TAX ALERT – JANUARY 5, 2018

U.S. Tax Reform: Implications on Accounting for Income Taxes

On December 22, 2017, President Trump signed into law the 2017 U.S. tax reform bill "*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 115-97 (the "**Act**"), formerly known as the "*Tax Cuts & Jobs Act*." Most of the Act's provisions are effective January 1, 2018.

The Act introduces the most significant changes to the U.S. tax system since 1986. From a financial reporting perspective, the Act requires companies, under Accounting Standards Codification ("ASC") 740, Income Taxes, to recognize the effects of changes in tax laws and rates on deferred tax assets and liabilities and the retroactive effects of changes in tax laws in the period in which the new legislation is enacted.

In the U.S., the enactment date is the date the bill becomes law, which occurs when the President signs the bill. Under U.S. Generally Accepted Accounting Principles, the financial statement effects of changes in tax law are recorded as discrete items and part of tax expense or benefit in continuing operations, regardless of the category of income or loss to which the deferred taxes relate.

The new tax laws were enacted prior to January 1, 2018; therefore, calendar-year companies will be required to include the effects of the tax law changes in their 2017 year-end tax provisions.

The following provides a brief summary of certain prior law and new law provisions and the impact to the accounting for income taxes arising from these changes. Examples are provided to illustrate some of the changes. For those clients wishing a more specific analysis, interpretation and calculation of the impact of the Act, we are available to answer your questions.

1. Reduction in Corporate Tax Rate

Prior Law. Under prior law, a graduated rate structure existed, whereby taxable income in excess of $10 million was subject to a 35% rate.

New Law. Effective January 1, 2018, the Act reduces the 35% corporate rate to 21% and eliminates the long standing graduated rate structure.

Income Tax Accounting Implications. The impact of a change in tax rate on deferred tax assets and liabilities is recognized as a component of income tax expense from continuing operations in the period of enactment. Adjustments to deferred tax balances related to the enacted change in tax rate should be included in income from continuing operations, regardless of whether the deferred tax

© Funaro & Co., P.C., 2018. All rights reserved.
This memorandum was prepared for clients of Funaro & Co., P.C. to report on recent tax developments. The information in it is therefore general and should not be considered or relied on as tax advice.

balances originated from charges or credits to another category of income (e.g., discontinued operations or other comprehensive income).

State tax temporary differences affect the calculation of federal taxes. Federal deferred tax effects of state deferred taxes and unrecognized tax benefits related to state taxes should be re-measured.

Companies in an overall net deferred tax asset ("**DTA**") position under prior law, will see a tax expense as the DTA is written down to reflect the lower 21% rate. This will also result in an increase to the effective tax rate ("**ETR**"). Conversely, companies in an overall net deferred tax liability ("**DTL**") position under prior law, will see a tax benefit as the DTL is written down to reflect the lower 21% rate. This will also result in a decrease to the ETR. The following example illustrates this.

Tax Rate Example. ABC Inc., a calendar year corporation, has taken advantage of federal accelerated tax depreciation rules and is currently in a net DTL position of $350,000. Due to the change in federal tax law enacted on December 22, 2017, ABC must re-measure its DTL to reflect the lower rate of 21%.

Remeasure		**Deductible (Taxable) Temp Difference**				**Deferred Tax Asset (Liability)**
Fixed assets	(Old Law)	(1,000,000)	x	35%	=	**(350,000)**
Fixed assets	(New Law)	(1,000,000)	x	21%	=	**(210,000)**

Required Journal Entries	**Balance sheet** DR	**Balance sheet** (CR)	**Income statement** DR	**Income statement** (CR)
Deferred tax liability	**140,000**			
Deferred tax benefit				**140,000**

Assuming pre-tax book income of $10,000,000, ABC's rate reconciliation and effective tax rate at December 31, 2017 will be as follows:

						ETR
Expected Tax @ 35% rate	10,000,000	x	35%	=	3,500,000	35%
Benefit of federal tax rate decrease					(140,000)	-1%
Tax Expense and Effective Tax Rate					**3,360,000**	**34%**

2. Repeal of Corporate Alternative Minimum Tax

Prior Law. The Alternative Minimum tax (“**AMT**”) regime imposed a 20% tax on Alternative Minimum Taxable Income. A Minimum Tax was then calculated equal to the amount of Tentative Minimum Tax (“**TMT**”) that exceeded the regular tax liability for the year. The Alternative Minimum Tax was considered a deferred tax asset as it could be used to offset future regular tax liabilities to the extent the regular tax exceeded the TMT for the year.

New Law. Effective for tax years beginning after December 31, 2017, the Act repeals the corporate AMT regime, provides for refunds of previously paid AMT, and repeals the election to accelerate AMT credits in lieu of claiming bonus depreciation.

Income Tax Accounting Implications. For companies with existing deferred tax assets for prior AMT credits, the Act provides a means of realizing the deferred tax asset without generating future income that is subject to tax. The benefit associated with the reversal of valuation allowances against existing AMT credit carryforwards would be recognized discretely in the period in which the change in judgment occurs and would provide a favorable impact on a company’s effective tax rate.

Minimum Tax Credit Example. ABC Inc., a calendar year corporation, had been paying alternative minimum tax for several years. Due to the "more likely than not" criteria, ABC was unable to record a financial statement benefit for the alternative minimum tax credit it had accumulated over the years. With the enactment of the new tax law, ABC will be able to claim the AMT credits as refundable credits over several years.

Remeasure		Deferred Tax Asset (Liability)
Minimum tax credit		200,000
Less valuation allowance		(200,000)
Net deferred tax asset	(Old Law)	-
Minimum tax credit		200,000
Less valuation allowance		
Prepaid expense	(New Law)	200,000

Required Journal Entries	Balance sheet DR	Balance sheet (CR)	Income statement DR	Income statement (CR)
Valuation allowance	200,000			
Deferred tax asset		(200,000)		
Prepaid tax			200,000	
Tax benefit				(200,000)

Assuming pre-tax book income of $10,000,000, ABC's rate reconciliation and effective tax rate at December 31, 2017 will be as follows:

			ETR
Expected Tax @ 35% rate	10,000,000 x 35% =	3,500,000	35%
Decrease in valuation allowance		(200,000)	-2%
Tax Expense and Effective Tax Rate		**3,300,000**	**33%**

3. Expensing of Capital Expenditures

Old Law. Previously companies were entitled to immediately expense 50% of the cost of qualified property acquired and placed in service.

New Law. The Act allows 100% expensing of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. In addition, it eliminates the separate definitions of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property and, instead, adds a general 15-year recovery period for qualified improvement property and a 20-year ADS recovery period for such property.

Income Tax Accounting Implications. Companies should consider the implications of accelerated capital expensing on deferred tax balances as of the period of enactment. Additionally, accelerated expensing may impact other previous assessments made with respect to the ability to realize certain deferred tax assets (e.g., net operating loss carryforwards or tax credit carryforwards). An entity may find it necessary to schedule the reversals of temporary differences related to depreciable assets.

For example: Accelerating income tax deductions with the election of 100% bonus depreciation may give rise to net operating losses and may also create taxable temporary differences that may be considered a source of income for purposes of assessing deferred tax asset utilization for realization in a future year.

Companies will also need to update their federal tax depreciation systems and processes for additional bonus depreciation in 2017 and to consider the impending state tax legislation that will either decouple from or conform to these new federal capex laws. Companies should identify which states will automatically conform by statute to the new federal cost recovery provisions for capital expenditures and consider the impact on current and deferred state taxes.

4. Net Operating Losses

Old Law. Previously, Net Operating Losses ("**NOLs**") could be carried back to the preceding two tax years, or an election could be made to forego this carryback period. Additionally, regardless of the election to forego the carryback period, remaining NOLs not carried back could be carried forward to offset taxable income for up to the subsequent twenty tax years. The utilization of NOLs against regular taxable income was not limited. Limitations applied to the utilization of NOLs against alternative minimum taxable income.

New Law. For losses arising in tax years beginning after 2017, the Act limits the NOL deduction to 80% of the taxpayer's taxable income (determined without regard to the carryforward deduction). These losses may be carried forward indefinitely. Additionally, the Act repealed the two year carryback, as well as special carryback provisions for losses arising in tax years ending after 2017 (with limited exceptions).

Income Tax Accounting Implications. Since carryback is still permitted for losses arising in tax years ending on or before 2017, the computation of (deferred) tax assets pertaining to such old NOLs will vary depending on the intention of the company to carry-back or to carryforward the NOL.

Generally, carrying back the NOL to a year in which the higher corporate tax rate was in effect would give rise to a higher tax asset.

5. Interest Expense Limitation

Old Law. Prior law limited the deductibility of interest expense of a thinly capitalized corporation where the interest was paid to a related payee that was totally or partially exempt from U.S. tax. Limitations also applied to interest that was paid or accrued to an unrelated person if there was a disqualified guarantee on the debt and no gross basis tax was imposed on such interest.

New Law. Effective for years beginning after 2017, the Act limits net interest expense deductions to 30% of earnings before interest, taxes, depreciation and amortization through 2021 and of earnings before interest and taxes thereafter. Any disallowed business interest deduction can be carried forward indefinitely (with certain restrictions for partnerships).

Income Tax Accounting Implications. On a go-forward basis, companies with interest limited under the Act will have to assess the need for a valuation allowance on any resulting deferred tax assets for interest carried forward. Deferred tax assets are not realizable (in accordance with ASC 740) simply because they can be carried forward indefinitely. Instead, the deferred tax asset is realizable only to the extent it can be sustained through the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law (i.e., the four sources of taxable income). Companies with attributes under prior law will have to evaluate the impact of any transition rules, which are currently unclear.

6. Transition Tax

Old Law. This is a new tax law that does not amend a previous tax law.

New Law. The Act imposes a one-time transition tax on US 10%-shareholder's pro rata share of foreign corporation's post-1986 tax-deferred earnings, at the rate of either 15.5% (for accumulated earnings held in cash, cash equivalents or certain other short-term assets) or 8% (for accumulated earnings invested in illiquid assets (e.g., property, plant and equipment). A foreign corporation's post-1986 tax-deferred earnings are defined as the greater of earnings as of November 2, 2017 or December 31, 2017. US shareholders may elect to pay the transition tax over eight years or less, with larger payments due in the last three years. Taxpayers may also elect not to use any carryover losses to reduce their transition tax liability. This is beneficial since those losses would then offset income subject to the higher 21% tax rate.

Income Tax Accounting Implications. Companies should record the transition tax liability in the period of enactment. Because a US shareholder could elect to pay the transition tax over eight years or less, companies should consider the impact on the balance sheet classification between current and non-current taxes payable. In addition, companies should validate US tax attributes such as earnings and profits accumulated after 1986, previously taxed income and foreign tax credit pools.

If you have any questions concerning this tax alert, please contact:

Luigi Perin, Partner
+1 (212) 273-5394
Luigi.Perin@funaro.com

John Harrison, Director
+1 (646) 277-8534
John.Harrison@funaro.com

Zachary Hollinshead, Senior Manager
+1 (212) 273-5376
Zachary.Hollinshead@funaro.com

ABOUT FUNARO & CO.

Funaro & Co. is a leading medium-sized audit and tax advisory firm. Founded in 1947 to service the unique needs of foreign companies with operations in the U.S, our firm has grown steadily over the years and the scope of our services has grown with us. For over 70 years, Funaro & Co.'s unmatched U.S./E.U. cross-border experience has kept us solidly in a position of leadership in our profession.

With more than 100 employees and offices in New York, Miami, Milan and Rome, the size of our firm is small enough to provide an unusual degree of personal service, yet large enough to provide every type of professional support required by its clientele.