# Notice

This presentation [and related panel discussion] contains general information only and the respective speakers and their firms are not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. The respective speakers and their firms shall not be responsible for any loss sustained by any person who relies on this presentation.

***TEI-SJSU High Tech Tax Institute (35th Annual)***

***Accounting for Income Taxes***


**Jesus Ochoa, PricewaterhouseCoopers LLP**
**JJ Schneider, Grant Thornton LLP**
**Jenny Chan, Deloitte Tax LLP**
**Rachel Breen, Ernst**

## ***Outline*** *of Topics*

1. Accounting for Income Taxes (ASC 740)
   - Permanent Differences
   - Valuation Allowances
   - Outside Basis Differences
   -

# ***Accounting for Income Taxes (ASC 740)***

## *Permanent Differences*

# *International Tax Provisions*

***While tax reform intended to move us from a worldwide to a territorial tax system, certain new provisions might result in current U.S. taxes on foreign earnings.***

***What are the new international provisions?***

- Global Intangible Low-Taxed Income (GILTI)

# *International Tax Provisions*

***Fundamental accounting question: should these items be recorded in the period as they are incurred, or should they somehow be considered in the tax rate used when measuring deferred taxes?***

**One question, three different answers!**

- Global Intangible Low-Taxed Income (GILTI) *period cost OR deferred*
- Base Erosion Anti-abuse Tax (BEAT) *period cost*
- Foreign-Derived Intangible Income (FDII) *special deduction*

# ***International Tax Provisions***

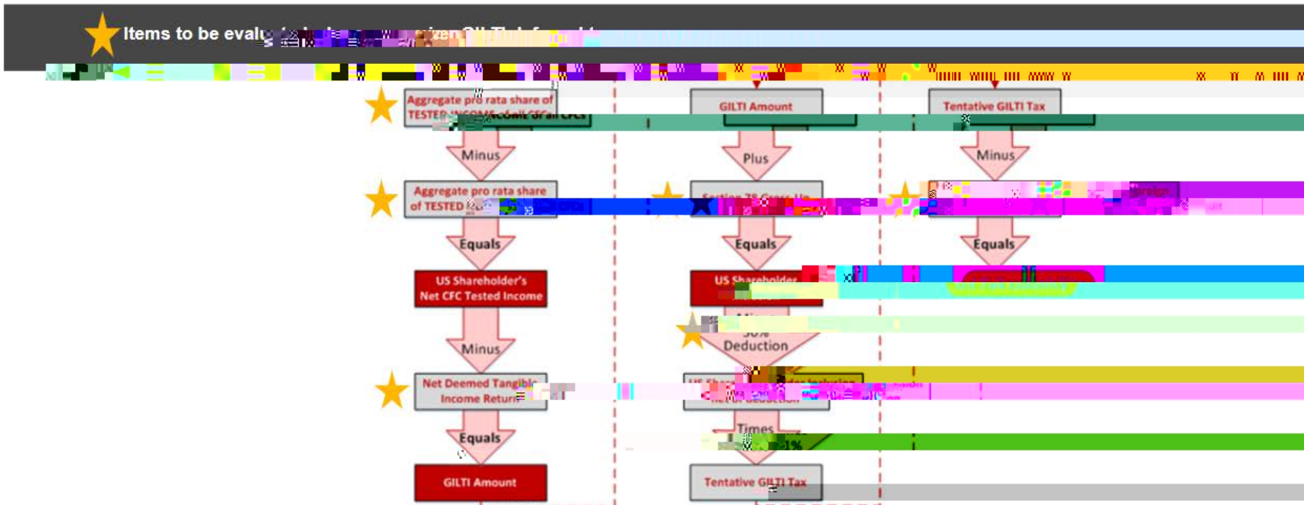
## *Complexities in Forecasting*

**Overview**

- The Tax Cuts and Jobs Act (the Act) targets erosion of the US tax base with the introduction of the 'base erosion and anti abuse tax' (BEAT) and a tax on 'global intangible low taxed income' (GILTI). Alternatively, the Act attempts to provide an incentive for US companies to produce goods and services domestically and sell them abroad by allowing a deduction for 'foreign-derived intangible income' (FDII). These provisions are complex and will require detailed modeling in order to estimate the tax effect for the year.
- Example – GILTI
  - As an example, in order to quantify the amount of GILTI subject to US tax, companies will need a significant amount of data, such as the CFCs tested income or loss computed on US tax principles, quarterly average tax basis in trade or business tangible assets, and available US tax attributes.
  - In order to model the amount of Section 250 deduction allowable to offset a US shareholder's GILTI inclusion,

# *GILTI Overview (Cont.)*

**Mechanics**




# *Deferred Tax Accounting for GILTI*

**Accounting policy election**

- FASB Staff Q&A, Topic 740, No. 5: Accounting for global intangible low-taxed income (“GILTI”), a company can make an accounting policy election to account for the deferred tax effects of GILTI in the future period as the tax arises or to recognize them as part of deferred taxes (to the extent temporary differences, upon reversal, would impact the GILTI calculation)

- **Considerations in making the election**
  - Impact on ETR
  - Impact on Valuation Allowance
  - Impact on Disclosures

# *Deferred Tax Accounting for GILTI (cont.)*

**GILTI Deferred Approach**

# *BEAT Overview*

**Framework**

- The base erosion anti-abuse tax ("BEAT") is essentially a 10% minimum tax (5% for tax years beginning in 2018) calculated on a base equal to the taxpayer's income determined without the tax benefits arising from base erosion payments and base erosion percentage of any NOL allowed for the tax year.
- **Base erosion minimum tax amount:** equal to 10% (5% in the case of taxable years beginning in calendar year 2018 and 12.5% for tax years beginning after December 31, 2025) of the *modified taxable income* over the regular tax liability, reduced (but not below zero) by the excess of credits allowed under Chapter 1 over the sum of:
  - Credits allowed under §38 which are properly allocable to the research credit under §41, plus
  - The portion of the *applicable §38 credits* not in excess of 80% of the lesser of the amount of such credits or the base erosion minimum tax amount (determined without regard to the applicable §38 credits).
- **Modified taxable income:** taxable income determined without regard to:
  - any base erosion tax benefit with respect to any base erosion payment, or

# *BEAT Overview (cont.)*

**Framework, continued**

- Base erosion payment: any amount paid or accrued by the taxpayer to a foreign person that is a related party and with respect to which a deduction is allowed. Also includes:
  - any amount paid or accrued to a related foreign person in connection with the acquisition of depreciable or amortizable property
  - any premium or other consideration paid or accrued to a related foreign person for reinsurance payments
  - any amount paid or accrued to a surrogate foreign corporation or a member of the expanded affiliated group which results in a reduction of the gross receipts of the taxpayer.
- Base erosion payments exclude:
  - Any amount paid for services if the services are eligible for using the services cost method (without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and the amount constitutes the total services cost with no markup component.
  - Any qualified derivative payment, i.e., a payment made pursuant to a derivative with respect to which the taxpayer marks to market, treats any gain/loss as ordinary, and treats gain/loss on any payment made under the derivative as ordinary.

# *FDII Overview*

### *Deduction Allowance*

- US domestic corporation may deduct an amount which is the lesser of:
  - the sum of 37.5% of its foreign-derived intangible income ("FDII") plus 50% of its GILTI inclusion; or
  - its taxable income.
- Allowable deduction percentage decreases to 21.875%for FDII and 37.5% for GILTI for tax years beginning after December 31, 2025.
- Treated as a special deduction (similar to the former §199 deduction).

**FDII defined**

Foreign derived intangible income is the amount which bears the same ratio to the corporations deemed intangible income as its foreign-derived deduction eligible income ("FDDEI") bears to its deduction eligible income ("DEI").

Intangible Income = Income X

# *FDII Overview (Cont.)*

**Deduction eligible income**

**Deduction eligible income** is the excess, if any, of:

• The gross income of a domestic corporation, excluding:
- Subpart F income
- GILTI inclusion
- Any financial services income (defined in §904(d)(2)(D))
- any dividend received from a CFC by its US shareholder
- any domestic oil and gas income of the corporation, and
- any foreign branch income (as defined in §904(d)(2)(J))

• **Over** the deductions (including taxes) properly allocable to such gross income.

Eligible Gross Income - Allocable Deductions (including taxes) = Deduction Eligible Income

# *FDII Overview (Cont.)*

**Foreign-derived deduction eligible income**

**Foreign-derived deduction eligible income** is any deduction eligible income of the taxpayer that is derived in connection with:

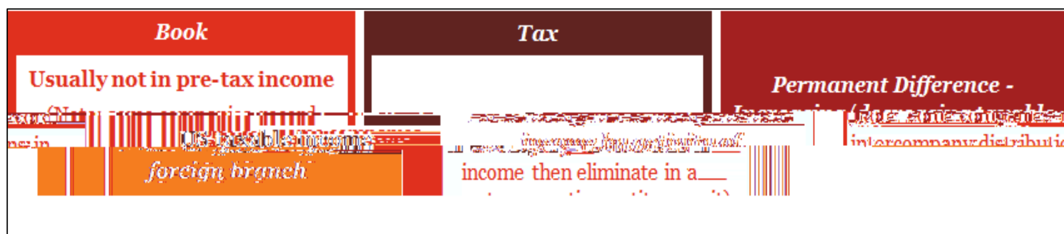
- **property** sold by the taxpayer to any person who is not a US person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use, or
- **services** provided by the taxpayer that it establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.

# *Foreign Branches - Income*

**Overview**

The income of a foreign branch of the US or disregarded foreign entity owned by the US is generally included in US taxable income

- US inclusion of foreign branch is computed under US law, which is likely different than amount computed under foreign law
- There may be limitations on use of losses, such as dual consolidated losses (§1503(d))
- §901 foreign tax credit may be available subject to new US FTC branch limitation



# *Foreign Branches – Deferred Accounting*

As ***foreign branch*** earnings are subject to taxation in both the US and foreign jurisdictions, deferred taxes should be recorded for both jurisdictions.

- The deferred taxes recorded in the US should also include the US tax effects of the foreign temporary differences, similar to the federal tax effect on state deferred taxes (often referred to as ***"mirror image deferreds"*** if it is expected foreign taxes are fully credible).

| | **Book-tax difference** | **Tax Rate** | **DTA / (DTL)** |
|---|---|---|---|
| PP&E (Country X) | (1,000) | 30% | (300) |
| PP&E (U.S.) | (1,000) | 21% | (210) |
| U.S. DTA on branch temporary differences* | | | 210 |
| Total DTA / (DTL) | | | **(300)** |

* The foreign deferred tax liability of $300 will increase foreign taxes paid when settled, resulting in an increase in future FTCs in the US. In this case, the FTCs will be limited based on the tax rate because the US tax rate is lower than the tax rate of Country X (i.e., 70%=21%/30%, 70%*300=210).

# *Foreign Branches – Other Considerations*

**Dual consolidated losses**

- When the foreign branch incurs a loss, a deferred tax asset would arise in the foreign jurisdiction for that loss if it can be carried forward to offset future foreign taxable income
- Generally, a foreign-branch loss would also be deductible under current US tax law. If that were the case, should a "double" tax benefit (i.e., current US deduction and foreign deferred tax asset) be recognized
- A DTL should be reported in the US jurisdiction because the future foreign taxable income necessary for the realization of the foreign deferred tax asset will also be reported as US income in future years, with no foreign tax credits available to offset the US tax in the year during which the foreign income is earned
  - The tax liability for this taxable temporary difference would generally be based on the foregone foreign tax credits that would otherwise have been available to the company had cash taxes been paid

# *Section 162(m)-$1 Million Dollar Compensation Deduction Limit*

**Pre-U.S. Tax Reform**

- Covered employees were the CEO and next three highest compensated named executives, **excluding CFO**, as of the **last day** of the tax year
- Exception for **qualified performance-based** compensation

**Post-U.S. Tax Reform**

- Expanded scope and repeals exception
- "Covered employee" definition expanded to **include CFO**
- Extended application to both **current and former covered employees**-applies to any payments made after retirement or death
- Anyone apo(o)-0ron./TT1gFOr3C / yer j6(e)-uFTJ 0 Tt421.2-rETJ 0 T oc 0.001 r3C (•)Tj EMC 1.6(nt)aTJ 0 Tt4day r3C

# *Section 162(m)-$1 Million Dollar Compensation Deduction Limit*

**Tax Accounting Considerations and Accounting Policy Election**

- The amount of deductible temporary differences associated with an executive's compensation should be based on the combination of the estimated deductible amount of share-based compensation for tax purposes using the grant-date fair value and the cash compensation
- Amounts that are expected to be subject to the §162(m) limitation are not considered deductible and therefore are not deductible temporary differences
- It

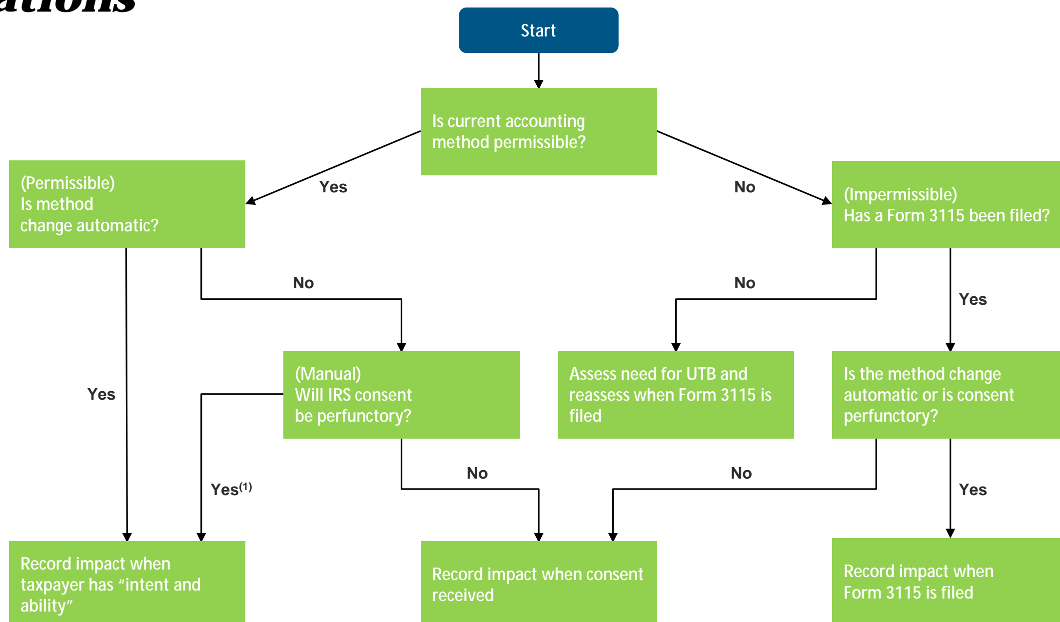
## *What is an Income Tax?*

## *What is not an income tax?*

Taxes and government assistance programs that are NOT within the scope of income tax accounting generally are either a non-income based tax or a government grant.

| Non-income-based tax | Government grant |
| --- | --- |
| Revenue, payroll, use taxes (accounted for under ASC 450, Contingencies and Concepts Statement No. 6, Elements of Financial Statements) | International Accounting Standards 20, *Accounting for Government Grants and Disclosure of Government Assistance* (collectible from government regardless of taxable income) |

# *Voluntary Method Changes & Unrecognized Tax Benefit Implications*



# ***Accounting for Income Taxes (ASC 740)***
*Valuation Allowances*

## ***Valuation Allowance Considerations***

**Cumulative income/losses**

- Look back period to consider depends on facts
- What is included in “income/loss”?

**Scheduling of temporary difference reversals**

- Expectations with respect to temporary differences on the balance sheet date
  - DTAs that will turn into NOL with 80% limitation
  - Should not consider originating temporary differences

# Valuation Allowance Considerations (cont.)

**Scheduling of temporary difference reversals**

- Net operating losses (NOLs)
  - Comparison of pre- and post-reform generated losses
  - Lack of expiration does not mean realizability
  - Indefinite lived assets DTL with indefinite carryforward NOL DTA
  - Limitations on usage and reversal pattern of taxable temporary differences
  - IRC 382 limitations and DTL on identifiable intangibles
- IRC 163(j) disallowed interest
  - Allowable amount can be impacted by other reversing temporary differences



# Valuation Allowance Considerations (cont.)

Indefinite-lived intangible asset ("naked credit") considerations

- Consider as source of income for NOLs generated after 12/31/17 that do not expire
- Consider as source of income for assessing the realizability of deferred tax assets that reverse into NOLs that do not expire

| Description | Tax Effected Balance | 2018 | 2019 | 2020 |
|---|---|---|---|---|
| Other deferred tax assets | 2,310,000 | (770,000) | (770,000) | (770,000) |
| Tax goodwill | (1,680,000) | | | |
| Net operating losses | 10,500,000 | 770,000 | 770,000 | 770,000 |
| Total temporary differences | 11,130,000 | | | |
| Valuation allowance (before indefinite- | | | | |

# ***Accounting for Income Taxes (ASC 740)***
*Outside Basis Differences*

## ***Outside Basis Differences and Indefinite Reinvestment***
*The presumption…*

ASC 740-30 provides a presumption for undistributed earnings of a subsidiary:

## ***Outside Basis Differences and Indefinite Reinvestment***
*The exception…*

Exception to the recognition of deferred taxes:

- If the indefinite reversal criteria is met, a deferred tax liability shall not be recognized for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary unless it becomes apparent that the temporary difference will reverse in the foreseeable future

The indefinite reversal criteria:

- The presumption that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation
- A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely
- Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity's representation of indefinite postponement of remittances from a subsidiary

## ***Outside Basis Differences and Indefinite Reinvestment***
*Reminders*

Tax reform ***did not eliminate*** the need for an entity to consider its assertion about the indefinite reinvestment of undistributed earnings when a taxable temporary difference exists

A company should consider its expected manner of recovery in determining to what extent, if any, a taxable temporary difference exists with respect to a subsidiary

- Temporary differences may exist with respect to Section 986(c) currency gains (losses) on previously tax income (PTI), section 965(b) PTI, withholding taxes, and state taxes

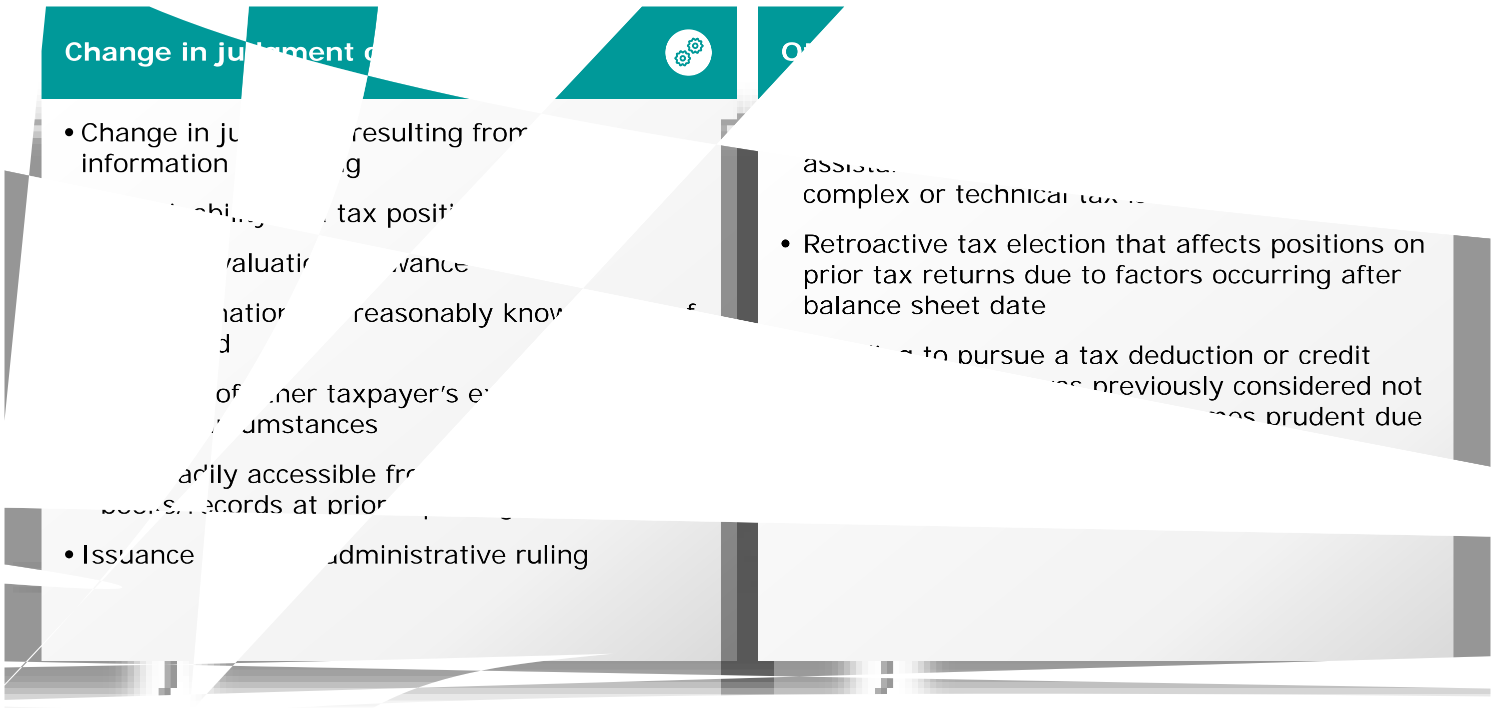
Continue to evaluate the ability to assert indefinite reinvestment to avoid recognizing deferred tax consequences associated with taxes that would become due once an actual distribution is made

Consider different intentions on the part of the operations of the business due to the potential accessibility of cash with limited tax cost

As economic conditions change or as new transactions are planned as a result of changing economic conditions, an entity may reevaluate its global cash needs and revise its plans for repatriating or reinvesting foreign earnings

# ***Accounting for Income Taxes (ASC 740)***
## *Accounting Changes and Error Corrections*

***es – ch … nates***



"A change in accounting estimate shall be accounted for in the period of change if the change affects that period only or in the period of

- Considered material if error(s) being corrected is **material**
- For public companies, generally results in additional filings, disclosures, and language in audit report and use of special financial statement column headings (e.g., "as previously reported," "adjustments," "as restated")

**Management's assessment** (auditor-detected errors)

•

## ***Impact of error on internal controls – classification of***

# ***FASB Developments and New Standards***

*FASB Disclosure Framework Income Taxes - Update*

## *FASB Disclosure Framework: Income Taxes*

**Proposed Additional Disclosures – All Entities**

- Income (or loss) from continuing operations before intra-entity eliminations and income tax expense (or benefit) disaggregated between domestic and foreign
- Disaggregate the following between federal, state and foreign*:
- • Income ta(t)-2.6(y)16001 Tw 1376EMC /2g0(ben)1(ef)-1.7.PTw [(i2PTw [(i2P)1(ef)3)1(ef6)0.73k2. [(I)-1

## *FASB Disclosure Framework: Income Taxes*

**Proposed Additional Disclosures – PBEs Only**

- The ending balance of unrecognized tax benefits by balance sheet line item
- The amount and explanation of the valuation allowance recognized and released

## *FASB Disclosure Framework: Income Taxes*

**Proposed Modifications to Disclosures – PBEs Only**

**Current**

- Amounts and expiration dates of carryforwards shown on the income tax return

**Proposed**

- Amounts of federal, state and foreign carryforwards (tax effected) before valuation allowance; disaggregated by expiration for the first 5 years, total for any remaining years and total for those that do not expire
- Amount of valuation allowance recognized for federal, state and foreign carryforward deferred tax assets
- Total amount of unrecognized tax benefits that reduces deferred tax assets for carryforwards

## *FASB Disclosure Framework: Income Taxes*

**Proposed Modifications to Disclosures – PBEs Only**

**Current**

- A reconciliation (using percentages or dollar amounts) of the reported income tax expense to the income tax expense that would result from applying the domestic federal rate to pretax income

**Proposed**

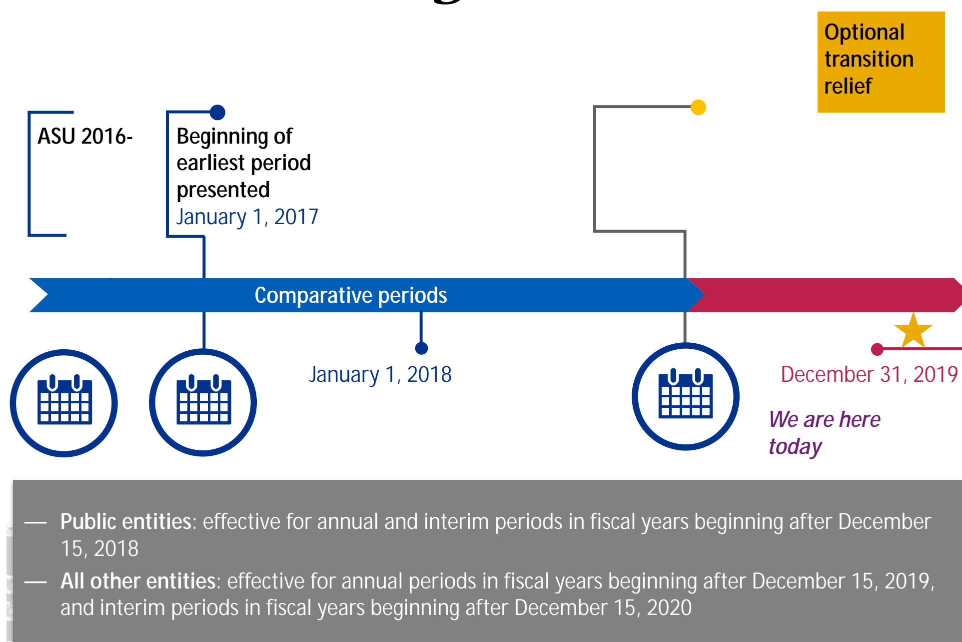
- Disclosure would be aligned with the SEC requirement to:
  - Identify the 'domestic' rate as the federal income tax rate in its country of domicile;
  - Explain the basis for using rate other than the federal rate; and
  - Separately disclose reconciling items that are more than five percent of the amount computed by multiplying income before tax by the applicable statutory federal income tax rate
  - Public

# FASB Disclosure Framework: Income Taxes

**Proposed Removal of Disclosures – All Entities**

- The nature and estimate of possible changes in unrecognized tax benefits for the next 12 months.
- The cumulative amount of each type of temporary difference not recognized because of the

# ASC 842 – Lease Accounting



# *ASC 842 – Lease Accounting*

**Tax rules governing leasing transactions will not change, however, the adoption of ASC 842 will likely affect the calculation of deferred tax assets and liabilities**

**ASC 842 may spotlight the company's historical tax treatment of leases**

- Double-check that it is correct
- Consider risk mitigation, if appropriate

**Lease classification**

- Is your company "just following books" to distinguish true leases from tax ownership?
- If so, develop a game plan for assessing and managing potential IRS audit exposure

**Capitalized costs**

- Tax generally capitalizes different lease acquisition costs than those required for financial accounting purposes

**Rent or interest / depreciation expense**

Does your company currently record any book/tax differences for rent expense (for true leases) or interest expense (for capital leases)?

If not, does this signal a potential IRS exposure item?

**Consider state and local tax implications**

# *Additional Considerations*

## *Altera Case Accounting Considerations*

June 7, 2019 decision by the U.S. Court of Appeals for the Ninth Circuit in Altera Corporation & Subsidiaries v. Commissioner of Internal Revenue

- 3-judge panel of the Ninth Circuit upheld the validity of the 2003 regulations overturning a Tax Court decision that held the regulations were invalid
- Ninth Circuit sided with IRS with respect to application of regulations requiring stock-based compensation costs to be included in the pool of costs shared in a cost-sharing arrangement

**FIN 48 considerations:**

- Assume positions will be examined
- Impact on Ninth Circuit resident Taxpayers
- Impact for taxpayers residing outside of the Ninth Circuit

## *Altera Case Next Steps*

**Panel rehearing**

• Any judge can ask the three-judge panel if it wants to rehear the case itself (grant panel rehearing). The panel has up to 90 days (from the date of the government's latest response to the court) to respond.

## *State Aid Case Updates*

The following European Commission (EC) state aid cases have either had rulings or are still in process:

| Country | Company | Case Status/Outcome |
|---|---|---|
| Luxemburg | Amazon | Ongoing |
| Ireland | Apple | Ongoing |
| Luxemburg | Fiat | EC decision upheld |
| Netherlands | Ikea | Ongoing |
| Luxemburg | McDonald's | Ongoing |
| Netherlands | Nike | Ongoing |
| Netherlands | Starbucks | EC decision overruled |

# *Appendix*

This year's theme was consistent with prior years focused on collaboration and transparency. All participants in the financial reporting supply chain need to work together to provide investors with transparent and decision-

## *SEC Staff Observations*

- Capital formation and disclosure effectiveness are among the top priorities of the SEC's Division of Corporation Finance
- The SEC staff has worked to streamline its rules, including making amendments to eliminate, modify, or integrate into other SEC requirements certain disclosure rules, and proposing rules to simplify certain disclosure requirements
- The SEC staff is also looking into whether the auditor attestation on ICFR continues to be beneficial for certain smaller reporting entities
- Key message simpler is better

## *SEC Staff Observations* (continued)

- Frequent SEC comment letter trends include
  - Revenue recognition
  - Business combinations
  - Goodwill and intangible assets
  - Income taxes
  - Non-GAAP measures
  - MD&A
  - Fair value disclosures
  - Segments

*Thank You*