February 20, 2018 NDS 2018-03 (Supersedes NDS 2018-02)

New Developments Summary

Accounting and financial reporting implications of the Tax Cuts and Jobs Act of 2017

Summary

This bulletin has been updated to reflect the FASB staff's views on accounting and financial reporting issues generated by the Tax Cuts and Jobs Act of 2017, as well as the guidance in ASU 2018-02 and other financial reporting developments.

The new tax legislation,[1] commonly referred to as the Tax Cuts and Jobs Act of 2017 (the Act), brings a sweeping overhaul of individual, business, and international taxes. Entities are required to record the tax effects of the Act in the interim and annual periods that include the new law's enactment date, which is December 22, 2017.

Although the existing guidance related to accounting for income taxes under ASC 740, *Income Taxes*, does not change under the Act, the staffs of both the FASB and the SEC have expressed their views on certain accounting and financial reporting issues related to the Act. Further, the FASB has issued an amendment to the existing guidance that gives entities an option to reclassify the stranded tax effects resulting from the tax law and rate changes under the Act from accumulated other comprehensive income to retained earnings (see Section B). This publication provides a summary of the requirements under ASC 740 for an enacted change in tax rates and tax law and discusses the impact of subsequent guidance.

For some entities, particularly multinationals, the effects of the changes may be complex. An entity should consult with a taxation specialist to ensure that it has a full understanding of how the applicable provisions will impact the amount and timing of its income tax obligations as well as its tax positions in order to appropriately apply the existing accounting guidance for recognizing, measuring, presenting, and disclosing changes under the Act.

Under ASC 740, an entity is required to remeasure its deferred tax positions at the enactment date of a tax law or rate change, and to recognize the change in the amount of deferred tax positions resulting from the change as a component of income tax expense (or benefit) in income from continuing operations in the reporting period that includes the enactment date. The provisions of the Act reducing corporate tax rates are effective in tax years beginning after December 31, 2017. As a result, taxes currently payable are not impacted until 2018, the effective date of the law that reduces the tax rate(s). Because the Act

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[1] *H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (Public Law No: 115-97)*

was enacted on December 22, 2017, an entity that either reports based on a calendar year-end, or whose fourth quarter includes the enactment date, should recognize the effects of the Act during its fourth quarter. The provisions of the Act are not retroactive to any years prior to 2018 except for certain provisions, for example, depreciation provisions that apply to property placed in service after September 27, 2017 and the one-time tax on the deemed repatriation of foreign earnings that occurs in the last taxable year beginning before January 1, 2018.

Entities that report based on year-ends other than a calendar year should recognize the effects of the Act in the interim (quarterly and year-to-date) periods that include the enactment date if the enactment date does not fall within the fourth fiscal quarter.

Entities with reporting periods ending prior to the enactment date that have not issued their financial statements for those periods are required to make certain disclosures related to the tax effects of the Act, but should not remeasure their deferred tax positions as of the end of their reporting period.

The SEC staff provided some relief through the issuance of Staff Accounting Bulletin (SAB) 118 to assist entities that are unable to complete the assessment of the impact of the Act in the period that includes the enactment date. Those entities may record the effects of those provisions of the Act for which the accounting is not complete in the period that includes the enactment date over a measurement period, similar to the measurement period used to account for business combinations. SAB 118, along with other SEC guidance, is discussed in Section J.

Contents

A. Summary of key provisions

The Act includes sweeping changes for individuals and businesses, and is expected to have a wide-ranging impact on every type of taxpayer in the country. This publication addresses the provisions of the Act that will have a major accounting impact on corporate entities. For a more detailed summary of the provisions in the Act, including those impacting personal and pass-through taxpayers, refer to Grant Thornton's detailed analysis of the tax reform bill.

Major changes to corporate taxation under the Act include

- Reducing the corporate rate to 21 percent
- Doubling bonus depreciation to 100 percent for five years and allowing used property to qualify
- Limiting net interest expense deductions to 30 percent of adjusted taxable income
- Limiting the net operating loss carryforward deduction to 80 percent of taxable income
- Repealing the corporate alternative minimum tax
- Further enhancing limitations on executive compensation deductions
- Shifting toward a territorial tax system whereby certain foreign earnings can be repatriated tax-free through a 100 percent dividends-received deduction
- Imposing a one-time tax on unrepatriated foreign earnings
- Creating anti-base-erosion and minimum tax provisions
- Repealing the Section 199 domestic production activities deduction

B. Recognition of changes in tax laws and rates

An entity records the effects of an enacted change in tax laws or rates in the period that includes the enactment date—that is, the date a tax bill becomes law—in accordance with ASC 740-10-25-47. Federal tax law and rate changes, for example, are enacted when the legislation is signed by the president. The effects of a change in tax laws or rates cannot be anticipated in the financial statements, so the effect of these changes should be recognized in the period in which the change is enacted.

The *enactment date* of tax law or tax rate changes is usually different from the *effective date*. Many tax rate changes do not apply immediately, but become effective at some future date. For example, the provisions of the Act reducing corporate tax rates are not effective until 2018. As a result, an entity's taxes on current taxable income are not affected until the rate change is effective; however, as discussed below, deferred tax liabilities and assets are adjusted at the enactment date under ASC 740-10-35-4.

The guidance in ASC 740-10-45-15 requires that the effect of adjusting deferred tax assets and liabilities related to an enacted tax law or rate change should be included as a component of tax expense (or benefit) in income from continuing operations for the period that includes the enactment date. The tax effect related to changes in tax laws is always reflected in continuing operations, regardless of where the related tax provision or benefit was previously recorded. Even temporary differences arising from prior-year transactions related to discontinued operations, or from items that were not originally included in income from continuing operations (such as adjustments for a change in accounting principle, a business combination, gains or losses on available-for-sale securities included in other comprehensive income, and differences for share-based compensation that were recorded directly to equity) are remeasured, with the change being reflected in current-period income tax expense (or benefit).

As a result, an entity is prohibited from "backwards tracing" the income tax effects of tax provisions or benefits originally recorded in other comprehensive income (OCI). "Backwards tracing" means recognizing the effects of changes in deferred tax amounts in the same line item where the deferred tax amounts were originally recognized in prior years. The tax effects of items that remain within accumulated OCI (AOCI) due to this prohibition are referred to as "stranded tax effects." In February 2018, the FASB issued ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, to address issues raised by stakeholders related to how tax rate changes affect deferred taxes originally recorded in OCI.

Stranded tax effects: Guidance under ASU 2018-02

ASU 2018-02 gives entities the option to reclassify the stranded tax effects resulting from the tax law and tax rate changes under the Act from AOCI to retained earnings. The option to reclassify stranded tax effects under ASU 2018-02 only applies to the income tax effects of tax law and tax rate changes under the Act, and does not apply to other stranded tax effects, such as those resulting from prior changes in tax laws.

If the entity elects to reclassify the income tax effects of the Act, the amount of the reclassification should include (1) the effect of the change in the federal corporate income tax rate on gross deferred tax amounts and related valuation allowances, if any, for items remaining in AOCI as of the date when the tax reform was enacted, and (2) other income tax effects of the Act on items remaining in AOCI that an entity elects to reclassify. The amount of the reclassification should exclude the effect of the change in the tax rate on gross valuation allowances that were originally charged to income from continuing operations.

All entities are required to disclose their accounting policy for releasing stranded income tax effects from AOCI. The new guidance adds this disclosure because there is diversity in practice on how entities release the income tax effects from AOCI. Some entities release the income tax effects from AOCI as each individual unit of account is derecognized (for example, when an individual available-for-sale security is sold), whereas others release the income tax effects from AOCI when the entire portfolio consisting of all of the individual units of account is derecognized (for example, when an entire portfolio of available-for-sale securities is sold).

In addition, entities are required to disclose in the period of adoption whether they have elected to reclassify the stranded tax effects related to the Act. Entities that elect to reclassify stranded tax effects related to the income tax effects under the Act, other that those arising from the change in the federal corporate income tax rate, are also required to describe these effects in the period of adoption.

The amendments are effective for all entities for fiscal years beginning after December 15, 2018 and for all interim periods within those fiscal years. Entities should apply the amendments either retrospectively to each period (or periods) in which the entity records the effect of the tax rate changes under the Act, or at the beginning of the annual or interim period in which the amendments are adopted. The reclassification might occur in multiple periods for entities recording provisional amounts under SEC Staff Accounting Bulletin 118 (see Section J) if they adjust those provisional amounts as they obtain, prepare, or analyze additional information.

Early adoption is permitted for public business entities that have not issued financial statements and for all other entities that have not made the financial statements available for issuance.

The following transition disclosures are required in the first interim or annual period of adoption for all entities, except as indicated below:

- The nature of, and reason for, the change in accounting principle
- A description of the prior-period information that has been retrospectively adjusted (this disclosure only applies to entities electing to apply the amendments retrospectively)
- The effect of the change on affected financial statement line items

ASU 2018-02 does not change any of the existing guidance prohibiting “backwards tracing.”

Entities will also need to closely monitor tax regulations issued after the enactment date because subsequent tax regulations might result in an interpretation of a provision under the Act that is different from an interpretation made on the enactment date.

C. Accounting and financial reporting implications of the key provisions of the Act

This section provides a summary of the key provisions of the Act, along with a discussion of the accounting and financial reporting implications of each provision.

Reduction in corporate tax rates

The Act reduces the existing corporate tax rate schedule to a flat 21 percent rate, effective for tax years beginning after December 31, 2017.

Accounting implications

The future tax impact of temporary differences in book income and tax income that are expected to create future taxable or deductible events should be measured using the applicable rate and recorded as deferred tax assets or liabilities. The applicable rate is the enacted tax rate, or rates, that are expected to apply to taxable income in the periods when the deferred tax item is expected to be settled or realized under the initial measurement guidance in ASC 740-10-30-8. When there is a change in tax rates, the subsequent measurement guidance in ASC 740-10-35-4 requires an entity to adjust its deferred tax assets and liabilities existing at the date of enactment using the newly enacted rates for the periods when they are expected to be realized. The effect of the remeasurement of deferred tax liabilities and assets is recognized as a component of income tax expense (or benefit) in income from continuing operations for the period that includes the enactment date.

For an entity with a December 31, 2017 year-end, the change in tax rates will not have an impact on tax rates used in the current-period provision calculation, as the tax rates are not used to calculate current taxes until the effective date of January 1, 2018.

As discussed in ASC 740-10-55-23, the measurement of deferred tax liabilities and assets is based on tax elections expected to be made in future years, such as electing to carry a future loss forward or a loss existing at December 31, 2017 backward. Deferred tax liabilities expected to be settled, and deferred tax assets expected to be realized, in future periods should use the future enacted tax rate. As discussed under the net operating losses section below, losses generated in tax years ending after December 31, 2017 can no longer be carried back to offset taxable income from prior year(s) under the Act.

Entities may consider remeasuring deferred tax liabilities and assets using balances as of December 31, 2017 instead of balances as of the enactment date if the related temporary differences are expected to approximate each other as of those dates. Entities that remeasure their deferred tax positions using balances as of December 31, 2017 need to consider the impact of changes in deferred tax positions occurring between the enactment date and December 31, 2017 when they determine the effect of tax rate changes. Any activity that could have an impact on deferred tax positions during that brief period should be appropriately reflected in the deferred tax remeasurement calculations. Transactions occurring in that period that might have an impact on deferred tax positions include business combinations, purchases of new assets with accelerated depreciation, issuances of share-based compensation, or other transactions that result in future taxable or deductible differences.

The following example illustrates an entity’s recalculation of deferred tax positions to (1) reflect the change in tax rates and (2) determine the effect of tax rate changes.

Calculated deferred tax assets

At December 31, 2016, an entity with a calendar year-end had only one temporary difference, a future deductible temporary difference of $150,000, which it expects to reverse in future periods. The enacted tax rate for the entity at the end of 2016 was 35 percent, and the entity recorded a $52,500 deferred tax asset in its financial statements at December 31, 2016.

On December 22, 2017, the tax rate was changed to 21 percent, effective for periods starting on January 1, 2018. At December 31, 2017, the future deductible temporary difference was also $150,000. The entity reviewed its transactions and activity between December 22 and December 31, noting no major activity that would impact its evaluation of this temporary difference, and therefore remeasured its deferred tax positions at December 31, 2017 rather than as of the enactment date. The entity applies the enacted rate of 21 percent to its temporary difference of $150,000 and records a deferred tax asset of $31,500 as of December 31, 2017, which represents a decrease in the deferred tax asset of $21,000 to be recorded in income tax expense (benefit) from continuing operations in the income statement for the period ended December 31, 2017.

Cost recovery provision

The Act provides for 100 percent bonus depreciation for property placed in service after September 27, 2017 and before January 1, 2023. The bonus depreciation rate phases down by 20 percent each year over the following five years beginning in 2023, returning to the regular depreciation rate in 2027.

Accounting implications

When an entity claims an income tax deduction for depreciation that is higher than the depreciation expense recognized for financial reporting purposes, this temporary difference results in a deferred tax liability that is settled over the depreciable life (for financial reporting purposes) of the related asset. The 100 percent bonus depreciation allowance will result in a higher tax benefit in 2017 due to the higher tax rates in 2017. This temporary difference will reverse in later years at a lower tax rate. In addition, claiming bonus depreciation at a higher rate may result in an additional deferred tax asset for an NOL carryforward in an entity that has taxable losses. The additional deferred tax asset for an NOL carryforward will need to be assessed for realizability.

Interest deduction limitation

The Act limits the deduction for net interest expense to 30 percent of adjusted taxable income for tax years beginning after December 31, 2017. Before January 1, 2022, the calculation of adjusted taxable income is similar to earnings before interest, taxes, depreciation, and amortization (EBITDA). After January 1, 2022, that calculation is equivalent to earnings before interest and taxes (EBIT). Any disallowed interest expense can be carried forward indefinitely.

Accounting implications

Entities need to consider this limitation on deduction when they prepare tax provision calculations for periods beginning on or after January 1, 2018, as disallowed interest expense can be carried forward indefinitely under the Act. Entities should record a deferred tax asset related to this carryforward, and should assess the realizability and the need for a valuation allowance on the deferred tax asset.

Alternative minimum tax

The Act repeals the corporate alternative minimum tax (AMT), effective for tax years beginning after December 31, 2017, but allows an entity to claim portions of any unused AMT credits over the next four years to offset its regular tax liability. An entity with unused AMT credits as of December 31, 2017 can first use these credits to offset its regular tax for 2017, and can then claim up to 50 percent of the remaining AMT credits in 2018, 2019, and 2020, with all remaining AMT credits refundable in 2021.

Refundable AMT credits in excess of amounts used to offset regular tax in any year may be subject to other enacted U.S. government regulations referred to as “sequestration.” As a result, these refund payments may be reduced by the applicable sequestration rate, which is 6.6 percent for the fiscal year ending September 30, 2018.

Accounting implications

The guidance in ASC 740-10-25-43 and 25-44 discusses the accounting for AMT credit carryforwards that existed before the Act. That guidance requires entities to recognize a separate deferred tax asset for AMT credit carryforwards, subject to the need for a valuation allowance. Under the Act, these existing AMT credit carryforwards offset future regular tax for four years, with any balance remaining refundable in 2021. Because AMT credits will eventually be refundable whether or not there is regular taxable income to offset for the year, entities will now be less likely to require a valuation allowance related to these deferred tax assets; however, entities should consider whether a portion of their refundable AMT credits may be reduced by the applicable sequestration rate, resulting in an uncollectible portion of the AMT credit.

Entities should also evaluate whether any or all of the deferred tax asset related to the existing AMT credit carryforward should be reclassified as income tax receivable as of the enactment date.

Should refundable AMT carryforwards be discounted to reflect the time value of money?

The FASB staff has issued a Staff Q&A, *Topic 740, No. 3: Whether to Discount Alternative Minimum Tax Credits That Become Refundable*, stating that neither a deferred tax asset nor an income tax receivable for AMT credits that become refundable should be discounted. The staff Q&A also states that the staff believes that the requirement to disclose the amounts of tax credit carryforwards in ASC 740-10-50-3 applies, regardless of whether an entity presents the AMT credit carryforward as a deferred tax asset or as an income tax receivable.

Net operating losses

Under the Act, net operating loss (NOL) deductions arising in tax years beginning after December 31, 2017 can only offset up to 80 percent of future taxable income. The Act also prohibits NOL carrybacks, but allows indefinite carryforwards for NOLs arising in tax years beginning after December 31, 2017. Net operating losses arising before January 1, 2018 are accounted for under the previous tax rules that imposed no limit on the amount of the taxable income that can be set off using NOLs (except for a 90 percent limit for AMT carryforwards) and that can be carried back 2, and carried forward 20, years.

Accounting implications

Entities should reevaluate the realizability of any deferred tax assets related to NOL carryforwards, taking into consideration how the Act affects future taxable income that will be offset by those NOLs. Although carryforwards on NOLs generated after December 31, 2017 do not expire, entities need to consider and document, rather than assume, their realizability since the NOLs do not expire. An entity that relied on taxable income in prior carryback year(s) to realize their NOLs under ASC 740-10-30-18(c) now needs to reevaluate the need for a valuation allowance on those NOLs based on when the NOLs arose. NOLs generated after December 31, 2017 cannot be carried back; only NOLs that arose in tax years beginning before January 1, 2018 are eligible for carryback.

Executive compensation deductions

For tax years starting in 2018, the Act limits a public entity's ability to deduct compensation in excess of $1 million for covered employees, regardless of the character of those payments. The bill expands the definition of a "covered employee" to include the CFO, and the $1 million deduction limit applies to a covered employee's compensation in all future years, including those years after termination of employment or death. The Act also expands the definition of a public entity subject to the limitation to include foreign corporations publicly traded through American depositary receipts (ADRs), certain large private corporations, and S corporations. The changes do not apply to compensation paid under a written binding contract that was in effect on November 2, 2017 if the contract is not subsequently materially modified. Once a contract is renewed, compensation paid under the contract becomes subject to this limitation.

Accounting implications

Overall, less executive compensation may be deductible under the Act, which needs to be factored into an entity's projections of future taxable income. Entities also need to carefully evaluate their executive compensation arrangements, as the transition requirements under the Act are complex and their impact might vary significantly on a company-by-company basis. Further, nondeductible compensation results in a permanent difference between book income and taxable income, impacting an entity's effective income tax rate. Entities should also consider these provisions when determining their estimated effective annual income tax rate during interim periods and the deferred tax asset related to share-based compensation paid to a covered employee.

Under ASC 718-740-25, *Compensation – Stock Compensation: Income Taxes,* entities account for the cumulative compensation cost as a deductible temporary difference if this cost ordinarily will result in a future tax deduction under existing tax law. Whether compensation cost related to an award will result in a future tax deduction depends on several factors, including the type of award and whether the recipient is a “covered employee.” Entities often need to exercise judgment when making this determination.

Entities recognize a deferred tax asset for the compensation cost recognized for financial reporting purposes related to these share-based payment awards, and they evaluate this deferred tax asset for future realization to determine whether a valuation allowance is required. This deferred tax asset usually reverses when the entity receives an income tax deduction related to the award, which generally coincides with the recipient of the award recognizing taxable income.

Compensation cost recognized for financial reporting purposes is usually different than the current fair value of the award (and ultimately, the amount claimed by the entity as a deduction on its income tax return) because the amount recognized for financial reporting purposes is based on the grant-date fair value of the award, but the income tax deduction is generally based on the intrinsic value of the award on the date the entity is entitled to the income tax deduction. The intrinsic value of an award can fluctuate significantly over the life of the award. The stock compensation guidance also addresses how entities should account for these differences.

Accounting for the income tax effects of compensation arrangements such as share-based payment arrangements is complex. Entities issuing share-based payment awards to “covered employees” need to consider limitations on the amounts of deductible compensation when accounting for the income tax effects because these limitations might have a significant impact on whether the compensation cost will result in a future tax deduction under existing law.

When issuing new share-based payment awards to “covered employees,” an entity needs to consider whether these limitations might apply and, if so, determine their effect on the amount of the deferred tax asset, if any, that the entity should recognize for financial reporting purposes. An entity also needs to evaluate outstanding awards to “covered employees” and to determine whether these limitations might impact the realizability of existing deferred tax assets.

Section 199 domestic production activity deduction

For tax years beginning after December 31, 2017, the Act repeals the Section 199 deduction for qualifying domestic production activities, which provided additional U.S. tax deductions for these activities if certain conditions were met.

Accounting implications

Calendar-year entities should consider the repeal of the Section 199 deduction when determining their estimated effective annual income tax rate during the first quarter of the year ending December 31, 2018. Because the repeal is effective for tax years beginning after December 31, 2017, entities that report based on year-ends other than a calendar year should not consider the tax effect of the repeal until the first tax year beginning after December 31, 2017. For example, an entity that uses a March 31 year-end would not be impacted by the repeal until the tax year beginning April 1, 2018.

D. Valuation allowance

In accordance with ASC 740-10-30-5(e), an entity is required to establish a valuation allowance if it determines that it is more likely than not that all or part of its deferred tax assets will not be realizable. Deferred tax assets include temporary differences and carryforwards for NOLs and tax credits, such as AMT. Whether deferred tax assets are realizable depends on whether sufficient future taxable income (of the appropriate character) exists within the statutory carryback or carryforward period, such as future reversals of existing taxable temporary differences, future taxable income exclusive of reversing temporary differences and carryforwards, taxable income in prior carryback years if permitted under the tax law, and tax-planning strategies that would be implemented. As a result, any changes to factors that an entity considers in determining whether deferred tax assets are realizable might also impact whether a valuation allowance is required or the amount of this allowance. As noted in the discussion of net operating losses in Section C, a carryback is no longer allowed for NOLs arising after December 31, 2017, so entities should ensure that they are using the correct periods in their evaluation of deferred tax assets.

After an entity adjusts its deferred tax balances for the effects of the Act as discussed in Section B, reevaluation of a valuation allowance may be required under ASC 740-10-35-4, and the valuation allowance may need to be recalculated. Entities should take into account the following considerations when performing this analysis:

- Future taxable income
- If performed for a carryback for an NOL, the appropriate tax rate and the entity's ability to carry back existing NOLs, as discussed in Section C
- The impact of changes under the Act that may cause changes in how the entity determines the future realizability of the tax benefit

An entity should record changes to the valuation allowance resulting from the Act in the period when it determines that there has been a change in judgment regarding the realizability of deferred tax assets.

Impact of tax reform: evaluating the realizability of certain deferred tax assets

Sources of taxable income of the appropriate character (for example, ordinary income or capital gains) in either the carryback or carryforward period may be available under the tax law in a particular jurisdiction to realize a tax benefit for deferred tax assets that are either

- Related to deductible temporary differences, such as expenses recognized in the current year for financial reporting purposes that will not be deductible under the tax law until future periods
- Related to carryforwards, such as net operating loss (NOL) deductions

The future reversal of deferred tax liabilities related to taxable temporary differences, such as expenses that are deductible under a tax law in the current period that will not be recognized for financial reporting purposes until future periods, is one of the more objective sources of future taxable income that should be considered available under the tax law to realize a tax benefit for deferred tax assets.

Many entities have recognized deferred tax liabilities related to land with a taxable temporary basis difference or to indefinite-lived assets (such as goodwill and nonamortizable intangible assets) that are not being amortized for financial reporting purposes but are deductible under a tax law. However, the reversal of deferred tax liabilities for taxable temporary differences related to indefinite-lived assets held for use should not be considered a source of future taxable income supporting the realizability of definite-lived deferred tax assets. These temporary differences (referred to as “naked credits”) would only reverse when the related assets are impaired or disposed of, and ASC 740 does not allow an entity to anticipate events such as impairments or disposals when predicting the reversal of the related deferred tax liabilities.

Because an entity cannot assert that a deferred tax liability related to an indefinite-lived asset will be realized prior to the expiration of the existing deferred tax asset, the naked credit generally cannot be considered a source of taxable income when evaluating the realizability of a definite-lived deferred tax asset.

As noted in “Net operating losses” in Section C, under the Act, NOL carryforwards arising in tax years beginning after December 31, 2017 can only offset up to 80 percent of future taxable income, and NOL carryforwards arising in tax years ending after December 31, 2017 have an indefinite carryforward period rather than the 20-year carryforward period applicable to pre-Act NOLs.

In the reporting period that includes the enactment date, entities need to determine whether the reversal of a naked credit may be a source of future taxable income when evaluating whether a valuation allowance is needed for deferred tax assets related to any deductible temporary differences (other than NOLs) that will reverse in future periods and become NOL carryforwards with an indefinite carryforward period. Entities should not assume that all NOLs arising in tax years ending after December 31, 2017, or all deductible temporary differences that will reverse and become NOLs in those tax years, are realizable and do not require a valuation allowance. Because the analysis is specific to an entity’s facts and circumstances, scheduling the pattern of reversal for these deferred tax assets and liabilities is generally necessary in order to determine the realizable portion of the deferred tax asset.

Further, it generally remains inappropriate for an entity to consider deferred tax liabilities related to naked credits as a source of taxable income when evaluating the realizability of deferred tax assets related to NOL deductions arising in tax years before January 1, 2018 because these NOLs remain subject to a 20-year carryforward period.

When an entity determines the amount of future taxable income available under the tax law in order to realize a benefit for deferred tax assets, it needs to consider that NOLs arising in tax years beginning after December 31, 2017 can be used to offset only 80 percent of the taxable income from the future reversal of all deferred tax liabilities, including any amounts related to naked credits.

The following example illustrates how an entity with both taxable temporary differences related to naked credits and deductible temporary differences (other than NOLs) reversing in future periods that become NOL carryforwards (with an indefinite carryforward period, subject to the 80 percent limit discussed above, and with carryback prohibited) might consider the effects of the Act on the realizability of its deferred tax assets as of December 31, 2017.

Evaluating the realizability of certain deferred tax assets

Assume the following fact pattern:

- Deferred tax liabilities related to either naked credits or to any other taxable temporary differences are $600.

- Deferred tax assets are also $600, and $300 is expected to reverse and become NOL carryforwards in each of 2018 and 2019, resulting in an NOL carryforward of $600 at the end of 2019.
- Temporary differences are all of the same nature (ordinary income) and relate to the same tax jurisdiction.
- Breakeven results are expected in 2018 and 2019, prior to the reversal of any temporary differences.

The entity must determine whether the reversal of the naked credits should be a source of future taxable income in 2018 and 2019 and whether it should consider this fact, among others, in determining whether a valuation allowance is needed.

If the entity determines that all or a portion of its deferred tax liabilities, including the naked credits, is a source of future taxable income, it then needs to consider the 80 percent limit on the amount of the NOL carryforwards that can be used to offset future taxable income. In this example, the entity would only be able to offset 80 percent of taxable income in any future tax year and, as a result, would need to recognize a valuation allowance against this deferred tax asset for up to 20 percent of future taxable income in each period.

For example, if the entity determines that reversal of deferred tax liabilities will result in future taxable income of $600 for 2020, it could offset only 80 percent ($480) with its NOL carryforward deduction of $600, and a valuation allowance of 20 percent ($120) would be required. However, if the deferred tax liability was substantially higher than $600 so that future taxable income for 2020 is expected to be $1,000, the 80 percent limit would not apply, and a valuation allowance would not be required because the deferred tax asset related to these NOL carryforwards of $600 is less than 80 percent of $1,000.

The existence of deferred tax liabilities related to naked credits is one of several factors that an entity should consider when it determines whether a valuation allowance is needed to reduce the carrying amount of deferred tax assets to those amounts it expects to realize in each relevant tax jurisdiction. For example, under ASC 740-10-30-18, projections of taxable income and the available tax-planning strategies are other possible sources of taxable income that may be available under a tax law.

These determinations are complex and require an entity to (1) have a deep understanding of its worldwide tax structure, (2) understand the tax law in each relevant tax jurisdiction, and (3) exercise significant judgment when applying all of the existing accounting guidance related to valuation allowances.

Entities may also need to determine the expected periods of reversal for their temporary differences because the reversal patterns of an entity's existing temporary differences may have a significant effect on whether a valuation allowance is required and, if required, the amount.

E. Earnings of foreign subsidiaries

One-time transition tax on unrepatriated foreign earnings

The Act subjects unrepatriated foreign earnings to a mandatory one-time transition tax on post–1986 earnings and profits (E&P) at a rate of 15.5 percent for E&P attributable to cash and certain liquid assets, such as net accounts receivable, and at a rate of 8 percent for all other E&P. U.S. shareholders in specified foreign corporations are required to include their pro rata share of E&P in taxable income for 2017 to the extent that such E&P has not been previously subject to U.S. tax, regardless of the entity's historical financial statement assertions related to indefinite reinvestment or whether it ultimately repatriates any of the E&P. The E&P calculations are performed as of November 2, 2017 and December 31, 2017, and the greater of the two computations are used for computing the one-time transition tax. The E&P is measured based on a foreign subsidiary's last taxable year beginning before 2018, and is determined without regard to any dividends paid during the taxable year.

An entity may elect to utilize NOL carryforwards to offset this one-time tax. Entities may also use foreign tax credits generated from the one-time tax to offset the tax, but are also subject to a "haircut" based on the difference between the new 8 percent and 15.5 percent rates and the normal 35 percent rate (or other applicable statutory rate). Existing foreign tax credit carryforwards can also be used to offset the one-time tax. U.S. shareholders can elect to spread the payment of the one-time transition tax liability over eight years.

Accounting implications

The Act does not change the existing guidance related to how an entity should account for the income tax effects of its investments in certain foreign entities. But, an understanding of how the entity has applied this guidance in the past is important when determining the accounting implications of the Act on these investments.

With limited exceptions, the guidance in ASC 740-10-25 requires entities to recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards. One exception to that requirement is undistributed earnings of foreign subsidiaries and foreign joint ventures that are, or will be, indefinitely invested in the foreign entity.

A parent entity often indefinitely invests the earnings of a foreign subsidiary, which results in a difference between the book carrying amount of the investment and the tax basis in the stock of the subsidiary (also known as the "outside basis" difference). Although the book carrying amount of the investment is increased by the subsidiary's earnings included in the parent's net income, the tax basis remains unchanged, unless the subsidiary is consolidated in the parent's U.S. federal tax return. Additionally, there may be other basis differences resulting from business combinations and cumulative translation adjustments, among other items.

A parent entity is required to recognize a deferred tax liability for the entire taxable outside basis difference of its investment in a foreign subsidiary, unless it qualifies for the exception in ASC 740-30-25-18. This exception applies only to investments in foreign (not domestic) subsidiaries, so an entity must first determine which subsidiaries qualify for the exception.

ASC 740-30-25-3 includes a presumption that all undistributed earnings of a subsidiary will be transferred to the parent entity and that an entity must have specific, definite plans to overcome this presumption. Further, ASC 740-30-25-17 includes guidance on the evidence that is needed for a parent entity to assert that undistributed earnings are invested indefinitely.

The indefinite reinvestment exception applies only to the taxable outside basis difference of a foreign investment. Deferred taxes should always be applied to basis differences of a foreign subsidiary's underlying assets and liabilities (called "inside basis differences").

If it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future and the parent has not yet recognized income taxes, income taxes should be accrued as current expense in the period when the determination changes. Likewise, if it becomes apparent that some or all of the undistributed earnings of a subsidiary for which income taxes have been accrued will qualify for the exception in ASC 740-30-25-18, an entity should adjust current-period income tax expense.

An entity should recognize the effect of this one-time transition tax on unrepatriated foreign earnings, as well as the effect on deferred tax liabilities or assets previously recognized for unrepatriated foreign earnings, as a component of income tax expense (or benefit) in income from continuing operations for the period that includes the enactment date.

An entity may still have outside basis differences related to its foreign subsidiaries, even after taking into account the one-time transition tax for its E&P. Entities need to continue to evaluate these differences and to record them appropriately.

Should the liability for one-time transition tax be discounted?

As discussed above, the Act subjects unrepatriated foreign earnings to a mandatory one-time transition tax, but permits entities to pay this tax, without interest, over eight years. A question that arises is whether the tax liability should be recorded at a discount to reflect the time value of money. The FASB staff has issued a Staff Q&A, *Topic 740, No. 2: Whether to Discount the Tax Liability on the Deemed Repatriation*, stating that the tax liability recorded for the mandatory one-time transition tax should not be discounted.

Establishment of participation exemption system

The Act replaces the current system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are repatriated with a partial territorial system that provides a 100 percent dividends-received deduction (DRD) to domestic corporations for foreign-source dividends received from 10 percent-or-more owned foreign corporations. Domestic corporations must hold the foreign stock for 365 days to be eligible for the DRD. The Act also allows a DRD on certain deemed income inclusions resulting from the disposition of lower-tier controlled foreign corporations (CFCs). Certain exclusions and rules apply to “hybrid dividends.” No foreign tax credit or deduction is allowed for foreign taxes on any portion of the dividend for which the DRD is allowed.

Minimum tax and incentives for intangible income

The Act imposes a minimum tax on certain foreign income deemed to be in excess of a routine return based on tangible asset investment, which is designed to discourage income shifting by subjecting certain foreign intangible and other income to current U.S. tax. Effective for tax years beginning after 2017, U.S. shareholders of CFCs are subject to current U.S. tax on their global intangible low-taxed income (GILTI). In general, GILTI is defined as the excess of a U.S. shareholder’s aggregated net “tested income” from CFCs over a routine return on certain qualified tangible assets. The “tested income” is the excess of the gross income of a foreign subsidiary net of allocable deductions and certain gross income exclusions, and the routine return is computed as 10 percent of the average aggregate adjusted tax bases in depreciable tangible property, adjusted downward for certain interest expense.

The Act calls for including GILTI in a U.S. shareholder’s income in a similar fashion to Subpart F income. Foreign taxes are available as a credit, limited to 80 percent of the amount that would otherwise be creditable. The Act creates a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. It provides domestic corporations with a 50 percent deduction of the GILTI amount (37.5 percent for tax years beginning after 2025).

Base erosion and anti-abuse

The provision of the Act referred to as the "Base Erosion Anti-Abuse Tax" (BEAT) imposes a tax on deductible payments to any "foreign-related party" and a minimum tax on certain domestic corporations' "modified taxable income." The tax is phased in at a rate of 5 percent for tax years beginning in 2018, 10 percent for tax years beginning in 2019 through 2025, and 12.5 percent for tax years beginning after December 31, 2025. For purposes of the BEAT, the term "foreign-related party" is broadly defined using current rules, and includes any 25 percent foreign shareholder or any person related to the domestic corporation or to a 25 percent foreign shareholder. Constructive ownership rules, with some modifications, apply when determining whether foreign parties are "related."

Accounting implications

Entities need to understand how to correctly account for foreign dividends for which the DRD is claimed, as it will be important to appropriately record these items to ensure that the overall tax provision is correct. Entities also need to consider whether foreign jurisdictions impose withholding taxes on distributions of earnings to shareholders.

Entities need to evaluate their liabilities under the minimum tax for GILTI and the BEAT to determine whether they have captured all of their tax positions and recorded them appropriately. In particular, the BEAT represents a departure from the AMT system. Under the AMT system, credit carryforwards were creditable against future taxes to be paid under the regular tax system and could be recorded at the tax rates under the ordinary tax system. However, BEAT does not result in credit carryforwards and therefore cannot be used to offset taxes under the regular tax system. The BEAT operates in the manner of a separate tax system.

How should an entity measure deferred tax assets and liabilities when it expects to be subject to BEAT in future periods?

As discussed above, BEAT creates a separate tax system that imposes a tax on deductible payments to any "foreign-related party," as well as a minimum tax on certain domestic corporations' "modified taxable income." A question that arises is whether an entity that is expected to be subject to BEAT in future years should measure deferred tax liabilities and assets at the regular federal tax rate of 21 percent or at the lower BEAT rate. The FASB staff has issued a Staff Q&A, *Topic 740, No. 4: Accounting for the Base Erosion Anti-Abuse Tax*, stating that the staff believes that an entity should measure deferred tax liabilities and assets using the regular tax rate system, similar to the guidance for recognizing deferred tax liabilities and assets for AMT in ASC 740-10-30-11, even if the entity expects to qualify under BEAT in future years. The staff Q&A further states that the guidance in ASC 740 indicates that the incremental effect of BEAT should be recognized in the period BEAT is incurred, and that an entity would not need to evaluate the effect of potentially paying BEAT in future years on the realization of deferred tax assets recognized under the regular tax system because the realization of the deferred tax asset would reduce its regular tax liability, even if an incremental BEAT liability is owed in that period.

How should an entity account for GILTI tax?

As discussed above, the U.S. shareholders of certain foreign corporations are subject to current U.S. tax on their GILTI for tax years beginning after 2017. A question that arises is whether entities should exclude the effects of the tax on GILTI from income tax expense until the future period when this tax arises, or instead include these effects as part of deferred taxes on the related investment in the foreign corporation. The FASB staff has issued a Staff Q&A, *Topic 740, No. 5: Accounting for Global Intangible Low-Taxed Income*, stating that the staff believes that the existing accounting guidance in ASC 740 is unclear, and that entities should therefore make an accounting policy election either to account for these effects in the future period when the tax arises or to recognize them as part of deferred taxes. The staff Q&A also states that an entity should disclose its accounting policy related to how it accounts for the effects of the tax on GILTI.

The staff Q&A further states that the staff will monitor how an entity that pays tax on GILTI is accounting for and disclosing its effects for consideration of further accounting or disclosure improvements.

F. Financial statement presentation and disclosures

One of the items that an entity is required to disclose in the notes to financial statements under ASC 740-10-50-9 are the significant components of income tax expense (or benefit) attributable to continuing operations for each year presented. These significant components may include income tax expense (or benefit) related to adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates. Under ASC 740-10-50-9(g), this component should be reported as a separate component of income tax expense (or benefit) attributable to continuing operations.

G. Financial reporting considerations for non-calendar-year entities

Subsequent event reporting

Entities with fiscal years ending before the enactment date that have not issued the financial statements as of the enactment date should follow the guidance on reporting subsequent events in ASC 855, *Subsequent Events*. As discussed in Section B, these entities should not reflect the effects of the Act in their annual financial statements because the enactment date is after the end of their fiscal year, but they should consider disclosing the anticipated effects of the Act in the notes to financial statements. The requirements in ASC 855-10-50-2 state that an entity should provide information about the nature of the nonrecognized subsequent event, as well as an estimate of its financial effect, or a statement indicating that the effect cannot be estimated when the subsequent event requires disclosure to keep the financial statements from being misleading. These entities need to exercise judgment when determining whether the effects of the Act should be disclosed.

Blended tax rate and estimated annual effective tax rate

The Act reduces the existing corporate tax rate schedule to a flat 21 percent rate, effective for tax years beginning after December 31, 2017. However an entity that reports based on a year-end other than a calendar year is required by Section 15 of the Internal Revenue Code to calculate a blended tax rate, based on the ratio of days in the tax year that occur before and after the effective date, for the remaining fiscal period. The income tax for the remainder of the fiscal year should be determined by applying the blended tax rate to the taxable income for the period, beginning from the period that includes the enactment date.

The following example demonstrates the calculation of a blended estimated annual tax rate.

Calculating a blended estimated rate

An entity has a year-end of June 30, 2018. The tax rate in effect from July 1, 2017 to December 31, 2017 is 35 percent, and the tax rate in effect from January 1, 2018 to June 30, 2018 is 21 percent. The entity calculates the estimated annual rate proportionally, based on the rates and number of days in the periods before and after the effective date, and determines that its estimated rate should be 28 percent. Starting in the period that includes the enactment date, the entity uses this blended rate in its calculation of income tax expense (benefit) for the year, as shown in the example below.

Period	Days	Proportion	Tax rate	Proportional rate
July 1, 2017 to December 31, 2017	184	50.4%	35%	18%
January 1, 2018 to June 30, 2018	181	49.6%	21%	10%
Estimated annual rate				28%

The guidance in ASC 740-270-25-5 requires an entity to record the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year after the effective date outlined in the tax legislation. The impact should be reflected in computing the estimated annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. Therefore, for entities with year-ends after December 31, 2017, the impact of the Act on the estimated annual effective tax rate effective January 1, 2018 should be factored into interim-period financial statements that include the enactment date. Entities with a year-end other than a calendar year also need to consider the requirements of Section 15 of the Internal Revenue Code when calculating the annual income tax provision.

However, the impact of the Act on deferred tax assets or liabilities is not factored into the adjustment of the estimated annual effective tax rate, but is instead reflected as of the date of enactment (see Section B for a discussion of these measurements). Many entities do not regularly adjust their deferred tax balances as of an interim date. Given that existing guidance requires this adjustment as a separate calculation, entities with fiscal year-ends after December 31, 2017 will likely need to measure their deferred tax positions, and evaluate the need for related valuation allowances, as of the date of enactment (that is, December 22, 2017) in order to reflect the adjustment in their next interim financial statements. For example, if the enactment date falls in an entity's third quarter, the entity would record the impact on deferred taxes as a discrete item in the income tax expense (or benefit) for the third quarter.

Example 6 from ASC 740-270, *Interim Reporting,* illustrates the computation of the estimated annual effective tax rate to be used for interim reporting of income taxes when a tax rate change is enacted in an interim period other than the first or fourth quarter. An enactment date in the first quarter requires an entity to consider the impact of the enacted legislation when it determines the estimated annual effective tax rate for the full fiscal year. Since ASC 740-270-25-5 does not permit the impact of a change in tax law to be apportioned among quarters, the entity should recognize the entire impact of that change in the first-quarter financial statements. An enactment date in the fourth quarter does not have a similar impact, as the fourth-quarter income tax provision is calculated as the difference between the third-quarter provision and the year-end provision. The following example illustrates the effects of a tax rate change on the calculation of the estimated annual effective tax rate.

Recognizing effects of a tax rate change on estimated annual effective tax rate

For the full fiscal year ending on June 30, 2018, an entity anticipates ordinary income of $100,000. All income is taxable in one jurisdiction at a 35 percent rate. No events that do not have tax consequences are anticipated.

New legislation enacted on December 22, 2017 reduces the tax rate to 21 percent. The new tax rate is effective for tax years beginning after December 31, 2017; however, the entity is required by Section 15 of the Internal Revenue Code to calculate a blended tax rate (see example above for calculating a blended rate). The effect of the tax rate change should be considered when the entity calculates the estimated annual effective tax rate for the reporting period that includes the enactment date. Quarterly tax computations are as follows.

Reporting period ending on	Ordinary income		Estimated annual effective tax rate	Tax provision		
	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
September 30, 2017	$ 20,000	$ 20,000	35%	$ 7,000	$ –	$ 7,000
December 31, 2017	$ 20,000	$ 40,000	28%	$11,200	$ 7,000	$ 4,200
March 31, 2018	$ 20,000	$ 60,000	28%	$16,800	$11,200	$ 5,600
June 30, 2018	$ 40,000	$100,000	28%	$28,000	$16,800	$11,200

Total	$100,000					$28,000

Interim disclosure requirements

ASC 740-270-50-1 notes that the interim-period requirements for reporting income taxes may result in a large variation from expectations in the relationship between income tax expense and pretax accounting income. These variances can result from discrete items, such as adjusting deferred taxes during the period that includes the enactment date, and from other adjustments that are necessary to appropriately reflect the impact of the new tax legislation on the current period, such as the impact of a tax rate change on the calculation of the estimated effective annual tax rate in the period that includes the enactment date. The guidance requires entities to disclose the reasons behind such variances in their interim-period financial statements if such differences are not readily apparent from the financial statements themselves or from the nature of the business of the entity.

H. Other financial reporting implications

The Act is likely to affect entities in areas other than accounting for current and deferred federal income tax expense. Presented below are additional accounting and other implications that entities should consider.

Impairment of assets and other fair value determinations

The provisions of the Act could affect measurements of asset impairments and other fair value determinations, such as when an entity measures compensation cost related to a shared-based payment arrangement. Many entities use assumptions in impairment tests and other fair value determinations that include projected financial results that are net of a tax effect. These assumptions should be updated and evaluated to determine whether the Act affects these measurements.

Entities might need to consider the provisions of the Act in connection with their required annual or interim impairment tests of long-lived assets, and when accounting for business combinations (including any related measurement-period adjustments).

Impairment testing

When an entity tests certain long-lived assets for impairment, it might need to consider the effects of income taxes when estimating the fair value of the assets that are being evaluated. For example, when testing a long-lived asset for impairment, an entity might

- Prepare a discounted cash flow analysis on an after-tax basis
- Present the weighted-average cost of capital on an after-tax basis
- Consider deferred income taxes when determining the carrying amount of a reporting unit
- Include the effects of an income tax amortization benefit in the fair value of an intangible asset, such as a license or trademark

An entity should consider the effective date of the impairment test when determining whether the tax effects of the Act should be considered when estimating these fair values. Therefore, the tax effects of the

Act should not be considered when the effective date of the impairment testing precedes the new tax law's enactment date, but the tax effects should be considered when the effective date is on or after the enactment date.

However, when the effective date is before the enactment date, an entity should also evaluate as of the enactment date whether the tax effects of the Act might have an adverse effect on the estimates of fair value in future periods. The entity should then determine whether the tax effects of the Act might constitute indicators of impairment, requiring an additional impairment test in the period of enactment.

Business combinations

Entities that enter into transactions accounted for as business combinations under ASC 805, *Business Combinations,* should consider the effect of income taxes when determining the fair value of certain identifiable assets (such as licenses and trademarks), and might therefore recognize deferred tax liabilities and assets when applying the acquisition method of accounting. When the accounting for the business combination is not complete as of the reporting date, an entity may record adjustments to the provisional amounts, including the balance of deferred tax liabilities and assets, in subsequent accounting periods.

When accounting for a business combination under ASC 805, the acquisition date is the primary factor in determining whether an entity should consider the tax effects of the Act when estimating the fair values of identifiable assets and recognizing deferred tax liabilities and assets. The same general principle discussed above for impairment testing applies: The effects are not considered when the acquisition date precedes the enactment date, but these effects are considered when the acquisition date is on or after the acquisition date.

When an entity has recognized deferred tax liabilities and assets for a business combination that occurs before the enactment date, it is required to remeasure these deferred tax assets and liabilities on the tax law's enactment date. Due to the prohibition on "backwards tracing" discussed in Section B, the entity is required to recognize any adjustments to these deferred tax balances as a component of tax expense (or benefit) in income from continuing operations in the period of enactment, even if these deferred tax balances were originally recognized in the business combination accounting. This guidance applies even when the acquisition date and the enactment date are in the same annual or interim reporting period.

If the accounting for a business combination is incomplete when the financial statements are issued or have been made available for issuance, entities should report estimates of the fair values of certain assets and liabilities, including any related deferred tax assets and liabilities, as provisional amounts as of the reporting date. Entities should adjust these provisional amounts during the period after the reporting date (referred to as the "measurement period") when the accounting for the business combination is complete. Under the existing guidance, measurement-period adjustments are recognized in the period when the entity determines these amounts.

Entities should initially recognize the income tax effects of measurement-period adjustments based on the income tax rates that were in effect on the original acquisition date. If the acquisition date precedes the enactment date, deferred tax liabilities and assets should be adjusted based on the rates in effect prior to the enactment date. Entities should then remeasure these deferred tax liabilities and assets to reflect the effects of the Act, and recognize any adjustments as a component of tax expense (or benefit) in income from continuing operations in the same period the related measurement period adjustments were recognized.

Financial covenants

Entities should review their lending agreements to determine the impact, if any, of financial statement adjustments related to the Act on their existing financial covenants.

Uncertain tax positions

Entities should review each tax position in light of the Act to determine if it continues to meet the more-likely-than-not threshold that is outlined in ASC 740-10-25-6. An entity may record the financial statement effects of a tax position only if it meets the more-likely-than-not threshold, defined as a greater than 50 percent likelihood of being sustained upon examination. Tax positons that meet this criteria are measured at the largest amount of tax benefit that is greater than 50 percent likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information. Any impact of uncertainty of an entity's positions should be recorded and disclosed in the period of the enacted change in tax law, and any anticipated changes that are reasonably possible within the next 12 months should be qualitatively disclosed as required under ASC 740-10-50-15(d).

State income tax implications

Entities need to consider the impact of the Act on state tax provisions. States might maintain conformity with the Internal Revenue Code either on a static or a rolling basis. States with static conformity maintain alignment with the Internal Revenue Code as it existed prior to federal tax reform. In these states, entities should monitor legislative activities of the state to advance the conformity date to align with the provisions in the Act. For states with rolling conformity, the provisions of the Act will automatically be adopted and applied, although this could be more complex based on whether states have decoupled their regulations from any specific regulations within the Internal Revenue Code. States may then react in various ways to the provisions of the Act. Entities should closely monitor the legislative process for all states where they file returns and calculate state income tax provisions to ensure that the requirements are properly reflected in the appropriate period.

I. Internal control considerations

The Act will likely require entities to reperform the risk assessment around income taxes to identify the relevant tax laws and rates, the timing implications of those laws and rates, and the identification of appropriate data necessary to account for any new or different tax laws and rates. The Act may impact internal controls over financial reporting since new data, estimates, and information may be needed to prepare tax provisions and related disclosures. Whenever new or different data is necessary, the entity must ensure the completeness and accuracy of that data and its suitability for the intended purpose. Entities then need to determine whether their existing internal controls related to income taxes are designed properly to accommodate the new or different laws and rates. In addition to controls over income tax accounting, entities also need to assess the need for new or modified internal controls related to new income tax disclosures, including any disclosures related to applying the new tax requirements during the measurement period when the accounting for the income tax effect of the new law is incomplete, as discussed in Section J below.

J. SEC staff guidance

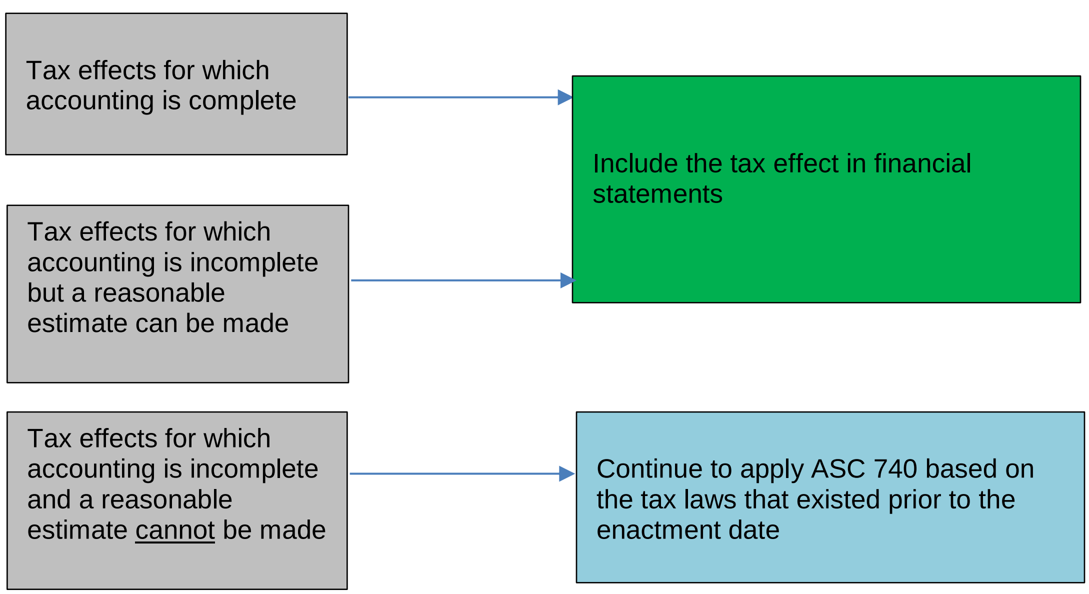
The SEC staff published guidance to help ensure timely public disclosures of the accounting impact of the Act, while acknowledging the challenges that some entities will face in recognizing tax changes in the financial reporting period that includes the Act's enactment date or in a subsequent financial reporting period. The guidance in Staff Accounting Bulletin (SAB) 118 and in Exchange Act Form 8-K Compliance and Disclosure Interpretation (C&DI) 110.02, along with an Information Update from the SEC's Division of Investment Management, is summarized below.

SAB 118

SAB 118 adds Section EE, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act,* to Topic 5, *Miscellaneous Accounting,* of the SAB series, which provides guidance on applying ASC 740 when the accounting for certain income tax effects of the Act are incomplete at the time the financial statements are issued for a reporting period. This guidance applies only to the application of ASC 740 in connection with the Act and should not be used for purposes of applying ASC 740 to other changes in tax laws.

In addition, SAB 118 states that the staff *expects entities to act in good faith to complete the accounting under ASC 740;* therefore, the guidance in SAB 118 does not imply that entities have additional time to recognize the impact of the Act. However, in issuing SAB 118, the staff recognizes that the impact of the Act will result in many complex calculations in an entity's financial statements, which may take more than one reporting period to finalize.

The following flowchart summarizes the guidance in SAB 118, based on whether an entity has completed the accounting requirements under ASC 740 as of the reporting date.



Tax effects for which accounting is complete

For the income tax effects of the Act for which an entity has completed the accounting by the time it issues the financial statements for a reporting period, the entity should record those effects in that reporting period. These amounts should not be reported as provisional amounts.

Tax effects for which accounting is incomplete – an estimate can be made

For the income tax effects of the Act for which an entity has not completed the accounting by the time it issues the financial statements for a reporting period but can determine a reasonable estimate, such estimate should be reported as a provisional amount in those financial statements.

Tax effects for which accounting is incomplete – an estimate cannot be made

For the income tax effects of the Act for which an entity has not completed the accounting by the time it issues the financial statements for a reporting period and cannot determine a reasonable estimate, the entity should continue to apply ASC 740 (for example, when recognizing and measuring current and deferred income taxes), based on the provisions of the tax laws that were in effect immediately prior to the enactment date of the Act. Therefore, an entity should not adjust its current or deferred income taxes for any specific tax effects of the Act until a reasonable estimate of their effect can be determined.

Subsequent changes to the provisional amounts of tax effects related to the Act

The entity is allowed to use a “measurement period” similar to the concept of measurement period in ASC 805 to complete the accounting for the income tax effects of the Act. The measurement period begins at the enactment date and ends when the entity has obtained, prepared, and analyzed the information required to complete the accounting requirements under ASC 740. The measurement period cannot extend beyond one year from the enactment date.

During the measurement period, an entity may record adjustments to provisional amounts, or to amounts that are recorded under the provisions of tax laws that were in effect immediately prior to the enactment of the Act, upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date. Such adjustments should be recorded in income tax expense (or benefit) from continuing operations in the financial reporting period when they are identified. However, any income tax effects of events unrelated to the Act or related to facts and circumstances that did not exist as of the Act’s enactment date should not be recorded as measurement-period adjustments.

Disclosures

Entities should include the following financial statement disclosures to provide information about the material financial reporting impact of the Act for which the accounting under ASC 740 is incomplete, whether or not a reasonable estimate can be made:

- Qualitative information about the income tax effects of the Act for which the accounting is incomplete
- Items reported as provisional amounts
- Existing current or deferred tax amounts for which the income tax effects of the Act have not been completed
- Reason why the initial accounting is incomplete
- Additional information that needs to be obtained, prepared, or analyzed to complete the accounting requirements under ASC 740
- Nature and amount of any measurement-period adjustments recognized during the reporting period
- Effect of measurement-period adjustments on the effective income tax rate
- When the accounting for the income tax effects of the Act has been completed

Are private companies and not-for-profit entities permitted to apply SAB 118?

The FASB staff has issued a Staff Q&A, *Topic 740, No. 1: Whether Private Companies and Not-for-Profit Entities Can Apply SAB 118*, stating that the staff would not object to private companies and not-for-profit entities (NFPs) applying SAB 118 and that this application would be in compliance with U.S. GAAP. In addition, the Q&A states that if a private company or an NFP applies SAB 118, they should apply all of its requirements, including disclosures, which should also include the accounting policy of applying SAB 118.

Exchange Act Form 8-K C&DI 110.02

C&DI 110.02 states that the remeasurement of a deferred tax asset to reflect the impact of a change in tax rates or tax laws is not considered to be an impairment under ASC 740. As a result, this remeasurement does not require an entity to file Form 8-K under Item 2.06, *Material Impairments,* of Form 8-K. However, the interpretation also states that enactment of new tax rates or tax laws could impact an entity's determination of whether it is more likely than not that a deferred tax asset will be realized.

Under the interpretation, entities using the measurement-period approach in SAB 118 that conclude an impairment of a deferred tax asset resulting from the enactment of the Act has occurred may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report (Form 10-Q or Form 10-K) rather than in a current report (Form 8-K) filing.

Division of Investment Management Information Update

The SEC's Division of Investment Management recently confirmed that investment companies that account for income taxes under ASC 740 may rely on the guidance in SAB 118 for purposes of calculating net asset values (NAV) and reporting measurement-period adjustments. The division also reminded registrants that they must disclose relevant information to investors, including information about the material impact of the Act on its calculation of NAV, and material provisions of the Act for which the accounting is incomplete, if applicable. The disclosure about those effects may be made in a press release, website disclosure, or some other reasonable manner.

K. International Financial Reporting Standards

Entities reporting under International Financial Reporting Standards (IFRS) that are also subject to taxation in the United States should primarily apply the guidance in International Accounting Standards (IAS) 12, *Income Taxes,* when determining how to account for the tax effects of the Act. Additionally, the European Securities and Market Authority released a public statement, *Accounting for Income Tax consequences of the United States Tax Cuts and Jobs Act under IFRS,* providing clarifications for the income tax effects of the Act under IFRS.

Under IAS 12, entities are required to recognize the effects of changes in tax rates and tax laws on current and deferred income taxes in the period in which the changes are "substantially enacted." As a result, the enactment date is the same under both U.S. GAAP and IFRS.

However, an important difference in accounting for the effects of the Act under IFRS relates to “backwards tracing” of adjustments to deferred tax liabilities and assets resulting from changes in tax rates and tax laws (see Section B for a discussion of “backwards tracing” under U.S. GAAP). Under IFRS, “backwards tracing” of adjustments to deferred tax liabilities and assets is required. As a result, an entity reporting under IFRS should recognize the effects of changes in deferred tax amounts in the current year in the same line item where the deferred tax amounts were originally recognized. For example, if the deferred tax provisions (or benefits) were originally recognized in either AOCI or equity, the effects of the Act should also be recognized in AOCI or equity, as applicable. Entities therefore need to determine where these deferred tax amounts were originally recognized.

IAS 12 provides guidance for entities that encounter difficulties when determining the amount of income taxes or benefits that were originally recognized in either AOCI or equity. Under this guidance, entities are permitted to use an alternative method, other than specific identification, for determining these amounts in certain circumstances.

The SEC staff guidance in SAB 118 (see Section J) would also need to be considered by public business entities, such as foreign private issuers, that report under IFRS.

The content in this publication is based on information available as of February 14, 2018. We may update this publication for evolving views as we continue to monitor the financial reporting impact of the Act.

For additional information on topics covered in this document, contact your Grant Thornton LLP professional.