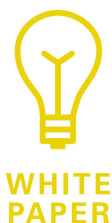


# 2018 ASC 740 Year-End Considerations

THE FREED MAXICK ASC 740 GROUP

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**Year-End Considerations Checklist**

Few aspects of financial reporting are more complex than the income tax provision. Like many accounting standards, the rules that govern accounting for income taxes (Accounting Standard Codification (ASC) 740) remain relatively stable. However, recent years have seen sweeping changes to the definition of income on both the GAAP side and the tax side. So while the process of reconciling book income to tax income hasn't changed, the equations for calculating the income amounts on each side of the equations have undergone major transformation. For instance:

- The Tax Cuts and Jobs Act (the Act) changed everything from the tax rates applied to recorded income tax balances to the treatment of profits held in controlled subsidiaries overseas.
- New GAAP Revenue Recognition standards apply to nonpublic entities with annual reporting periods beginning after December 15, 2018. Public entities are covered for years that began after December 15, 2017.
- State tax laws have continued to change throughout the year and the Supreme Court's decision in South Dakota v. Wayfair has raised significant questions about where businesses may have an obligation to collect and remit state sales taxes.

This publication provides the user with a very brief introduction to the variables in play when preparing the income tax provision for the 2018 year-end, including a checklist highlighting some key areas of focus. It is intended to help the reader understand some of the complex moving pieces that will be discussed during a consultation with tax and accounting professionals on the topic.

# 1

# Tax Reform Updates

### STAFF ACCOUNTING BULLETIN 118 (SAB 118)

Under ASC Topic 740, the impact of changes in tax rates and laws on existing recorded income tax balances is recorded in the year of enactment. Since the Tax Cuts and Jobs Act (Act) was signed into law on December 22, 2017, many calendar year companies faced challenges when trying to finalize the impact of the Act on their 2017 year-end financial statements. As a response, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin 118 (SAB 118), which provided financial reporting guidance for SEC registrants. Since SAB 118 was only applicable to SEC registrants, the Financial Accounting Standards Board (FASB) adopted the provisions of SAB 118 for all companies through Accounting Standards Update No. 2018-05.

Under this guidance, companies could either finalize their analysis of the Act and fully record the impact on the financials, develop reasonable estimates of the impact, or record their income tax accounting under the provisions of the tax law that existed prior to the Act. This guidance included not only calendar year end filers, but also fiscal year-end filers, whom may have had filing requirements for periods that included the enactment date. If a full analysis was not completed by the year-end encompassing the enactment date, companies are expected to either originally record or adjust amounts previously recorded as reasonable estimates. SAB 118 provides companies with a measurement period of up to one year after the enactment date to finalize the impact to their financial statements and make these entries or adjustments.

With the maximum measurement date being one year from the date of enactment, by December 22, 2018, which is nearly upon us, all calendar-year companies  will have to show the entire impact of the Act no later than their 2018 financial statements. Fiscal year end filers will have to finalize all impacts by the filing which includes December 22, 2018, which could be a quarter-end filing rather than a year-end filing. In addition to finalizing the financial statement impact, it is also important to remember that SAB 118 requires the following disclosures about material financial reporting effects of the Act, which companies will likely disclose in financial reporting periods between the enactment date, and either the finalization of the impact of the Act, or the period including December 22, 2018, whichever is earlier:

- The effect of measurement period adjustments on the effective tax rate
- Disclosures of when the accounting for the income tax effects of the Act has been completed

## NAKED CREDIT & VALUATION ALLOWANCE CONSIDERATIONS

Companies may need to reassess the amount of valuation allowance needed if a "naked credit" deferred tax liability ("DTL") exists. A "naked credit" exists when a company has a full or partial valuation allowance and a DTL related to an indefinite lived asset. The reversal of a DTL related to indefinite-lived assets (i.e. goodwill, trademarks, other intangible assets with an indefinite useful life) does not provide a source of taxable income when determining the amount of valuation allowance needed on a deferred tax asset ("DTA") with a finite life. Therefore, for companies with a full or partial valuation allowance and a DTL related to an indefinite-lived asset, the DTL will continue to exist on the balance sheet resulting in the "naked credit".

However, due to the Act, a net operating loss ("NOL") generated in tax years beginning on or after January 1, 2018 has an indefinite carryforward and can only be used to offset 80% of taxable income. Therefore, a "naked credit" DTL can be considered a source of income to support the realization of a DTA for these NOLs, since the NOLs do not expire. Due to the changes in NOL rules, companies will need to separately track NOLs subject to the 20-year carryforward period and NOLs that have an indefinite carryforward period, as well as understand the importance of scheduling the pattern of reversal for DTAs and DTLs in order to determine the realizable amount.

## GILTI & FDII

The Act's GILTI provisions, short for "Global Intangible Low Taxed Income," imposes a US tax on a controlled foreign corporation's (CFC's) foreign income (less excludable items and allocable expenses) in excess of 10% of their basis in tangible assets. The FDII, or "Foreign Derived Intangible Income" provision, is almost the exact opposite of GILTI. It provides a permanent deduction for the US income on exported goods and services (including certain exclusions and expense allocations) in excess of 10% of US tangible assets. One of the biggest takeaways for year-end planning is that in order to compute both of these amounts, you will need to calculate both your US depreciable assets and foreign depreciable assets using the Alternative Depreciation System (ADS).

For GILTI, planning should be occurring now as there are some risks with the calculation. If there is insufficient taxable income that would limit the GILTI deduction, GILTI will absorb deductions at a lower rate. Also, NOLs are utilized without consideration of the GILTI deduction, therefore utilizing them at a faster rate. FDII can be an important tool to companies. It can help lower cash taxes and the company's overall effective tax rate. However, both the GILTI and FDII calculations are highly complex and require significant amounts of information, so starting the calculation as soon as possible is imperative for year-end.

**Read Freed Maxick's other blog posts on GILTI, including our GILTI calculator**

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## TAX ACCOUNTING EFFECT OF DEEMED REPATRIATION FROM FOREIGN SUBSIDIARIES (ASC TOPIC 740-30-25, FORMERLY APB23)

The general rule for US income taxation of undistributed earnings of foreign corporate investments is that such earnings are not taxed until distributed, with some exceptions. Such a rule creates basis differences for financial reporting and tax purposes that require analysis to determine if a deferred tax liability or asset is required.

The presumption under APB 23 is that all earnings will be distributed and therefore a deferred tax liability should be recorded if the recipient expects to pay income taxes on those earnings when distributed. However, the presumption that all undistributed earnings will be transferred to the recipient entity may be overcome, and no income taxes shall be accrued by the recipient entity, if sufficient evidence supports a "permanent reinvestment assertion" that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.

If such a position is taken by the taxpayer, and there is enough support, then the deferred tax liability is not necessary.

Due to the passage of the Act in December 2017, the landscape of APB 23 has changed. The Act has accelerated the taxation of unremitted earnings of controlled foreign corporations at November 2, 2017 or December 31, 2017. Additionally, for distributions made after December 31, 2017 the Act allows a domestic corporation that is a U.S. shareholder of a specified 10% owned foreign corporation to take a deduction in an amount equal to the foreign-source portion of any dividend received from the specified 10% owned foreign corporation. As a result, future distributions from a specified foreign corporation may not create a U.S. level income tax unless distributions exceed outside basis in the foreign entity. As a result, we foresee the following changes to the applicability of APB 23:

- The permanent reinvestment assertion still needs to be analyzed to determine whether or not the company meets this exception. However, unlike under the pre-Act rules, if a permanent reinvestment assertion can not be upheld, the applicable taxes to accrue may be limited to withholding tax on undistributed earnings.

- Additionally, if the permanent reinvestment assertion can not be made, it may be necessary to accrue currency adjustments on undistributed earnings based on the differences between the exchange rate at the balance sheet date and the rate used when income was recognized on the undistributed earnings, if any.

- The new global intangible low-taxed income (GILTI) rules need to be addressed. Currently, there are various different viewpoints within the industry as to whether or not entities should recognize deferred taxes for temporary basis differences to reverse as GILTI in future years. A common approach that has been acceptable is that it would not be appropriate to provide deferred taxes on these basis differences due to the fact that the computation for GILTI is dependent on contingent events which suggests that taxes on GILTI should be accounted for as period costs similar to special deductions.

- If disposition of a foreign entity is likely to occur in the foreseeable future, gain or loss should still be considered under APB 23.

## RETURN TO PROVISION ADJUSTMENTS

After filing the 2017 income tax return, companies can begin analyzing the various return to provision adjustments ("RTP"s) that need to be made. RTP analysis involves comparing the estimated book-tax adjustments that were identified during the provision with the adjustments actually recorded on the tax return. All of these variances are recorded as a true up to the prior year current tax expense, while variances to the temporary differences are also recorded on the 2018 provision as a true up to the prior year deferred tax expense. Historically, the RTPs for temporary differences had no impact on a company's overall tax expense since the increase or decrease in current tax expense for the RTP adjustment was subsequently offset by an increase or decrease in the deferred tax expense. However, because of tax reform and the change in the federal rate from 35% to 21% beginning on January 1, 2018, a calendar year end corporation will have an RTP temporary adjustment that increases or decreases the current year federal tax at 35% but the offsetting adjustment to deferred tax expense will only increase or decrease the deferred tax expense at 21%. Therefore, because of the change in rate, RTP adjustments on temporary differences which historically had no effect on a company's rate or federal tax expense will now ultimately impact the company's overall tax expense or benefit.

## FISCAL YEAR FILERS

For Tax Reform, many Fiscal Year filers who extended their tax returns are in the midst of preparation or just getting started. There are many items from Tax Reform that should be taken into considerations for fiscal year filers whose tax year bridges into 2018. For example, the new tax rate of 21% is now a blended rate for fiscal year filers based on how many months of their tax year are included in 2018 vs. 2017.

From an international perspective, there are items that should be taken into consideration relating to the fiscal year. If you are filing Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, and are an in accumulated earnings position, Section 965, the mandatory transition tax, will most likely be included in fiscal year 2018 as long as the 5471's tax year is the last year beginning before January 1, 2018. One reprieve for fiscal year filers is that two other international provisions of the Act, GILTI and FDII, will apply to fiscal years beginning after December 31, 2017. Therefore, filers that are currently preparing the tax returns that bridge into 2018 will not have to calculate those amounts until the following year.

Another reprieve is that the new interest expense limitations (163(j)) will also apply to fiscal years beginning after December 31, 2017.

Businesses must also consider the Act's changes to deductibility of business meals and entertainment expenses. Meals are still 50 percent deductible in most situations but entertainment such as sports and theater tickets are non-deductible if they were incurred after December 31, 2017. Expenses for company-sponsored events such as holiday parties and company picnics still remain at 100 percent deductible.

Bonus deprecation will now be increased to 100 percent for qualified property acquired and placed in service after September 27, 2017. One item of note is that after September 27, 2017 to December 31, 2017, 39-year assets (typically buildings or building-related items) are 100 percent deductible allowed under bonus deprecation. However, after December 31, 2017 bonus deprecation is no longer applicable for 39 year assets and must be depreciated under MACRS.

## RATE RECONCILIATION

The difference between the statutory and effective tax rates is disclosed in the rate reconciliation. There are various items that will affect the rate reconciliation in this year-end that did not have an effect in the past. Any difference in the Section 965 transition tax calculated in the previous year-end provision compared to what was filed with the tax return should be included in your rate reconciliation. Also, particular to this year, provision to return temporary items will also affect the effective tax rate. As highlighted above, the difference in the enacted federal tax rate will cause these temporary items that typically do not have an effect on your effective tax rate to either increase or decrease it. The new GILTI and FDII tax reform items are permanent in nature and will also have an effect on your effective tax rate.

The new Section 162(m) executive compensation limits could create a permanent item on any compensation in excess of $1M to any covered employee. This no longer has the performance-based compensation exception and increases the pool of covered employees. It is another item to think about when calculating the difference between the statutory and effective rates.

For disclosure purposes, reporting entities are required to disclose the nature of significant differences between the statutory income tax rate and a company's effective tax rate.  Although, "significant" is not defined in accounting standards, the SEC requires the disclosure of individual reconciling items that has an effect on the rate of 5% of the statutory rate. Prior to the Act, this typically would have approximately been any item that would affect the rate by 1.7%. Now that the statutory rate is 21%, this threshold decreases to approximately 1.1%.

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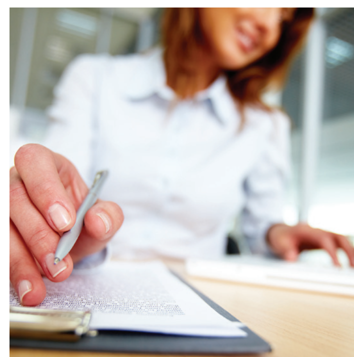
# Revenue Recognition and Other Accounting Standard Updates

## ASC 606 – REVENUE RECOGNITION

Public entities saw new revenue recognition standards that were required for all annual reporting periods beginning after December 15, 2017. Nonpublic entities will need to follow the new guidance for GAAP purposes for all annual reporting periods beginning after December 15, 2018. As a result, companies need to determine if the new guidance creates additional book-tax differences that need to be considered going forward.

Under GAAP, the main principle of the new guidance is to recognize revenue in an amount that reflects the consideration a company expects to gain in exchange for providing goods or services to a customer. This requires each company to 1) identify the contract; 2) identify the performance obligations under the contract; 3) determine the transaction price; 4) allocate the transaction price to the performance obligation; and 5) recognize revenue when the obligation is satisfied. The objective of the standard is to make revenue recognition more consistent and comparable between companies.

From a tax perspective, once the GAAP treatment has been determined, the same information can be used to determine the proper tax treatment. Items that have been particularly difficult to determine from a tax perspective include determining the performance obligations for tax, the tax treatment of variable compensation, and advance payments. These differences could create additional book-tax differences that will now need to be tracked in each jurisdiction.



## ASU 2015-17 CLASSIFICATION OF ALL DEFERRED TAX LIABILITY AND ASSETS AS NON-CURRENT

While this is already effective for public entities, it will be effective for all periods beginning after December 31, 2017 for all other entities.

## ASU 2016-09 STOCK COMPENSATION

This guidance requires entities to treat all excess tax benefits or deficiencies as tax expense in the income statement without regard to if the benefit reduces taxes payable in the current period. Again, while this is already effective for public entities, it is effective for all other entities for annual periods beginning after December 15, 2017.

## ASU 2016-16 INTRA-ENTITY TRANSACTIONS OTHER THAN INVENTORY

Under current guidance, deferred taxes are not provided for the tax effects of intercompany transactions. The new guidance, effective for public entities for years beginning after December 15, 2017 and December 15, 2018 for all other entities, will require current accounting for intercompany transactions with the exception of inventory transactions.

## ASU 2018-2 RECLASSIFICATION OF DISPROPORTIONATE TAX EFFECTS IN OCI

Under current guidance, the tax impact of items recorded through other comprehensive income is not adjusted for tax rate changes, as all tax rate changes are required to be recorded through the P&L. This new guidance, effective for years beginning after December 15, 2018, with early adoption permitted, allows the company to elect to reclassify the "trapped" taxes from accumulated other comprehensive income to retained earnings. The amount reclassified can only be the impact of the Tax Cuts and Jobs Act of 2017; any other trapped effects must stay in OCI.

## ASU 2018-11 LEASING STANDARD

On July 30, 2018 the FASB issued ASU 2018-11 which provided updates to ASC 842, accounting for leases. The ASU focused on two main areas, transitioning to the new standard and separating components of a contract. Entities may elect to not report comparative periods when transitioning to ASC 842, but rather can elect to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The lessor may also elect not to separate the lease and non-lease components when both the timing and pattern of transfer are the same for the non-lease components and associated lease component and the lease component, if accounted for separately, would be classified as an operating lease. We do not anticipate this update to have an impact on accounting for income taxes.

# 3

# State Tax

## STATE LEGISLATION

Conformity in tax treatment across all the states has always been a taxpayer's dream. Unfortunately, the enactment of the federal Tax Cuts and Jobs Act ("the Act") has only complicated matters and left many taxpayers scrambling to understand what the effect the Act will have on their state tax computations for their 2018 tax year. As states have been slow to release their provisions of conformity to the Act throughout the past year, taxpayers must do their best to attempt to estimate their state tax liabilities. Whether through actual legislation or guidance released, a determination of treatment must be made for the year end provision.

Several Act concepts have created the most concern when it comes to state conformity: IRC Section 965 transition tax, IRC Sections 951A and 250 GILTI inclusion and deduction, IRC Section 163(j) interest limitation, expanded IRC Section 179 expensing and bonus depreciation, and net operating loss treatment, among others. Issues that pertain to each taxpayer vary and must be assessed. Most states have issued guidance pertaining to the required treatment of IRC Section 965, since that was required to be picked up on the 2017 tax return. Enacted legislation has been much slower to come through. The other issues have also been addressed by many of the states, although once again, many states have not actually enacted legislation.

As expected, most states have been following their historic approach to conformity with the Internal Revenue Code. Eighteen states and the District of Columbia have rolling conformity, or they automatically implement federal tax changes as they are enacted, unless they decouple specifically from a provision. Nineteen states have fixed-date conformity, where they must specifically adopt the new provisions. The remaining states selectively conform to federal provisions as they are released. Research into each state where a taxpayer has nexus is required to understand their treatment of the Act provisions.

Finally, as is typical throughout the tax year, some states change their tax rates and their apportionment methods and ratios.

- Illinois, Indiana, Maine, and New Hampshire have recently changed their rates.
- New Jersey is changing their minimum tax for each member of a combined return to $2,000 each for tax years ending on or after July 31, 2019.
- North Carolina is on a single sales factor formula as of 2018.
- Delaware, Maryland, and Utah are phasing in single sales factor apportionment over the next few years.
- Kentucky and Montana switched to market based sourcing for tax years after 2017.
- Colorado and New Jersey are switching to a market based sourcing for tax years after 2018.

## SOUTH DAKOTA VS. WAYFAIR, INC. AND ASC 450

On June 21, 2018, the U.S. Supreme Court released its landmark decision in the South Dakota vs. Wayfair, Inc. case ("Wayfair"). Wayfair related to sales and use tax physical presence standards and whether states were allowed to assert a tax on an out of state seller with no physical presence in their state. By ruling in favor of South Dakota, the Court effectively paved the way for states to impose sales tax collection obligations on businesses whose connection to their state was a certain threshold of economic activity, with the threshold for nexus determined by the state.

Since then, the states have been passing state legislation with lightning quickness to jump on the sales tax bandwagon. As with everything else related to state taxes, the states have not been uniform in their determination of their nexus thresholds nor their required enforcement dates. The flurry of activity has left many taxpayers scratching their heads wondering what they need to do in relation to these new requirements and what effect they may have on their financial statements.

A determination should be made as to a companies' collection and filing obligations in each state where sales thresholds are met. If it is determined that a taxpayer will be subject to liability for sales and use taxes, the liability should be measured and recognized based on the applicable guidance of ASC 405, Liabilities, as such a liability does not represent a loss contingency, but a contractual obligation.

If there is uncertainty as to the taxpayer's liability as a result of Wayfair, ASC 450, Contingencies, provides guidance for loss contingencies. A loss contingency includes existing conditions which involve uncertainty for possible loss that will be resolved when one or more future events occur or fails to occur. As uncertainties involving sales taxes are not within the scope of ASC 740, Income Taxes, ASC 450 should be used to determine when and how to recognize a loss contingency if necessary.

An estimated loss from a loss contingency is accrued if it is probable that a liability has been incurred as of the date of the financial statements and the amount of the loss can be reasonably estimated. If a taxpayer concludes it is probable it will be subject to sales and use tax, then the liability should be measured and recognized. Once recognized, derecognition of the liability would also be based on the guidance in ASC 405, which requires the debtor to derecognize a liability if and only if it has been extinguished.

**Read our other posts on state sales tax obligations for remote sellers**

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## CONNECT WITH A FREED MAXICK TAX EXPERT

As we mentioned at the outset, the tax provision is one of the most complex calculations in financial reporting. While this paper has presented numerous considerations regarding ASC 740 for year-end 2018, it is no substitute for discussing the specific facts and circumstances of your business with an advisor who understands the rules. The following checklist should help you gather your thoughts and documentation for such a meeting.

Please contact Freed Maxick if we can be of any further assistance by clicking on the button or calling us at 716.847.2651.

**Get a fresh look at your tax position and ways to reduce taxable income**

Schedule a Tax Situation Review

# YEAR-END CONSIDERATIONS CHECKLIST

*Please note: this checklist is not all-inclusive. It covers some of the more important topics within this document.*

- ☐ **Review all items that were covered by SAB 118 in the prior year as they no longer are protected under that bulletin.**
- ☐ **If in a Naked Credit position, review all current year attributes that may offset it (i.e. tax reform NOLs, and 163(j) carryforward).**
- ☐ **If you have CFCs, consider the GILTI tax.**
- ☐ **If you have exports, consider the FDII deduction.**
- ☐ **If you are planning on distributing cash from foreign subsidiaries due to the 965 transition tax, consider whether or not a permanent reinvestment assertion still applies.**
- ☐ **If you are planning on disposing a foreign subsidiary in the foreseeable future, consider the future gain or loss in your year-end tax provision.**
- ☐ **Consider the following for your rate reconciliation disclosure:**
  - The change in the 965 transition tax from the prior-year tax provision and the tax return filed.
  - Temporary provision to return items.
  - The GILTI tax.
  - The FDII deduction.
  - Section 162(m) limitations under the new tax regime.
  - Any item that affects the effective tax rate by 1% or more should be broken out separately.
- ☐ **Consider the following Accounting Standard Updates (ASUs):**
  - ASC 606 – Revenue Recognition
  - ASU 2015-17 Classification of all deferred tax liability and assets as non-current
  - ASU 2016-09 Stock Compensation
  - ASU 2016-16 Intra-entity transactions other than inventory
  - ASU 2018-2 Reclassification of disproportionate tax effects in OCI
  - ASU 2018-11 Leasing Standard
- ☐ **Consider all disclosure items related to tax reform.**
- ☐ **Consider any changes in enacted rates both domestically (federal and states) and internationally.**
- ☐ **Consider changes in how state taxes are calculated, such as the calculation of apportionment and minimum taxes.**
- ☐ **Consider any sales tax exposure due to the Wayfair case.**
- ☐ **Fiscal Year Tax Return Preparation Considerations related to Tax Reform:**
  - Blended tax rate
  - Section 965 transition tax
  - Bonus depreciation considerations
  - Meals & Entertainment considerations

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