2018 YEAR-END TAX UPDATE

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With You Today

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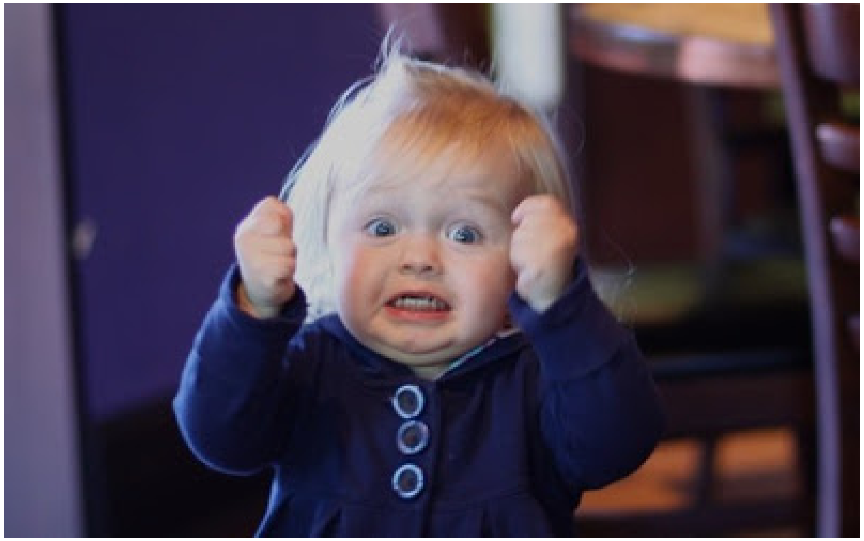
Today’s Discussion Topics

- Three Stages of Tax Reform
- Domestic Tax Issues
- International Tax Issues
- Proposed Income Tax ASU’s
- Significant Practice Issues
- ASC 740 Refresher on Key Provisions

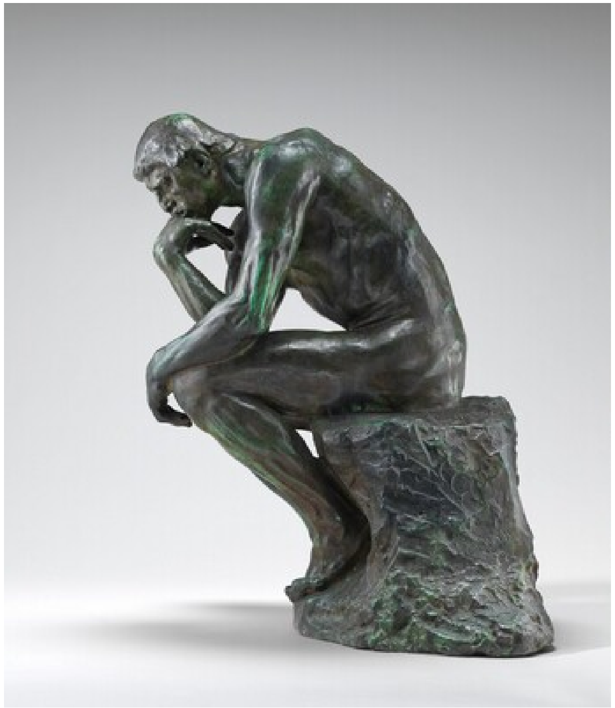
THE THREE STAGES OF TAX REFORM

Anticipating Tax Reform



Digesting Tax Reform

Reflections on Tax Reform

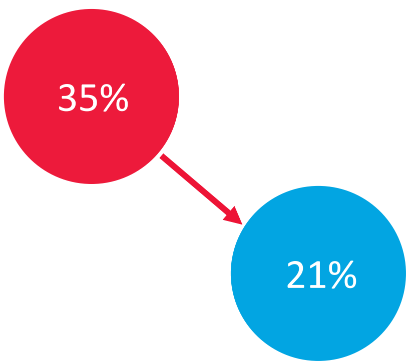


DOMESTIC TAX ISSUES

Reduced Tax Rates

Tax Law Change

Corporate tax rate was reduced from 35% to 21% effective January 1, 2018.



Reflections

The rate cut was a cornerstone provision of the TCJA but was coupled with various, less favorable provisions which offset some of that benefit including impacting many unsuspecting taxpayers:

- Interest Deduction Limitations
- Repeal of DPAD
- GILTI
- BEAT
- Modified Ownership Attribution Rules

State Income Tax Conformity = Windfall!!!

Tax Law Change

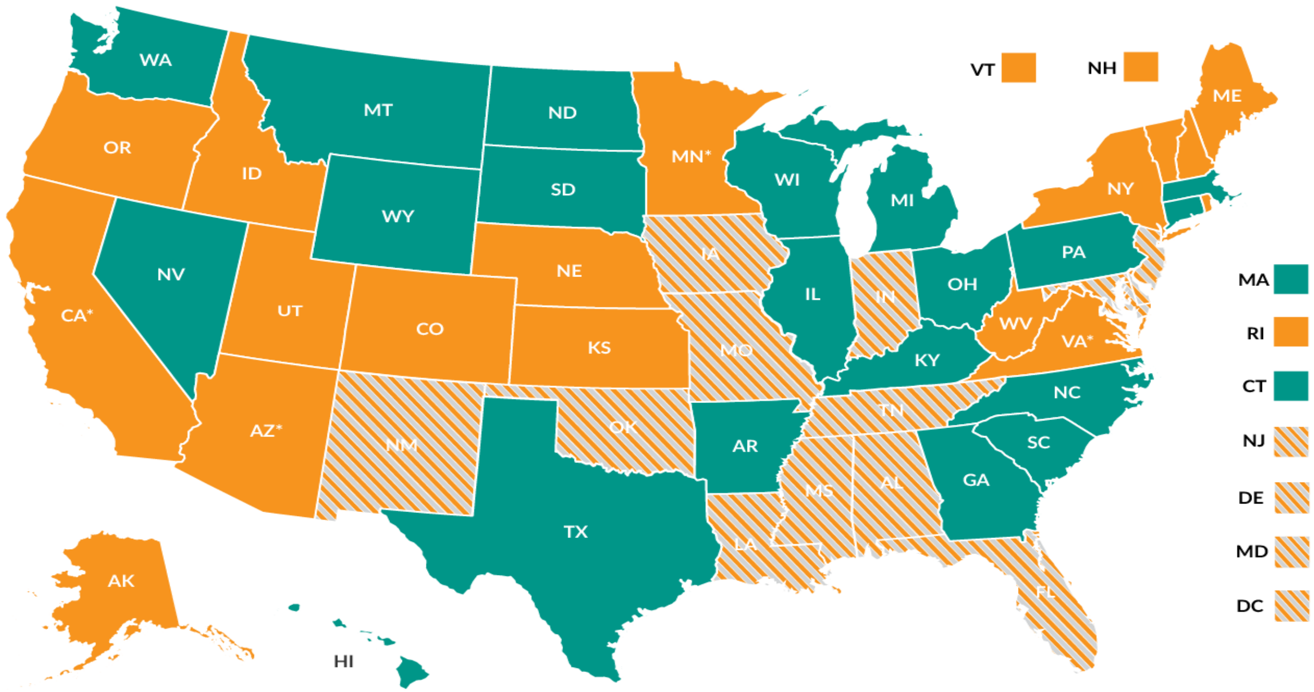
- Many of the state jurisdictions conformed their rules to the federal rules while others decoupled

Reflections

- Significant added complexity in complying with the varied conformity around the new federal provisions
- For those states which conformed, in most cases, the new provisions had an unfavorable impact on the income base without a corresponding reduction to their own tax rates creating windfalls for state governments

State Income Tax Conformity (cont'd)

Global Intangible Low-Taxed Income (GILTI)



Does Not Tax GILTI
Taxes GILTI
Taxes GILTI (Constitutional Issue)

Notes: In states with separate reporting, taxation of GILTI creates constitutional issues under the foreign commerce clause. Arizona, California, Minnesota, and Virginia still conform to pre-TCJA versions of the IRC, but stand to tax GILTI if their conformity date is updated.

Source: State statutes; revenue offices; Bloomberg Tax; Council on State Taxation

TAX FOUNDATION @TaxFoundation

Net Operating Loss Carryovers

Tax Law Change

- Tax loss carryovers are limited to 80% of taxable income for losses arising in tax years beginning after December 31, 2017.

- The carryback provisions have been repealed for tax years ending after December 31, 2017.

- Carryforward period is indefinite for NOL's generated in post-2017 tax years

Reflections

- Scheduling of deferred tax assets has become noticeably more complex
- The ability of an organization to "smooth out" its income over time has some significant limitations now and will require companies to be more cautious in planning out taxable income/loss from one year to the next
- Secondary tax incentives such as tax credits will now be of greater utility to companies with NOL carryovers
- Some taxpayers should consider opting out of bonus depreciation or other capitalization provisions
- Impact of Code Sec. 382 has changed given the indefinite carryforward period

Limitation on Deduction for Interest

Tax Law Change

- Interest deduction is limited to 30% of a business' adjusted taxable income
- Adjusted taxable income is computed without regard to deductions for business interest expense or business interest income, net operating losses, 20% deduction for certain pass throughs and, in the case of tax years beginning before January 1, 2022, depreciation, amortization, and depletion.
- Complicated rules relating to partnership interests included.
- Provisions do not apply to a taxpayer that has annual gross receipts less than $25M for the three taxable years prior to the reporting year.
- Unused interest can be carried forward indefinitely.
- Effective for tax years beginning after December 31, 2017.

Reflections

- Significant lost deduction for many companies, in particular, private equity owned portfolio companies
- While initially recorded as a deferred tax benefit due to indefinite carryforward period, for many this will become a "permanently" lost deduction absent significantly improved operating performance
- Beginning in tax year 2022 and beyond, the lost deduction will affect a large number of additional taxpayers and further limit the benefit for those already impacted
- Complex interaction with foreign subsidiaries – potential opportunity to increase the US parent's 30% ceiling

Under Simplification

Tax Law Change

Most of the TCJA provisions, in particular, international provisions

Reflections

The plain language of the TCJA provisions alone created a significant amount of additional complexity coupled with the need to interpret many hastily written provisions created an environment of uncertainty and confusion for many taxpayers

The sheer volume of compliance increased dramatically for most taxpayers, most notably with respect to:

- Computing and reporting around foreign subsidiary activity including GILTI, FDII, foreign tax credits and foreign earnings and profits
- State conformity analysis
- Sec. 199A analysis
- Interest deduction limitations
- Transportation fringe benefits

Bright Spots

Tax Law Change

- 199A Deduction
- 100% Bonus Depreciation
- Transition Tax and 100% Dividends Received Deduction

Reflections

- Significant benefit to small business owners and investors as was not tied to material participation
- Ability to expense capital expenditures but flexibility to opt-out if it better serves your tax circumstances
- Should promote greater ease of cash repatriation

Research and Experimental Expenditures

Tax Law Change

- Sec. 174 research and experimental expenditures will be required to be capitalized including software development costs for tax years beginning after December 31, 2021
- 5-year amortization if activity is conducted in the U.S.; 15-year amortization for activity conducted outside the U.S.

Reflections

- Delayed applicability provision which has not received a lot of press time yet
- Will impact virtually every business in some way, at a minimum, needing to demonstrate they do not have any Sec. 174 expenses which might be subject to capitalization
- Most taxpayers have not historically done much around this because they were eligible to deduct these costs immediately so there was no reason to differentiate
- "Includes all such costs incident to the development or improvement of a product"

INTERNATIONAL TAX ISSUES

Section 965 Transition "Toll" Tax

Tax Law Change

- Required the Dec 31, 2017 inclusion by shareholders of specified foreign corporations of their pro-rata share of "deferred foreign income" ("DFI")
- DFI was defined as earnings accumulated back to 1986
- DFI was taxed at a 15.5% rate to the extent it was attributable to the foreign corporation's aggregate cash position and at an 8% rate otherwise.
- An election was available to pay the tax over an 8 year period interest-free
- Deferral for S Corps

Reflections

- Not Old and Cold
- Certain Triggering Events can accelerate payments that would have otherwise been deferred interest-free over 8 years.
- Complex rules for different categories of Previously Taxed Income that can be repatriated free of federal tax (but consider foreign withholding tax and state income tax).
- Expect this to be an area of focus in due diligence exercises.

Global Intangible Low-Tax Income (GILTI)

Tax Law Change

- New IRC Sec. 951A taxes GILTI in a manner similar to Subpart F, i.e., whether or not the income is distributed.
- GILTI = Net tested income over its "net deemed tangible income return."
- "Consolidate" the Controlled Foreign Subsidiaries (CFCs) to determine tested income and tested loss.
- Net deemed tangible income return equals 10% of the excess of the profitable CFCs' depreciable tangible assets.
- IRC Sec. 250 allows corporate taxpayers a deduction of 50% of GILTI (reduced to 37.5% for years after 2025) and a Foreign Tax Credit (FTC) equal to 80% of foreign taxes incurred.
- GILTI has its own separate FTC basket and there is no carryover of any excess FTC – use it or lose it.

Global Intangible Low-Tax Income (GILTI)

Reflections

- Arguably the provision within the TCJA with the biggest impact on multinational taxpayers – in effect a global minimum tax of 10.5% for corporations.
- Much worse for individuals and flow-through entities – no 50% deduction and no FTC (absent partial relief via an election to be taxed as a corporation).
- Requires calculation of each CFC's income or loss as if it were a US corporation; pre-TCJA, Earnings & Profits (E&P) were often not tracked in practice until determined to be meaningful.
- For taxpayers with US interest expense, GILTI can trigger a cash liability to the IRS even if the foreign tax incurred exceeds 13.125%.
- For taxpayers with US NOLs, GILTI both accelerates utilization of the NOL (no 50% deduction) and prevents potential future use of excess FTCs.

Foreign Derived Intangible Income (FDII)

Tax Law Change

- Provides corporations a reduced rate of tax on qualifying income: 13.125% though 2025, then 16.4%
- FDII is income earned from export transactions, broadly defined: includes services and intangibles, not just product sales, and includes related parties, not just third parties
- Similar to GILTI, it applies to the excess of qualifying revenue less allocable expenses, over 10% of tangible property used in production of the income.
- Limited to profitable corporations – FDII cannot reduce taxable income below zero.

Reflections

- Determining qualified export transactions – especially for complex supply chains where components cross borders to result in a final product.
- Favorable development: ability to claim FDII benefit on branch transactions, such as sales to foreign subsidiary for which a check-the-box election has been made to treat the subsidiary as a disregarded entity for US tax purposes.
- Allocation of expenses is based on facts and circumstances (getting granular can be beneficial), but there are special rules regarding interest, R&D and depreciation expenses.
- Shelf life query: is FDII an illegal export subsidy?

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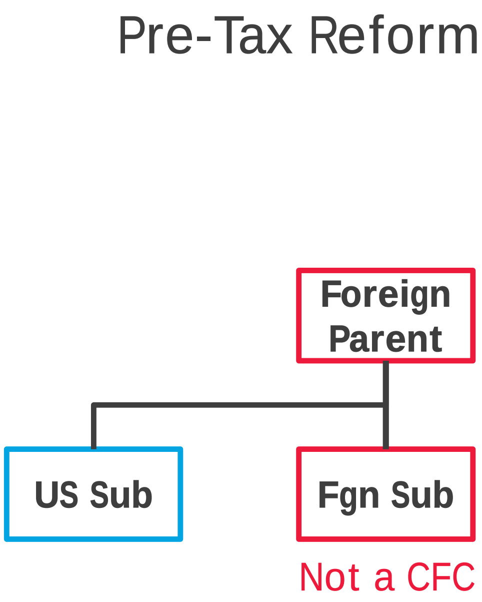
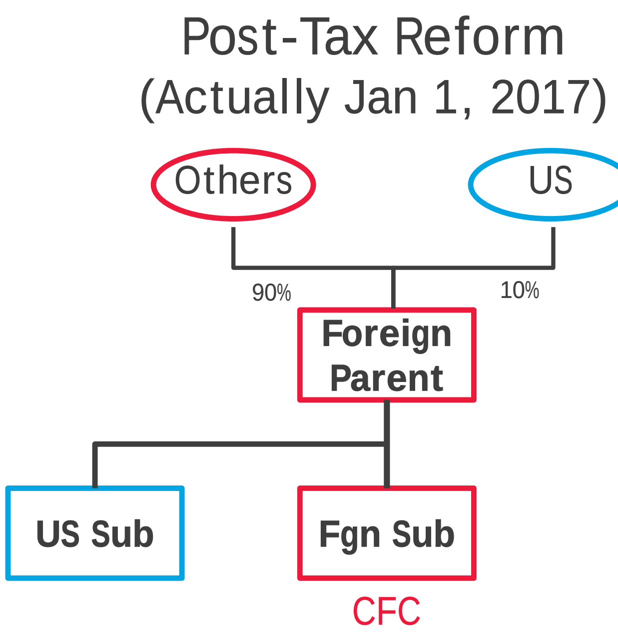
Unexpected CFCs: Repeal of Sec 958(b)(4)





PROPOSED ASUS

ASC 740 SIMPLIFICATION

ASC 740 Simplification

- At its April 10th Board meeting the FASB decided to add to its agenda a project regarding simplifications to accounting for income taxes
- Project is part of the Board’s Simplification Initiative
- The FASB had noted that accounting for income taxes has been among the top areas of restatement over the last several years (13-15 % of all restatements)
- Based on feedback from accounting firms as well as suggestions from preparers and practitioners the Board identified certain requirements that had less relevance given tax reform as well as other requirements which were complex and prone to errors

ASC 740 Simplification (cont'd)

The Board decided to remove the following exceptions in Topic 740, Income Taxes:

- Exception to the incremental approach for intraperiod tax allocation when there is a loss from continuing operations and income or a gain from other items (for example, discontinued operations or other comprehensive income)
- Exception to the requirement to recognize a deferred tax liability for equity method investments when a foreign subsidiary becomes an equity method investment
- Exception to the ability not to recognize a deferred tax liability for a foreign subsidiary when a foreign equity method investment becomes a subsidiary (therefore, an entity would have the ability to assert indefinite reinvestment for the entire basis difference of a subsidiary)
- Exception to the general methodology for calculating income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year.

ASC 740 Simplification (cont'd)

The board also decided the following:

- An entity should recognize a franchise tax that is partially based on income in accordance with Topic 740 and account for any incremental amount as a non-income-based tax.
- An entity should evaluate when a step up in the tax basis of goodwill should be considered part of the initial recognition of book goodwill and when it should be considered a separate transaction.
- An entity should be permitted to forgo the allocation of consolidated current and deferred tax expense to legal entities that are not subject to tax in their separate financial statements.
- An entity should reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date.

ASC 740 Simplification (cont'd)

- The Board also decided to make Codification improvements for income taxes related to employee stock ownership plans and investments in qualified affordable housing projects accounted for using the equity method.
- The Board decided to exclude from the scope of the project an issue involving the accounting for nondeductible goodwill by private companies.

ASC 740 Simplification (cont'd)

The Board affirmed its initial decisions at a meeting on September 4, 2019. In addition, the Board decided that an entity should apply the amendments as follows:

- Either retrospectively or modified retrospective for franchise taxes that are partially based on income (changed from initial retrospective recommendation)
- Retrospectively for the election to forgo the allocation of consolidated taxes to legal entities that are not subject to tax in their separate financial statements
- Using a modified retrospective approach for ownership changes to a foreign equity method investment or subsidiary
- Prospectively for all other amendments to Topic 740.

DISCLOSURE FRAMEWORK

Disclosure Framework

On, March 25th, the FASB issued a proposed Accounting Standard Update (ASU), Disclosure Framework-Changes to the Disclosure Requirements for Income Taxes:

- This proposed ASU is a revision to an exposure draft which was issued on July 26,2016
- The amendments in the ASU will apply to all entities that are subject to income taxes
- Certain of the disclosures would only be applicable to public business entities as that term is defined in the Master Glossary of the Codification
- Comments were received on May 31,2019

Disclosure Framework (cont'd)

As proposed all entities would need to disclose:

- Income (or loss) from continuing operations before income tax expense (or benefit) and before intra-entity eliminations disaggregated between domestic and foreign
- Income tax expense (or benefit) from continuing operations disaggregated between federal, state, and foreign
- Income taxes paid disaggregated between federal, state, and foreign.

Disclosure Framework (cont'd)

The following disclosures would be required for PBEs only:

- The line items in the statement of financial position in which the unrecognized tax benefits are presented and the related amounts of such unrecognized tax benefits
- The amount and explanation of the valuation allowance recognized and/or released during the reporting period –requires an explanation of what increases were and what decreases were and not merely a statement regarding that there was a net change-SEC Regulation S-X 210.12-09, Valuation and Qualifying Accounts requires registrants to provide a schedule (basically a rollforward) on valuation reserves if that information is not disclosed elsewhere in the financial statements.
- The total amount of unrecognized tax benefits that offsets the deferred tax assets for carryforwards.

Disclosure Framework (cont'd)

The proposed ASU would:

- Modify the existing rate reconciliation requirement for PBEs to be consistent with U.S. Securities and Exchange Commission (SEC) Regulation S-X 210.4-08(h), Rules of General Application—General Notes to Financial Statements: Income Tax Expense.
- That regulation requires separate disclosure for any reconciling item that amounts to more than 5 percent of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate.
- The reconciliation may be presented in percentages or in reporting currency amounts.
- The proposed amendments would further modify the requirement to explain the change in an amount or a percentage of a reconciling item from year to year.
- Do percentages make sense?—sensitive to variations in pre tax income
- An entity other than a public business entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

Disclosure Framework (cont'd)

The amendments in this proposed Update would reduce diversity in practice by explicitly requiring a PBE to disclose:

- The amounts of federal, state, and foreign carryforwards (tax effected before any valuation allowance) by time period of expiration for each of the first five years after the reporting date, a total for any remaining years, and a total for carryforwards that do not expire.
- The valuation allowance associated with the total tax-effected amounts of federal, state, and foreign carryforwards.
- The total amount of unrecognized tax benefits that offsets the deferred tax asset attributable to carryforwards in accordance with paragraph 740-10-45-10A.
- An entity other than a public business entity would be required to disclose the total amounts of federal, state, and foreign credit carryforwards and the total amounts of other federal, state, and foreign carryforwards (not tax effected), separately for those carryforwards that do not expire and those that do expire, along with their expiration dates (or a range of expiration dates).

Disclosure Framework (cont'd)

The proposed amendments in the ASU would:

- Eliminate the requirement for all entities to (1) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made
- Remove the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures.
- Clarify that the disclosure of income taxes paid during the period under Topic 230, Statement of Cash Flows, is required for interim periods.
- Clarify that income taxes on foreign earnings that are imposed by the jurisdiction of domicile shall be included in the amount for that jurisdiction of domicile (currently there is diversity in practice—relates to withholding taxes).
- Replace the term Public Entity with term Public Business Entity throughout the Topic 740 in accordance with ASU 2013-12, Definition of a Public Business Entity.

Disclosure Framework (cont'd)

The amendments in this proposed Update would be applied prospectively. The effective date and whether early adoption of the proposed amendments should be permitted will be determined after the Board considers stakeholder feedback on the proposed amendments.

SIGNIFICANT PRACTICE ISSUES

Temporary Differences Acquired Other Than In A Business

Combination ASU 2017-01 & ASC 740

ASU 2017 -01 Clarifying the Definition of a Business, Issued in January 2017

- Under the new model fewer sets (integrated set of activities and assets) will result in business combination accounting
- Possibility that more transactions will be accounted for using simultaneous equation method (Biotech/Pharma)
- ASU 2017-01 is effective for public business entities for fiscal years beginning after December 15, 2017 (annual and interim periods). Other business effective for years beginning after December 15, 2018 and interim periods beginning after December 15, 2019

ASU 2017-01 & ASC 740

Example

Assume that an entity pays $1,000,000 for the stock of an entity in a nontaxable acquisition (that is, carryover basis for tax purposes). The acquired entity's sole asset is a Federal Communications Commission (FCC) license that has a tax basis of zero. Since the acquisition of the entity is in substance the acquisition of an FCC license, no goodwill is recognized. A deferred tax liability would need to be recorded for the temporary difference (in this example, the entire $1,000,000 plus the tax-on-tax effect from increasing the carrying amount of the FCC license acquired) related to the FCC license. The combined Federal and state tax rate is 25 percent.

ASC 740 requires that the amounts assigned to the FCC license and the related deferred tax liability should be determined using the simultaneous equation method as follows:

- Tax Rate / (1 minus Tax Rate) * Initial temporary difference

ASU 2017-01 & ASC 740

Example (cont'd)

1) Tax Rate / (1 minus Tax Rate) * Initial temporary difference
2) 25% / (1 – 25%) * 1,000,000
3) 25%/75% = 33.3333% * 1,000,000
4) Deferred Tax Liability = $333,333

Accordingly, the entity would record the following journal entry:

FCC License	1,333,333	
DTL		333,333
Cash		1,000,000

- It is important to note that there is NO goodwill created from this entry. Rather, the US GAAP value of the asset acquired is adjusted by the corresponding adjustment to deferred taxes

ASU 2017-01 & ASC 740 (cont'd)

Example

In January 2018, ABC Biotech Co. ("ABC" or "Company") entered into a Stock Purchase Agreement and completed its acquisition of XYZ Biotech, Inc. ("XYZ"). After the acquisition, XYZ remains and operates as a wholly-owned subsidiary of ABC where it will file as part of ABC's consolidated US tax return. The Company assessed the acquisition under ASU 2017-01 and determined that the assets acquired did not meet the definition of a business and that the transaction would be accounted for as an asset acquisition. ABC is a calendar-year public business entity.

The total purchase price was $3M and was allocated entirely to in-process research and development (IPR&D). The IPR&D assets acquired from XYZ are at an early stage of development and are considered to have no alternative future uses. As such, determining the future economic benefit of the acquired assets at the date of acquisition is highly uncertain. In accordance with ASC 730 (Research and Development), the IPR&D is charged to expense at the acquisition date. In addition, at the time of the acquisition and at the end of the year, ABC was in a full valuation allowance position.

What entry or entries are required as a result of this transaction? Assume a 21% tax rate.

ASU 2017-01 & ASC 740

Example (cont'd)

Entry # 1 – Record initial purchase

DR: Intangible Asset	3,000,000	
CR: Cash		3,000,000

Entry #2 – Record deferred tax liability on Book/Tax basis difference

DR: Intangible Asset	797,468	
CR: Deferred tax liability		797,438

($3,000,000 * .21 / .79 = 797,468)

Entry #3 – Record VA release of ABC due to recording a DTL on the acquisition of XYZ (ASC 805-740-30-3)

DR: Valuation Allowance – ABC	797,468	
CR: Deferred Tax Benefit – ABC		797,438

Entry #4 – Write-off IPR&D in accordance with ASC 730 – Research and Development

DR: IPR&D Expense	3,797,468	
CR: Intangible Asset		3,797,438
DR: Deferred tax liability	797,468	
CR: Deferred Tax Benefit – P&L		797,468
DR: Deferred Tax Expense – P&L	797,468	
CR: Valuation Allowance		797,468

After reversal of the DTL, ABC and subsidiary still need to be in a full valuation allowance position. The overall tax impact to the P&L from these four entries is a benefit of $797K. Entry #4 has a net zero tax impact so Entry #3 is the only entry impacting consolidated tax expense.

ASU 2017-01 & ASC 740

Example –Alternative View (cont’d)

An alternative application of the previous accounting which is published in one firm's guide and we have seen another firm take the position is to treat the immediate write off of the IPR&D as a permanent difference i.e. no tax effect. The theory behind the accounting is that the write off of the allocation of purchase price to IPR&D comes before the identification of deferred taxes because GAAP dose not allow the acquirer to recognize an asset. The approach is the same as that in EITF 96-7 except the EITF was issued with respect to the immediate write-off in a business combination.

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ASU 2017-01 & ASC 740

Key Take-aways

- It is critical to understand how a company will be accounting for a transaction. The decision is not guided by tax
- Complexities arise in situations such as:
  - The acquisition of future tax benefits (e.g. NOLs) by acquiring the stock of an entity with minimal assets or activity
  - The acquisition of financial assets as they are generally recorded at fair value. Potential deferred tax assets may result in the recognition of a deferred credit
- IFRS does not follow this deferred tax accounting. Rather, IAS 12 has what is known as the “Initial Recognition Exemption” (IAS 12, para. 15(b))

Pass-Through Subsidiaries

- Investments in partnerships can be accounted for under the consolidated, equity or cost method of accounting
- Partnerships and other entities treated as partnerships (i.e. LLC's/S-Corps) are not taxable entities. Rather, the tax consequences of transactions within the partnership flow through to the partners
  - Exceptions include certain state taxes/NYC UBT and foreign taxes
- The partners then report their proportionate share of the partnership's income or loss in their individual capacities
- Under ASC 740, a partner's future tax consequences of recovering the financial basis of its investment in the partnership are recognized as deferred tax assets or liabilities
- Errors and restatements are surfacing in this area due to companies not reconciling inside to outside basis ,carefully reviewing special allocations e.g. 704(c) and improper allocations per 704(b).
- Partnership taxation is complex. Make sure that the partnership group is involved in the analysis.

Pass-Through Subsidiaries (Cont'd)

- Deferred taxes are recognized on the outside basis difference of investments in pass-through subsidiaries – the difference between the financial statement carrying value and the tax basis of the investment in the partnership
  - Will often be equal to the net basis differences in the assets and liabilities of the partnership (watch 704(c) allocations)
  - Watch for exceptions related to goodwill and/or investments in foreign subsidiaries – discussed on the next two slides
- The exceptions to recognizing deferred taxes in ASC 740 (both taxable and deductible) do not apply to the outside basis of the investment in pass-through subsidiaries
  - Consideration is necessary for recoverability should there be a deductible temporary difference
  - There may be circumstances where a temporary difference only reverses upon a future sale or liquidation. As a result, the exception under ASC 740-30-25-9 could be considered – <u>Discuss with the audit firm involved as firms have different views on this</u>
  - Ordinary versus capital?
- The exceptions in ASC 740-10-25-3 (general exceptions) and 740-30-25-9 (deductible outside basis difference) generally **<u>will</u> apply to a pass-through subsidiary's investment in <u>another</u> entity**

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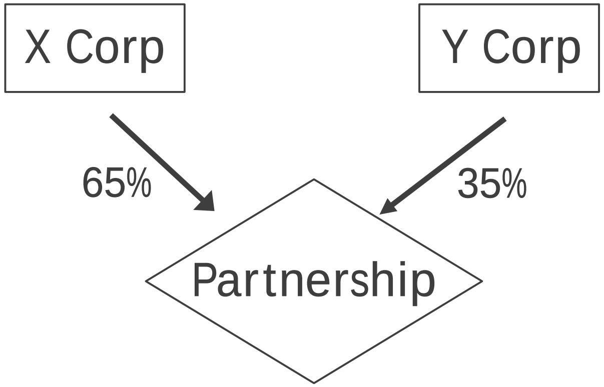
Pass-Through Subsidiaries (Cont'd)

Example 1

Example of outside basis difference issues



Facts:

- X Corp & Y Corp contribute cash of $6.5M and $3.5M respectively to the venture
- X will consolidate the partnership for financial reporting purposes
- The partnership purchases assets of an operating business for $10M

- What issues need to be addressed with respect to this structure from an initial formation perspective and on a continuing basis?

Unrealized Subpart F Income

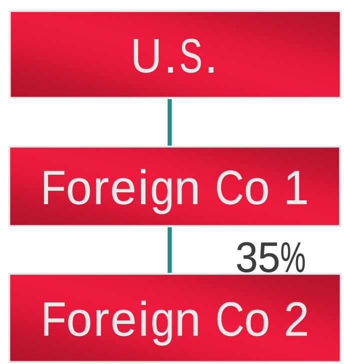
Certain types of foreign income generate Subpart F income e.g. foreign base company sales, services and personal holding company income. Whether the income is realized or unrealized (will generate subpart F income) deferred tax should be recorded due to a foreign temporary difference that will generate Subpart F income.

Examples of unrealized Subpart F income include but are not limited to:

- Unrealized gains on available for sale securities
- Equity method investments
- Cost method investments (could be remeasured in P&L)
- Installment sale(if underlying sale will be FBCSI)

Example of Unrealized Subpart F Income

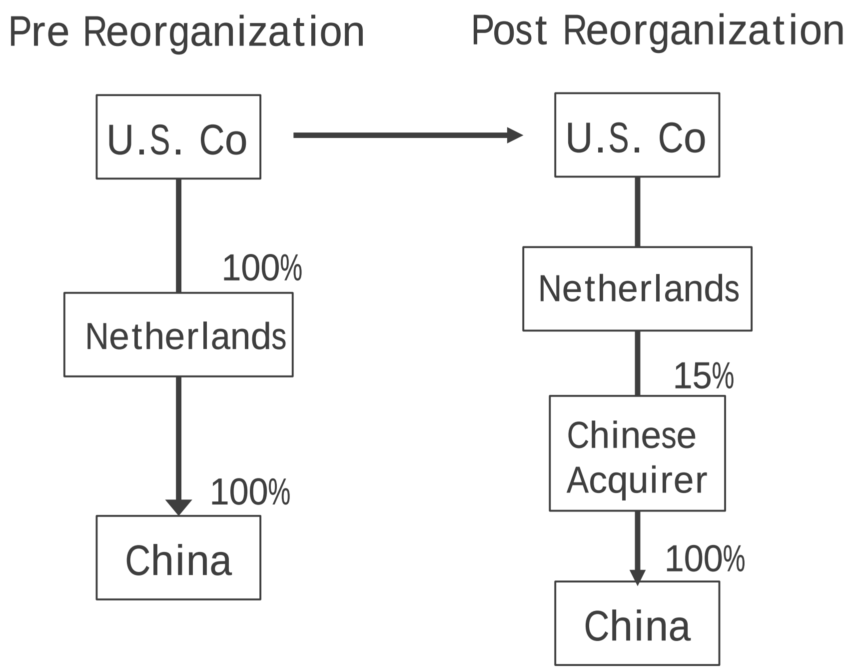
- The 35% investment in Foreign Co 2 is accounted for under the equity method. The law in the country of Foreign Co 1 would exempt the gain on the sale of Foreign Co 2 from tax. Foreign Co.2 has been owned by Foreign Co 1 since 2016 and has always been profitable.



Issues

1. FC2 would be eligible for 100% DRD since a specified foreign corporation (Code Sec 245A (also see Code Sec. 951(b)).
2. FC2 is not a CFC so Code Sec. 1248 would not be applicable.
3. U.S. group would need to assess how in the future the outside basis difference would be recovered at the date of the transition tax inclusion and based on future earnings. Could it assert that it would be recovered by dividend distributions subject to the 100% DRD? Generally, since FC1 does not control FC2 it would be difficult to argue that the basis would be recovered through dividend distributions and thus would need to provide on the outside basis difference (sale v. distribution analysis).

Example of Unrealized Subpart F Income



Facts:

- U.S. Co owns 100% of Netherlands Co and 100% of Chinese Co.
- Netherlands transfers 100% of its interest in Chinese Co to Chinese acquirer solely in exchange for voting stock worth $7B
- For U.S. tax purposes treated as a B reorganization
- Tax free treatment for Dutch purposes
- U.S. group recognizes a $6.5B gain for financial statement purposes
- Assume book and tax basis of Netherlands in China is equal at the date of sale

Analysis: Based on these facts U.S. Co. would recognize income tax expense of $1,365B and a related DTL. Due to the fact that the Chinese acquirer is not a subsidiary it cannot be asserted that the outside basis difference is "Permanent in duration" (ASC 740-30-25-18a).

ASC 740 REFRESHER ON KEY ISSUES

Sec. 163(j) Limitation on Deduction for Interest

- In practice could be one of the most if not the most complicated issue from an ASC 740 and tax return perspective
- Proposed regulations were issued in December,2018 (over 450 pages of reading enjoyment), rules are complicated
- Certain view for loss companies that will now become profitable due to 163(j) limit that a valuation allowance could be released with respect to NOLs based on the projected income in spite of the fact that the entity could be creating additional 163(j) limitation which will need to be reserved for
- In addition, we have seen profitable companies that are leveraged now required to set up a VA on the 163(j) limited interest since unable to project utilization (requires extensive analysis and modeling)
- 30% limitation needs to be considered in ASC 740 analysis including relying solely on reversing taxable temporary differences (unlimited carryover period allows for offset versus a naked credit subject to the 30% limitation)

168(k) Bonus Expensing

Tax Law Change

- The bill allows for 100% expensing for qualified assets placed in service after September 27, 2017 and before January 1, 2023.
- Expensing amounts are phased down between 2023 through 2026.
- Expands the definition of qualified property to include used property provided the taxpayer had not used the property and it is not acquired from a related party.
- Final regulations issued in September 2019.
- Need to ensure there is a proper election out of bonus depreciation when appropriate
- Can create issues with various limitations (e.g. Code Sec 250 deductions for GILTI & FDII)

ASC 740 Issues

- Creates a larger temporary difference related to depreciation.
- Larger taxable temporary differences could give rise to a future source of income which may impact the ability to realize deferred tax assets in the future.
- Will states adopt or decouple – If decouple, will need a separate deferred for state depreciation.
- State issues and separate state deferreds for depreciation

162(m) Excessive Employee Remuneration

Tax Law Change

- The Act eliminates the exceptions for commissions and performance based compensation thus classifying all compensation greater than $1M as subject to limitation.
- Expanded the definition of "covered employee" to include the CFO.
- Covered employee now means the CEO, CFO, plus the three highest compensated officers for the year.
- Adds a rule that once an employee is a "covered employee," will always be a "covered employee".
- Provisions are effective for tax years beginning after December 31, 2017.
- Awards that are subject to a written binding contract as of November 2, 2017 are grandfathered.

ASC 740 Issues

- Requires that any disallowed compensation due to IRC Sec. 162(m) provisions not be recognized for financial statement purposes.
- The revised 162(m) rules would now require that all compensation in excess of $1M be disallowed.
- Companies should determine what method they are using for disallowed compensation for reporting purposes:
  - Cash compensation first
  - Equity compensation first
  - Pro Rata Method
- Be cognizant of modifications to written binding agreements as of November 2, 2017 which could make the award no longer exempt from disallowance.

162(m) Excessive Employee Remuneration(cont'd)

Issues encountered include:

- Monitoring grants to recently hired covered employees
- Reviewing grants that have been grandfathered for modification
- Scheduling the reversal of year end deferred tax asset to determine if when it vests or is exercised that it will not be limited(issue always existed but more focus with tax reform(ASC 740 concern whether you elect cash first method, stock compensation first or pro rata method in assessing the realizability of the DTA))

Accounting For Outside Bases Differences

Overview of U.S. Taxation of Foreign Earnings

- How are the earnings of a foreign company taxed to its US shareholders after tax reform?
- General Rule was – a U.S. taxpayer was not subject to taxation on the earnings of a foreign subsidiary until the earnings were distributed to the taxpayer with certain exceptions e.g. subpart F income
- Post Tax Reform U.S. Outside basis difference concerns – income recognition
  - Transition tax (Code Sec. 965) – One time tax on untaxed foreign earnings
    - Complicated basis adjustment rules as outlined in final regulations issued in January 2019.
  - Subpart F inclusions – virtually the same as under pre-tax reform and takes precedence over any other inclusions; tax basis adjusted for inclusion.
  - GILTI inclusions (to be discussed further) – final and proposed regulations issued in June 2019 but did not address basis rules as had been done in the proposed regulations (reserved for future regulation)

Accounting For Outside Bases Differences

Overview Of U.S. Taxation Of Foreign Earnings

- Code Sec. 245A – allows for the distribution on a tax free basis of residual income after the previous mandatory inclusions, does not create a basis adjustment for tax purposes but this portion of the outside basis difference (book vs tax) can be recovered tax free.
- Code Sec 956 (Investment in U.S. Property)
  - ➢ Proposed regulations issued in November 2018 and final regulations in May,2019 all but eliminates the impact of Code Sec 956 – regulations limit the application of 956 to instances where an amount would be taxable after the application of Code Sec. 245A
    - ❑ Fails holding period requirement in Code Sec. 245A
    - ❑ Hybrid dividend application in Code Sec 245A
  - ➢ Still need controls in place to monitor this if either of above issues are applicable
    - ❑ Need to know client/company position
- Need to know and track book vs tax basis

Global Intangible Low-Tax Income

Tax Law Change

- IRC Sec. 951A has been added to the law which taxes GILTI in a manner similar to Subpart F. Applies whether the income is distributed or not (specifically stated that it is not Subpart F income).
- GILTI = Net tested income over its "net deemed tangible income return."
- "Net tested income"=Tested income over tested loss. For this purpose tested income generally includes gross income of the CFC other than:
    - ECI;
    - Subpart F income;
    - Amounts excluded from Subpart F (954(b)(4));
    - Dividends received from a related person (954(d)(3)); and
    - Foreign oil & gas extraction income (907(c)(1)).
- Tested loss means the excess (if any) of deductions (including taxes) properly allocable to the corporation's gross income, determined without regard to the tested income exceptions over the amount of such gross income.
- Net deemed tangible income return equals 10% of the excess of the CFC's qualified business asset investment ("QBAI") over interest expense.

ASC 740 Issues

- For GILTI to have an ASC 740 consequence, a company must conclude that it will be a GILTI taxpayer.
- As discussed, the rules are complex and will require systems to be developed to track the necessary data to conclude whether the tax applies or does not apply.
- Needs to be considered for the 1st Q of 2018 (calendar year) and 2019 (fiscal year) companies in developing effective tax rate.
- Query whether companies should recognize deferred taxes for any outside basis differences that are expected to reverse as GILTI.
    - Unrealized GILTI analogous to unrealized Subpart F income.
    - At the January 18, 2018 meeting, the FASB staff concluded that companies could make a policy election to recognize or not recognize deferred taxes on underlying temporary differences that would reverse as GILTI.

Global Intangible Low-Tax Income - continued

Tax Law Change

- QBAI is determined as the average of the aggregate of its adjusted bases as of the close of each quarter in specified property. Adjusted basis is determined using the alternative depreciation system under IRC Sec. 168(g).
- New IRC Sec. 250 would allow a deduction of 50% of GILTI for the tax years beginning after December 31, 2017 and before January 1, 2026 reduced to 37.5% for years thereafter.
- Allows a deemed paid credit equal to 80% of GILTI inclusion amount over aggregate tested income multiplied by the aggregate tested foreign income taxes paid or accrued by all CFCs (GILTI is in its own separate tax credit basket and there is no carryover allowed).
- Effective for tax years beginning after December 31, 2017.

ASC 740 Issues

- Exception for high tax “kick out” is based upon effective rate – e.g., foreign taxes paid/accrued over E&P earnings and not based upon comparison of US vs. foreign statutory rates.

GILTI (cont’d)

- For GILTI to have an ASC 740 consequence, a company must conclude that it will be a GILTI taxpayer.
- As discussed, the rules are complex and will require systems to be developed to track the necessary data to conclude whether the tax applies or does not apply.
- Needs to be considered /projected for quarterly reporting of in developing effective tax rate.
- Query whether companies should recognize deferred taxes for any outside basis differences that are expected to reverse as GILTI.
- Final regulations issues in June did not address basis issues and reserved this matter for a future regulation project.

GILTI (cont'd)

- Temporary differences impacting GILTI is analogous to unrealized Subpart F income.
- At the January 18, 2018 meeting, the FASB staff concluded that companies could make a policy election to recognize or not recognize US deferred taxes on foreign subsidiary temporary differences that would reverse as GILTI.
- Most companies do not provide US deferred taxes for temporary differences impacting GILTI
- Exception for high tax "kick out" is based upon effective rate – e.g., foreign taxes paid/accrued over E&P earnings and not based upon comparison of US vs. foreign statutory rates (in June proposed regulations were issued which would allow all high tax earnings and not just subpart F income to be excluded).

GILTI (cont'd)

Valuation allowance considerations

- GILTI earnings may provide a source of income for realization of US DTA's which have a valuation allowance
- Reduction of some or all of V/A may be appropriate
- Two policy elections available in determining v/a reduction:
- Tax law ordering- if GILTI inclusions allow for NOL's to be utilized, project out NOL utilization and reduce valuation allowance
- With and without method- reduce V/A only if there is an incremental cash tax benefit due to NOL's.
- Compute US tax on GILTI earnings with and without the NOL's. If there is less tax with the NOL's , reduce V/A by such amount. Need to consider FTC's and section 250 deduction in this comparison.

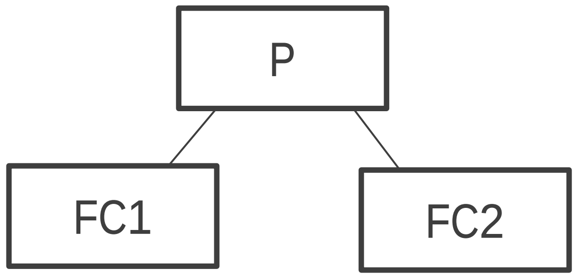
Accounting For Outside Bases Differences

Example GILTI Tested Loss

P's BOY in FCI = 100
P's tax basis in FC1 = 100

P's BOY in FC2 = 0
P's BOY tax basis in FC2 = 0

50 tested loss
0 Book loss



100 tested income
100 Book income

Under the proposed regulations the basis of P's investment in FC1 was written down at the time of the disposition of FC1 by the utilized tested loss of $50.This rule was not finalized. Under the proposed rules , a suspense account was set up which would have been adjusted when the CFC's future tested income is offset by a tested loss of another CFC or triggered when the stock of the Subsidiary was sold. The final regulations reserved the basis adjustment rules and they will be addressed in a future regulation project.

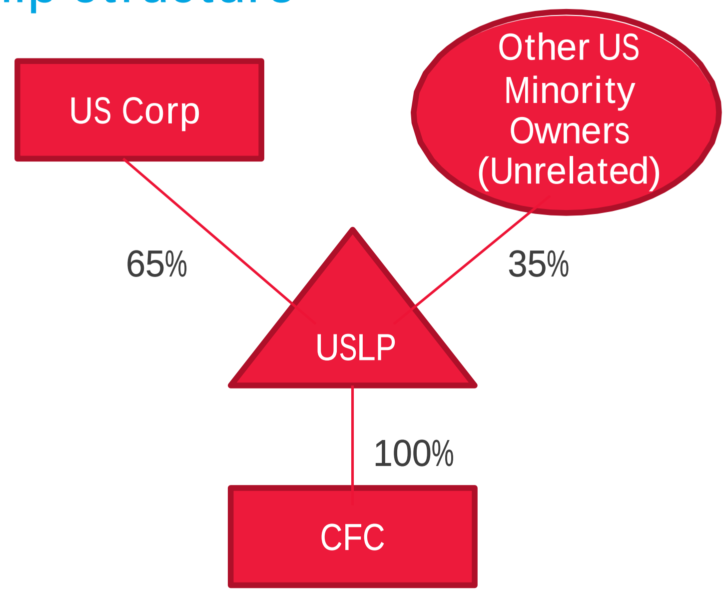
Question: Should P record a deferred tax liability for the amount of the tested loss that was absorbed by P?

Accounting For Outside Bases Differences

Example GILTI Basis Adjustment In Partnership Structure

Year 1

- Assume beginning book and tax basis is zero
- Assume no foreign taxes paid and no FTCs available
- CFC has tested income of $1m
- QBAI of $500,000
- US Corp and USLP do not own any other CFCs
- Assume 35% is held by non-US shareholder partners
- Assume no interest expense
- Assume zero beginning basis and no other activity
- Pursuant to GILTI proposed regulations, US Corp is a US shareholder partner in regards to CFC and is required to separately compute its GILTI inclusion with regard to CFC
- USLP does not pass through a separately computed/allocated GILTI amount to US Corp – USLP is treated as a foreign partnership for purposes of computing US Corp's GILTI inclusion
- US Corp computes a gross GILTI inclusion attributable to CFC of $617,500 and a Section 250 deduction of ($308,750)
- US Corp's tax basis in USLP is increased by $617,500
- However, as USLP is treated as a foreign partnership with regards to US Corp's GILTI inclusion, absent further guidance it appears there is not a basis increase in CFC shares held by USLP



- Basis differences
- US Corp basis in USLP
  - Book - $650,000
  - Tax - $617,500
- USLP basis in CFC
  - Book - $1,000,000
  - Tax - $332,500 (only includes 35% of $1m less 10% of QBAI amount)

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