay attention to the variance between the two measures and what impact that may have on the outside basis difference to be recorded

One-time Transition Tax

- One-time Transition Tax on Non-Previously Taxed Post 1986 Accumulated Foreign Earnings
- Cash and Cash Equivalents taxed at 15.5%
- Operating Assets (E&P in excess of "Cash Position") taxed at 8%
- Tax picked up in graduated installments over 8 years

  ** Consider classification as payable or as non-current payable*

One-time Transition Tax (Continued)

Immediate Consideration

- Positive and negative E&P at various CFCs, first netted based on common shareholder, then further netted among shareholders within same affiliated group
- "Cash Position" defined as greater of average for past two tax years or ending balance
- Tax based on greater of untaxed E&P on either 11/2/2017 or 12/31/2017
- 35% punitive rate on full inclusion amount for Companies that perform an "Inversion" within 10 years of bill passage

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One-time Transition Tax (Continued)

Immediate Consideration

- Partial disallowance of foreign tax credits "that would otherwise be available in respect of the deemed inclusion"
  - ➢ Credit Disallowance on Cash Portion of Inclusion
    - ❖55.7%
  - ➢ Credit Disallowance on Non-Cash Portion of Inclusion
    - ❖77.14%

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One-time Transition Tax (Continued)

Immediate Consideration

- Mandatory one-time repatriation tax may fully or partially invalidate APB 23 assertion with respect to un-repatriated foreign earnings
- Record payable balance at 12/31/2017
- Unborn foreign tax credits complicated by partial credit disallowance
- Outside basis difference considerations still remain with regards to possible Subpart F income, Capital Gains on future dispositions, foreign-to-foreign transactions (withholding taxes), section 986(c) or structures, etc.

Earnings & Profits

- E&P is calculated using U.S. tax rules, not local country tax rules
  - Schedule H of Form 5471 is very commonly overlooked or shortcutted
- For fixed-asset heavy foreign subs, consider possible E&P reduction for Cost-Segregation studies and opportunities to accelerate depreciation under U.S. ADS rules
- Other previously unexplored planning opportunities may be available (depending on nature of business) to reduce foreign E&P ahead of the effective date of mandatory repatriation tax
- Congress has authorized the Treasury to issue anti-abuse rules related to E&P planning. Limited information currently available on what planning might be curtailed.

Polling Question #3

At what rate are cash and cash equivalents taxed under the one-time transition tax?

A. 8%
B. 12.5%
C. 15.5%
D. 10%

Polling Question #3

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A. 8%
B. 12.5%
C. 15.5%
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Misc. International Items

Misc. International Items – Territorial System

- Quasi-Territorial System: Changes to outside basis calculations
  - Subpart F still in place
  - Consider non-dividend repatriation potential
  - Consider realization through future sale of entity
- New IRC §245A for 100% foreign DRD

Misc. International Items – Foreign Tax Credits

- Foreign Tax Credit Regime
  - Repeal §902 indirect foreign tax credits
  - Retain §960 for indirect foreign tax credits on current year method (change from current pooling method)
  - No change to §901 direct foreign tax credits
  - No FTC allowed with respect to any dividend allowed a 100% DRD

Misc. International Items – Outbound Base Erosion

- Current year inclusion of global intangible low-taxed income (“GILTI”)
  - New Code Section 951A
  - Complex provision, acts as a sort of “Global Minimum Tax”
- Limit income shifting through intangible property transfers
- Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities

Misc. International Items – Inbound Base Erosion

Immediate Consideration

- Base Erosion and Anti-Abuse Tax (BEAT) – Excise Tax
  - Outbound payments to related parties
    - ➢Exemption for items includable in COGS
    - ➢Exemption for items treated as reduction to gross receipts
  - Applies to domestic corps with:
    - ✓$500M of domestic receipts
    - ✓3% or higher “base erosion percentage”
      (2% for certain financial institutions)
  - Rates increase from 2018 through 2025
    - ➢Begins at 5% *(6% for certain financial institutions)*
    - ➢Ends at 12.5% *(13.5% for certain financial institutions)*

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Misc. International Items – Inbound Base Erosion

- Base Erosion and Anti-Abuse Tax (BEAT) – Excise Tax
  - Relatively complex formula to calculate
  - Could be in essence parallel tax system for certain corporations
  - May be in conflict with existing treaties
  - May be challenged by World Trade Organization and European Union

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Misc. International Items – Accounting for Base Erosion

- ASC 740 treatment of BEAT and GILTI will be similar to the tax accounting treatment applied to Subpart F income
  - Estimate exposure and include in current tax provision
  - Include in current taxes payable
  - Consider possible deferred tax effects of parallel BEAT system
- Consider impact of GILTI on outside basis differences
  - Generally treated as previously-taxed income

SEC Staff Guidance

SEC Staff Guidance

- SEC Staff issued transition guidance on December 22, 2017
- Guidance provides a "measurement period" for issuers to evaluate the impacts of tax reform on their financial statements
  - Staff Accounting Bulletin (SAB) No. 118
  - Compliance and Disclosure Interpretation 110.02
- During the measurement period, the SEC Staff expect that entities will be acting in good faith to complete the accounting under ASC Topic 740

"Measurement period" not to exceed beyond one year from the enactment date

SEC Staff Guidance – SAB No. 118

1. Complete tax accounting for tax effects of the "Act" where possible
2. Where complete accounting not possible, complete reasonable estimate
   - Provide complete accounting later within measurement period
3. Where reasonable estimate not possible, provide detailed disclosure around why a reasonable estimate is not possible
   - Provide reasonable estimate later within measurement period
   - Provide complete accounting when available within measurement period

SEC Staff Guidance – SAB No. 118

Required Disclosures for Incomplete Accounting:

1. Qualitative disclosures of the income tax effects of the Act for which the accounting is incomplete;
2. Disclosures of items reported as provisional amounts;
3. Disclosures of existing current or deferred tax amounts for which the income tax effects of the Act have not been completed;
4. The reason why the initial accounting is incomplete;
5. The additional information that is needed to be obtained, prepared, or analyzed in order to complete the accounting requirements under ASC Topic 740;
6. The nature and amount of any measurement period adjustments recognized during the reporting period;
7. The effect of measurement period adjustments on the effective tax rate; and
8. When the accounting for the income tax effects of the Act has been completed.

SEC Staff Guidance – Compliance and Disclosure Interpretation 110.02

Question: Does the re-measurement of a deferred tax asset (“DTA”) to incorporate the effects of newly enacted tax rates or other provisions of the Tax Cuts and Jobs Act (“Act”) trigger an obligation to file under Item 2.06 of Form 8-K?

Answer: No, the re-measurement of a DTA to reflect the impact of a change in tax rate or tax laws is not an impairment under ASC Topic 740.

Polling Question #4

How long is the permitted "Measurement Period" under SEC Staff Guidance?

A. Within two (2) quarters following enactment
B. Not to extend beyond one year from the enactment date
C. Within six (6) months of the enactment date
D. Within one (1) quarter following enactment

Polling Question #4

How long is the permitted "Measurement Period" under SEC Staff Guidance?

A. Within two (2) quarters following enactment
B. Not to extend beyond one year from the enactment date
C. Within six (6) months of the enactment date
D. Within one (1) quarter following enactment

Questions