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Accounting & Auditing Update

Effects of the New Tax Law on Financial Statements

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The Tax Cuts and Jobs Act, signed into law on December 22, 2017, enacted significant U.S. tax reform that is expected to have major implications on the financial reporting of most U.S. corporations. Many provisions of the new law will also surely affect the cash management policies and strategies of most U.S. corporations. To some extent, certain provisions will also affect financial ratios on account of the recognition [or, in certain cases, the de-recognition] of additional current and deferred tax balances.

The provisions of the FASB Accounting Standards Codification ("ASC 740"), ***Income Taxes***, require the taxpayer to recognize the effect of a change in tax laws or rates at the date of enactment. Therefore, the effects must be recognized in the December 31, 2017 financial statements of U.S. corporations, even though the effective date of the law for most provisions starts January 1, 2018. Critical items that U.S. corporations should address on their December 31, 2017 financial statements include the:

- effects on their deferred tax assets and liabilities from the reduction of federal tax rates,
- evaluation of future utilization of its net operating loss carryforwards and alternative minimum tax credit carryforwards, and
- provision for the one-time deemed repatriation of undistributed earnings held in certain foreign corporations.

This article summarizes several of the key items to be considered in evaluating the financial statement effects of the new tax law categorized by:

- Temporary Timing Differences
- Permanent Book-Tax Differences
- International Book-Tax Differences

Temporary Timing Differences

Reduction in Tax Rates

Prior Tax Law	New Tax Law
• Corporations are subject to graduated tax rates depending on taxable income.	• Corporate tax rate is reduced to a flat 21% rate with no graduated rate schedule.

Income Tax Accounting Considerations: The reduction of the tax rates will entail re-measurement of the effective tax rate utilized to measure deferred tax balances. ASC 740 requires that the effects of changes in tax rate and laws on deferred tax balances be recognized as a component of tax expense related to continuing operations for the period in which the law is enacted.

The reduction of effective tax rate will most likely result in lower deferred tax assets with a corresponding increase in income tax expense, and lower deferred tax liabilities with a corresponding decrease in income tax expense.

Modification of Net Operating Losses ("NOLs") Deduction

Prior Tax Law	New Tax Law
• NOLs may generally be carried back two years and carried over 20 years to offset taxable income in such years, subject to various provisions on how the NOLs arose.	• NOLs that arise after the tax year ending December 31, 2017 can be carried forward indefinitely; the two-year carryback and the special carryback provisions are repealed, except for certain losses incurred in the trade or business of farming. • NOL deduction is limited to 80% of taxable income (determined without regard to the NOL deduction) for losses arising in tax years beginning after December 31, 2017.

Income Tax Accounting Considerations: ASC 740 requires corporations to establish deferred tax assets for accumulated federal, state and local NOLs, adjusted for management's best estimate on realization of such NOLs in the future.

The new tax law will require U.S. corporations to evaluate the future utilization of its NOLs and re-measure deferred tax assets established for NOLs considering that the NOLs will carry forward indefinitely and the 80% limitation for losses arising in tax years beginning after December 31, 2017. While some states and localities have recently imposed limitations on NOL carryforwards, U.S. corporations should consider which states will conform by statute to the NOL provisions of the new law and factor these in the re-measurement.

In addition, pre-2018 NOLs are still subject to two-year carryforward and 20-year carryforward; thus, measurement of realization on the deferred tax assets for those NOLs still need to be considered.

Depreciation: Shortening of the Recovery Period for Property

Prior Tax Law	New Tax Law
• An additional first-year bonus depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property placed in service before January 1, 2020. • There were various definitions, criteria and thresholds for qualified improvement property, depending if it was for leasehold, restaurant or retail, that dictates the depreciable lives of such property. • The recovery period for residential rental property for corporations that elected to utilize the alternative depreciation system (ADS) was 40 years.Under Code Sec. 179, U.S. corporations could elect to expense	• 100% first-year deduction is allowed for the adjusted basis of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. That deduction phases down after 2022 to 80% for property placed in service during 2023; 60% for property placed in service during 2024; 40% for property placed in service during 2025; 20% for property placed in service in 2026; and, 0% for property placed in service during 2027. • An election can be made not to take bonus depreciation immediately. • Elimination of separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail

Prior Tax Law	New Tax Law
the cost of qualifying property, rather than to recover such costs through depreciation deductions, with a maximum of $500,000 of the cost of the qualifying property placed in service during the tax year, reduced by the amount by which the cost of qualifying property placed in service during the tax year exceeded $2 million. • The like-kind exchanges rule provided that no gain or loss was to be recognized to the extent that the property, which included a wide range of property from real estate to tangible personal property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that also was held for productive use in a trade or business or for investment.	improvement property for property placed in service after December 31, 2017. • General 15-year recovery period and straight-line depreciation and a 20-year ADS recovery period are provided for qualified improvement property. Restaurant building property that does not meet the definition of qualified improvement property that is placed in service after December 31, 2017 is depreciable as nonresidential real property, using the straight-line method and the mid-month convention. • ADS recovery period for residential rental property is shortened from 40 years to 30 years for property placed in service after December 31, 2017. • Maximum amount that can be expensed under Code Sec. 179 is increased to $1 million, and the phase-out threshold amount is increased to $2.5 million (indexed to inflation) for property placed in service in tax years beginning after December 31, 2017. Definition of Code Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging, roofs, heating, ventilation, air-conditioning, fire protection and alarm systems, and security systems for nonresidential real property. • Effective for transfers after December 31, 2017, deferral of gain on like-kind exchanges is modified to only allow for like-kind exchanges to real property that is not held primarily for sale.

Income Tax Accounting Considerations: The provisions of the new law related to property will create larger temporary timing differences between U.S. GAAP and income tax reporting. U.S. corporations should address the need to update their federal and state tax depreciation systems and processes for additional bonus depreciation in 2018 and for future state tax legislation decoupling or conforming to the new law and identify which states will conform by statute to the cost recovery provisions of the new law. U.S. corporations that engage in nonmonetary exchange transactions for non-real property after December 31, 2017 may no longer be able to defer the tax on the asset disposal and, therefore, may have new temporary differences to the extent the exchange is not measured at fair value for book purposes.

Reduction in Domestic Dividends-Received Deduction (DRD) Percentages

Prior Tax Law	New Tax Law
• Corporations that received dividends from other corporations were entitled to a deduction for dividends received, 80% for corporations that owned at least 20% of the stock of another	• For tax years beginning after December 31, 2017, the 80% dividends-received deduction is reduced to 65%, and the 70% dividends- received deduction is reduced to 50%.

corporation, otherwise, a 70% deduction was allowed.

Income Tax Accounting Considerations: The new dividends-received deduction rules should be reflected into the deferred tax liability established for outside basis differences for equity method investees that reflect any DRDs. The reduction on the percentages of DRDs will create a much larger temporary timing difference between financial statements and tax returns.

Repeal of the Alternative Minimum Tax

Prior Tax Law	New Tax Law
• Corporate alternative minimum tax (AMT) rate was 20%, with an exemption amount of up to $40,000 for corporations with average gross receipts of more than $7.5 million for the preceding three tax years.	• For tax years beginning after 2017, corporate AMT is repealed. • For tax years beginning after 2017 and before 2022, the existing AMT credit carryforward will be allowed for use to offset the regular tax then claim a refund for 50% of the remaining AMT credit carryforwards beginning in year 2022.

Income Tax Accounting Considerations: If a corporation has recorded a deferred tax asset for AMT credit carryforwards and a valuation allowance has been recorded, under the new tax law, it could now be released since U.S. corporations now have the ability to apply for a refund for applicable AMT credit carryforwards. U.S. corporations should consider if it is appropriate to reclassify deferred tax assets as current or long-term receivables.

The FASB during its last board meeting has decided that the discounting of any refundable AMT credits is prohibited, since such credit did not arise from an arms-length bargained transaction.

Limits on Deduction of Business Interest

Prior Tax Law	New Tax Law
• Interest paid or accrued was generally deductible in the computation of taxable income, subject to various limitations such as interest paid to a related foreign entity when the payor's debt-to-equity ratio exceeded the safe harbor ratio of 1.5 to 1.0, and the payor's net interest expense exceeded 50% of its adjusted taxable income.	• For tax years beginning after December 31, 2017 and before 2022, every business, regardless of its form, is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business earnings before interest, taxes, depreciation and amortization (EBITDA) that is determined at the tax filer level, except for pass-through entities where a special rule applies wherein the net interest expense disallowance is determined at the entity level. • The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships.

Income Tax Accounting Considerations: The provisions of the new tax law regarding the limits on the deduction of business interest, and the ability to carry it forward indefinitely, will create temporary timing differences. U.S. corporations should assess the realizability (or need for a valuation allowance) of the deferred tax assets for interest expense carried forward since it can be realized to the extent of future taxable income.

Revenue Recognition

Prior Tax Law	New Tax Law
• U.S. corporations recognized revenue using the cash basis method or accrual basis of accounting, subject to satisfaction of various factors.	• For tax years beginning after December 31, 2017, corporations are required to recognize revenue during the tax year that the revenue is recognized as revenue on an applicable financial statement, except for long-term contract income. • Current deferral methods of accounting for advance payments is codified for goods and services provided by Revenue Proclamation 2004-34 that allows the deferral of the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.

Income Tax Accounting Considerations: The change in the taxable temporary timing difference related to revenue recognition under the new tax law will result in the reversal of any existing temporary timing differences, acceleration of revenue recognition, and expectation of future taxable income. This change will also affect the evaluation of the realizability of NOLs.

Permanent Book-Tax Differences

Limitation on Deduction for Fringe Benefit Expenses

Prior Tax Law	New Tax Law
• U.S. corporations may deduct up to 50% of expenses relating to meals and entertainment. • Various fringe benefits provided by employers were not included in an employee's gross income, such as housing and meals provided for the convenience of the employer on the business premises of the employer and qualified transportation fringe benefits.	• For amounts incurred or paid after December 31, 2017, deductions for entertainment expenses are disallowed, eliminating the subjective determination of whether it is business related. • Current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer, and deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. • No deduction is allowed for transportation expenses that are the equivalent of commuting for employees, except as provided for the safety of the employee.

Income Tax Accounting Considerations: U.S. corporations with sizable sales personnel should review their general ledger codes used to record meals and entertainment expenses to properly consider the activities for any potential new book-tax differences under the new tax law. U.S. corporations that have non-calendar year-ends should reflect changes to their permanent differences attributable to meals and entertainment in tax currently payable or refundable on estimated ordinary income for the current fiscal year.

The provisions of the new tax law regarding the disallowance of the deduction for entertainment expenses and qualified transportation fringe benefits will create or increase permanent timing differences.

Limitation on Excessive Employee Compensation

Prior Tax Law	New Tax Law
• Deduction for compensation to a covered employee of a publicly-traded corporation was limited to no more than $1 million per year, subject to exemptions for commissions, performance-based compensation, including stock options, payments to a tax-qualified retirement plan, and amounts excludable from the executive's gross income.	• For tax years beginning after December 31, 2017, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed. • The definition of "covered employee" is revised to include the CEO, CFO, and the three other highest paid officers. • An individual who is a covered employee for tax years beginning after December 31, 2016 will remain as a covered employee for all future years.

Income Tax Accounting Considerations: The provisions of the new tax law regarding the repeal of the exemptions for commissions and performance-based compensation, and the inclusion of the CEO and CFO under the definitions of a covered employee, will create or increase permanent timing differences. U.S. corporations should also consider whether it meets the transition grandfathering provisions for equity based awards, and adjust the related deferred tax assets.

International Book-Tax Difference

Deduction for Foreign-Source Portion of Dividends

Prior Tax Law	New Tax Law
• Foreign income earned by a foreign subsidiary of a U.S. corporation is generally not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation. • A U.S. corporation is taxed on the foreign earnings when these earnings are distributed to the U.S. corporation.	• For tax years beginning after December 31, 2017, dividends received from a foreign corporation (other than a passive foreign investment company that is not also a controlled foreign corporation) in which the U.S. corporation is at least a 10% shareholder is 100% exempted. • No foreign tax credit or deduction is allowed for any foreign taxes paid or accrued associated with a dividend that qualifies for dividend received deduction.

Income Tax Accounting Considerations: U.S. corporations should analyze the realizability of deferred tax assets for foreign tax credits since dividend income will not be a source of foreign source income to support such realization. In addition, U.S. corporations will still need to consider and assess their intentions with regard to indefinite reversal assertions for undistributed earnings.

Deemed Repatriation of Earnings Held In Certain Foreign Corporations ("Toll Charge")

Prior Tax Law	New Tax Law
• U.S. corporations were generally taxed on all income, whether earned in the U.S. or in foreign jurisdictions, which is generally referred to as the "worldwide" system of taxation. • Foreign income earned by a foreign subsidiary of a U.S. corporation is generally not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation.	• U.S. shareholders owning at least 10% of a foreign subsidiary generally must include in income, for the subsidiary's last tax year beginning before 2018, the shareholder's pro rata share of the accumulated post-1986 historical earnings and profits (E&P) of the foreign subsidiary as of the "measurement date" to the extent such E&P has not been previously subject to U.S. tax. The "measurement date" is November 2, 2017, or December 31, 2017, whichever date produces a greater result. • The portion of the E&P comprising cash or cash equivalents is taxed at a reduced rate of 15.5%, while any remaining E&P is taxed at a reduced rate of 8%. • At the election of the U.S. shareholder, the tax liability is payable over a period of up to eight years. The payments for each of the first five years equals 8% of the net tax liability. The amount of the sixth installment is 15% of the net tax liability, increasing to 20% for the seventh installment and the remaining balance of 25% in the eighth year. • U.S. corporations can utilize existing foreign tax credits and NOLs to settle the Toll Charge.

Income Tax Accounting Considerations: Historically, U.S. corporations with foreign subsidiaries have not provided a deferred tax liability on earnings not distributed to their U.S. parent corporation as it has been assumed to be permanently reinvested overseas. The provisions of the new tax law regarding the Toll Charge will give rise in the recognition of a tax payable in the period of enactment to most U.S. corporations with foreign operations. U.S. corporations should evaluate the proper balance sheet classification of the tax payable, since an election can be made to pay the Toll Charge over eight years and there may be a related impact on financial ratios required by debt and equity instruments to which the corporation may be a party. If U.S. corporations utilize existing foreign tax credits and NOLs to settle the Toll Charge, it should assess any valuation allowances previously recorded against foreign tax credits and NOLs due to the potential realization of such assets and the enactment of a territorial system.

Similar to AMT credits, the FASB has also decided during its last board meeting that the tax payable regarding the Toll Charge cannot be discounted as such payable did not arise from an arms-length bargained transaction.

Proper cash management and planning is required to evaluate the cash flow impact and timing of payment of the Toll Charge. In addition, the tax consequence on remaining book and tax basis in the foreign investees should continually be assessed to evaluate the U.S. corporation's intentions with respect to outside basis difference.

Foreign Tax Credits

Prior Tax Law	New Tax Law
• U.S. corporations that owned at least 10% of the voting stock of a foreign corporation were allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the U.S. corporation treated as having paid when the income on which the foreign tax was paid was distributed to the shareholder as a dividend. • U.S. corporations were allowed to take a deemed-paid credit for foreign taxes paid by the controlled foreign corporation (CFC) on the portion of the CFC's earnings that U.S. corporations were required to include in income.	• For tax years beginning after December 31, 2017, certain indirect foreign tax credit (FTC) provisions are repealed. • FTCs or deductions for taxes paid or accrued are eliminated on dividends where 100% dividend-received deduction applies, and there is a new limitation of FTC on foreign branch and global intangible low-taxed income.

***Income Tax Accounting Considerations*:** U.S. corporations should carefully analyze the realizability of foreign tax credit carryforwards based on the provisions of the new law, and provide for valuation allowance on existing deferred tax assets established for tax credits.

Looking Forward

This summary is not intended to encompass all the accounting considerations required by the new tax law, and there may be situations unique to your business that are not addressed in this newsletter that require further analysis and evaluation of facts.

As professional oversight bodies study the consequences of the new tax law on accounting financial statements, additional explanatory and/or regulatory pronouncements may be disseminated. We will bring any such communications to our readers as may be significant.

Contact Us

If you have any questions about accounting matters related to the new tax law — the most significant tax law change in a generation — please contact Ronald Martinez at rmartinez@pkfod.com, Kelly Lin at klin@pkfod.com, or your PKF O’Connor Davies engagement team. We are here to help.