Tax accounting considerations of recent U.S. tax reform proposals

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In brief

President Trump and the Republican-controlled Congress have indicated that comprehensive tax reform is currently one of the federal government's top legislative priorities. During his first address to a joint session of Congress, President Trump called for action on U.S. tax reform to "restart the engine of the American economy" and said that his economic team is "developing historic tax reform." It is widely anticipated that such U.S. tax reform may occur later this year and could result in significant changes to existing U.S. tax law in several areas including corporate tax rates, business deductions, and international tax provisions. As companies continue to closely monitor developments and assess the implications of potential tax reform, questions may arise as to the financial reporting implications of the various tax reform proposals. To aid in this assessment, we have summarized below key proposals from the tax plans of both President Trump and House Republicans along with related accounting for income tax considerations under U.S. GAAP.

For an in-depth discussion on the outlook for tax policy in 2017 and additional information on recent tax reform proposals, please see PwC's Washington National Tax Services publication, *Decision time for tax reform: 2017 Tax Policy Outlook*.

In detail

Proposals to reform the U.S. tax code are at the forefront of President Trump's and Congress' current agendas. Comprehensive U.S. tax reform may occur later this year and could significantly impact many organizations, including their financial statements.

In June of 2016, House Republicans released a 35-page report on tax reform (the Blueprint). The increased potential for comprehensive tax reform in 2017 has put a spotlight on the Blueprint, and the Ways and Means Committee staff have been working to draft statutory language that reflects the goals and principles outlined therein. President Trump has also identified certain key areas for reform, and White House officials have recently said that the President's updated tax reform plan will be released in the next few weeks. In summary, the proposals from President Trump and the Blueprint call for significant changes to existing U.S. tax law, including the corporate tax rate, business deductions, and international tax provisions.

Many companies have been closely monitoring tax reform developments since the November elections and have begun to assess the potential impacts on their businesses. This article analyzes potential U.S. GAAP financial statement considerations associated with key U.S. tax reform proposals from both President Trump and the Blueprint. To the extent these, or any, U.S. tax reform proposals result in the enactment of a law, the impact of the change will need to be assessed and recorded in the financial statements in the period of enactment irrespective of the effective date.

Corporate tax rate reduction

President Trump's tax proposals and the Blueprint have called for a reduction from the current 35-percent top marginal tax rate for subchapter C corporations (to be lowered to 15-percent and 20-percent, respectively). Any phasing in of the reduced tax rate is currently unknown. President Trump's tax proposals and the Blueprint couple corporate tax rate reduction along with the elimination of most business tax expenditures, including the Section 199 manufacturing deduction. If enacted, these changes would impact a company's effective tax rate.

ASC 740, *Accounting for Income Taxes*, requires deferred tax assets and liabilities to be measured at the enacted tax rate expected to apply when temporary differences are to be settled or realized. If the U.S. corporate tax rate is lowered, companies would be required to recognize the impact of the change in the tax rate on existing deferred tax assets and liabilities as a discrete item in the period in which the legislation is enacted. Any effect would be reported as part of tax expense or benefit in continuing operations, regardless of the category of income to which the underlying pre-tax earnings or deferred taxes relate.

PwC observation: A delayed effective date or phased approach to enacting a reduction in the statutory tax rate could add complexity as it would require consideration of the period in which temporary differences are expected to reverse, in order to measure deferred tax assets and liabilities.

U.S. deductions

Full expensing

President Trump's tax proposals and the Blueprint provide certain provisions around full expensing of business costs. The Blueprint provides for full expensing (in lieu of depreciation and amortization) for investments in both tangible property (e.g., equipment and buildings) and intangible assets (e.g., intellectual property). In a more limited manner, President Trump has proposed to allow only U.S.-based manufacturers the option of electing full expensing of plant and equipment.

Interest

As part of the proposals to move to full expensing for business investments, a limitation on the ability to deduct interest expense has also been proposed. The Blueprint eliminates the current deduction for net business interest expense associated with debt incurred to finance such investments. Businesses will be allowed to deduct interest expenses only against any interest income. The Blueprint provides that "any net interest expenses may be carried forward indefinitely and is allowed as a deduction against net interest income in future years." As part of President Trump's proposals, U.S.-based manufacturers that elect full expensing for investments would be required to give up the ability to deduct interest expense.

Once effective, companies would need to consider the impact that the full expensing provisions and the limitation (or disallowance) of interest deductions would have on current and deferred taxes. For example, full expensing of business costs for tax purposes could result in significant new temporary differences, including both deferred tax liabilities on the acceleration of deductions for tax purposes and deferred tax assets if full expensing results in a taxable loss.

To the extent disallowed interest can be carried forward, the associated deferred tax asset that is recorded will be subjected to a valuation allowance assessment. In some respects, this assessment may be similar to determining the realizability of capital loss carryforwards as both tax attributes would attract a valuation allowance absent taxable income of a particular character.

In addition, the changes to full expensing and interest may impact a company's analysis of future taxable income when assessing the ability to realize other deferred tax assets, including net operating loss ("NOL") carryforwards.

Net operating losses

The Blueprint provides that the deduction allowed with respect to a NOL carryforward in any year "will be limited to 90-percent of the net taxable income for such year determined without regard to the carryforward." However, NOLs will be allowed to be carried forward indefinitely, and will be increased "by an interest factor that compensates for inflation and a real return on capital." NOL carrybacks would not be permitted under the plan.

If enacted, companies would need to consider the impact that any changes in limitations and carryforward periods would have on the ability to realize its deferred tax assets associated with NOLs. This may include deferred tax assets that exist at the time of enactment to the extent new legislation extends the indefinite carryforward period to pre-enactment NOLs. If the law change applies only to post-enactment NOLs, there may be added complexity driven by a need to consider the sources of future taxable income to determine which NOL carryforwards (pre- or post-enactment) are able to be utilized.

PwC observation: Tax-planning strategies generally cannot be used as a possible source of taxable income for realizing the tax benefit of a NOL with an indefinite carryover period. If tax planning strategies have previously been relied upon for realization, there may be an impact to a company's valuation allowance assessment once legislative guidance is enacted.

International tax reform

Mandatory repatriation

The Blueprint includes a mandatory "toll tax" on previously untaxed foreign earnings. An 8.75-percent tax rate is proposed on previously untaxed foreign cash and cash-equivalents, with a reduced 3.5-percent tax rate for all other previously untaxed foreign earnings. The Blueprint would allow for payment of the tax liability over a period of eight years. The provisions for mandatory repatriation are consistent with the terms from the international tax section of HR1, the Tax Reform Act of 2014, introduced by former House Ways and Means Committee Chairman Dave Camp.

In a similar proposal, President Trump has proposed a mandatory 10-percent toll tax on previously untaxed foreign earnings.

If a mandatory repatriation provision is enacted, a tax liability will arise for companies with unremitted foreign earnings regardless of whether or not they have historically asserted indefinite reinvestment. Assuming enactment occurs prior to the effective date, companies would need to record a deferred tax liability (or adjust an existing deferred tax liability) for the toll tax to be levied on all historical earnings and profits ("E&P") that will be subject to the toll tax.

PwC observation: The measurement of deferred taxes on outside basis differences in foreign subsidiaries is inherently complex and often involves the use of judgment which may require a significant effort to compute the impact of mandatory repatriation. In recording this liability, companies would need to critically analyze the planned manner of repatriation to appropriately account for the potential taxes, as well as withholding taxes. Consideration must also be given to the ability to net aggregate foreign subsidiary E&P deficits against aggregate positive E&P and the ability to utilize foreign tax credits, to the extent these provisions (as previously introduced in HR1) are included in enacted legislative guidance.

Additionally, it is possible that some companies may decide to repatriate unremitted foreign earnings prior to enactment. In this case, the tax impacts would be recorded based on the existing U.S. and foreign tax laws that apply to the repatriations.

Territorial system

Under the Blueprint, the U.S. would move from a worldwide international tax system to a 'territorial' dividend-exemption system. Under the current plan, the foreign earnings of U.S. businesses (not taxed through mandatory repatriation, discussed previously) will receive a 100-percent exemption for dividends from foreign subsidiaries.

Enactment of a territorial system with a 100-percent dividend exemption would likely impact a company's global cash repatriation strategy going forward and reduce the likelihood of deferred taxes on the U.S. tax impact of repatriation. However, as outside basis differences need to be considered at every level of an organization's legal entity structure, deferred taxes would still need to be evaluated for outside basis differences in tiered structures. In addition, the effects of any foreign withholding taxes would still need to be considered when repatriation is expected by dividends.

President Trump at one point during the campaign proposed to repeal the deferral of U.S. income taxes for unrepatriated foreign earnings within the current U.S. worldwide tax system, but that proposal was dropped.

PwC observation: Given the brevity of the Blueprint, it is currently unclear what impact the transition to a territorial system would have on the current U.S. foreign tax credit regime. To the extent deferred tax assets have been recorded for U.S. foreign tax, an assessment will need to be performed regarding the ability to realize such deferred taxes based upon enacted legislative guidance.

Border adjustments

The Blueprint states that a "cash-flow based approach will replace our current income-based approach for taxing both corporate and non-corporate businesses" and that this "consumption-based" tax system will be "applied on a destination basis." This "destination-based" approach to taxation generally will mean that the tax will be based on the place of consumption of goods and services rather than source of income or the residence of the taxpayer. Destination-based taxation is achieved through "border tax adjustments," exempting gross receipts from exported goods and services while taxing without deductions goods and services imported into the U.S. [For additional information on the "cash-flow" taxation and border adjustability provision of the Blueprint, see PwC's Insight "The House Republican Blueprint: A destination-based cash-flow tax."]

The principles of ASC 740 are applicable to "taxes based on income." Given the focus on the currently-proposed cash-flow based approach in the Blueprint, it is uncertain whether the new taxing structure will be accounted for under ASC 740 or if it would be considered a non-income based tax that would be accounted for outside of ASC 740. The conclusion on the appropriate accounting model will need to be determined once there is sufficient information to clearly understand the tax structure that will be represented in the final legislation.

PwC observation: Regardless of whether the impacts of border adjustment provisions are accounted for in pre-tax income or below the line in tax expense, it is expected that the tax return and financial statement impact on companies could be significant.

The takeaway

President Trump and the Republican-controlled Congress are expected to push for action on comprehensive tax reform. It is anticipated that tax reform will include the combination of a lowered corporate tax rate, the elimination of certain deductions, and changes to international taxation. While many items remain in question, companies should stay abreast of current legislative developments and evaluate the potential implications that these developments may have on their business, including financial reporting, to ensure they are prepared to account for these changes in the period of enactment.

Let's talk

You should not rely on the information contained within this alert without seeking professional advice. For a deeper discussion of how certain tax reform proposals may affect your business, please contact your PwC engagement team or a Tax Accounting Services network member listed here:

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