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KPMG report: Income tax accounting considerations of U.S. tax reform

The U.S. House of Representatives passed a tax reform bill—H.R. 1, the "Tax Cuts and Jobs Act"—on November 16, 2017. The Senate Finance Committee also, approved its version of a tax reform bill on November 16, 2017, thus setting the stage for Senate consideration of the bill as early as this week.

As the pace of tax reform accelerates, taxpayers need to begin to consider the financial reporting impact of potential fundamental changes to the U.S. tax system. When to record adjustments and what to disclose is quickly moving up the priority list of items for corporate tax professionals to consider.

Tax law changes, implications

The entire impact of the change in tax law would need to be reflected directly in income tax expense (benefit) from continuing operations—regardless whether items of deferred tax were originally accounted for through "Other Comprehensive Income" (i.e., no backwards tracing).

Deferred tax assets (liabilities) would be re-measured as of the date of enactment, even though the changes may not be effective until future periods. If the enactment date is different from a taxpayer entity's normal closing cycle, a company would need to make reasonable efforts to estimate the temporary differences at the date of enactment. If for example, the proposed reduction in the corporate tax rate would be delayed until January 1, 2019, scheduling would be required to determine deferred tax temporary differences that would reverse prior to the effective date, and those that would remain for re-measurement to the lower rate at January 1, 2019.

Attributes that have been established as deferred tax assets could also require adjustment. For instance, if the alternative minimum tax (AMT) regime were repealed as currently proposed in both the House and Senate versions of the tax bills, transition

guidance that permits partial or full monetization of existing AMT carryforwards would need to be considered. For other credits carryforwards, a complete write-off of the associated deferred tax asset may be necessary.

What if enactment is delayed until January 2018? Taxpayers would need to consider a subsequent events disclosure in 2017 year-end financial statements, addressing the financial reporting impact of the new law accounted for in Q1 of 2018.

Indefinite reinvestment assertion

Mandatory taxation of foreign earnings would cause a significant impact to existing assertions on investments in foreign subsidiaries (APB 23 exception), as the assertion may not be supportable if taxation is required. This may result in an income tax liability; however, deferred tax assets may continue to be prohibited unless they become apparent to reverse within the foreseeable future or otherwise offset taxation of other foreign earnings.

For some time now, tax professionals have encouraged companies to determine the balance in all of the earnings and profits (E&P) pools and the tax pools of their foreign subsidiaries. The House and Senate versions of the tax bills call for a tax on deferred, untaxed E&P with one rate applying to cash and other liquid assets, and another rate applying to all other E&P.

The proposals currently contain several complex concepts on how to measure the amount to which each rate will apply. If a new law is enacted in 2017, or early 2018 before year-end financial statements are issued, one thing is for certain—the filing date of companies' 10-K would not change, and the analysis would need to be completed before the 10-K is filed.

Also, independent of the date of enactment, what if a taxpayer were to reconsider its indefinite reinvestment assertion to remit a dividend in 2017 under existing law, perhaps in an attempt to monetize excess foreign tax credits? Those changes in judgment would be required to be accounted for in Q4.

Valuation allowances

Under the proposed transition to a territorial system (or a partial territorial system), a company may need to assess whether existing foreign tax credit carryforwards are realizable. With the sweeping changes proposed to the taxation of future foreign earnings and the ability to offset U.S. tax with foreign tax credits, careful consideration of the realizability of carryforwards would be necessary.

Other proposed features of the House and Senate versions of the bills may affect future realizability assessments. For example, to the extent net interest expense is limited to a percentage of EBITDA or EBIT, future taxable income may be higher than that forecast under current tax law based upon the same underlying operating

assumptions. This alone could potentially change management's judgment on the realizability of its U.S. deferred tax assets.

And to the extent that net interest expense carryforwards expire after, for example, five years as proposed in the House bill, scheduling would be required to determine the amount of accrued interest-related deferred tax assets that may require a valuation allowance.

If certain existing carryforwards (e.g., net operating loss (NOL) carryforwards) no longer expire as a result of tax reform, then those carryforwards that previously needed a valuation allowance may now need to be considered realizable as a result of the taxable temporary differences associated with indefinite-lived assets.

And to the extent that such NOL carryforwards are indexed for inflation, the uplift on the amount of NOL carryforwards in a future period may create new permanent differences in the annual effective tax rate calculation.

Disclosure

There are a growing number of inquiries concerning potential disclosures in upcoming annual financial statements. As noted previously, assuming enactment is delayed until 2018 but before the filing of 2017 financial statements, it would be appropriate for companies to disclose this subsequent event as well as the expected quantitative impact on the accounts being presented.

If however, enactment is delayed until after the filing of annual financial statements, management may consider a discussion in the MD&A or elsewhere in describing "Risks and Uncertainties" impacting the business, as they would for any pending legislation that could have a material impact on their business.

How KPMG can help

The forgoing is intended as a starting point for a discussion between tax and finance professionals on the financial reporting implications of tax reform. As the tax reform legislative process continues over the next several weeks and possibly into early next year, keep in mind that these changes may need to be quickly distilled and quantified for accounting and/or disclosure in the company's financial statements.

For more information, contact your local KPMG Business Tax Services lead partner who can connect you to a member of the Accounting for Income Tax Group in your region or, contact the Accounting for Income Taxes group in Washington National Tax:

Ashby Corum | +1 (313) 230-3361 | acorum@kpmg.com

Jenna Summer | +1 (202) 533-3614 | jsummer@kpmg.com

Direct comments, including requests for subscriptions, to Washington National Tax. For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.