SUMMARY

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015 (the “Act”) and the Fiscal Year 2016 Budget (the “omnibus”). The Act contains provisions that retroactively restore and extend a large number of expired tax provisions, commonly known as “tax extenders”. These extenders, which had expired prior to 2015, have been retroactively restored effective January 1, 2015. While some provisions have been extended permanently, others have been extended only temporarily. The omnibus also contains several important income and excise tax provisions (e.g., certain excise taxes required under the Affordable Care Act have been delayed or temporarily suspended).

DETAILS

The Act restored and extended the following key provisions (non-inclusive):

- The research credit under Code Section 41 for qualified research and development (“R&D credit”) is permanently extended;
- The election under Code Section 179 to expense the cost of property placed in business is permanently extended with an expensing limit of $500,000 and an overall investment limit of $2,000,000 before phase out;
- A 15-year straight-line depreciation under Code Section 168 is permanently extended for certain qualified leasehold improvements, restaurant property and retail improvements;
- The exception under Code Section 953 from current U.S. tax of active financing foreign income is permanently extended (i.e., Subpart F exception for active financing income).
The exception under Code Section 954 from current U.S. tax of foreign intercompany income including dividends, royalties, interest, and rents is temporarily extended through 2019 (i.e., the Subpart F “look-through” exception); and

The additional first-year depreciation (i.e., bonus depreciation) under Code Section 168(k) is temporarily extended through 2019 under a phased-down schedule with a 50 percent bonus depreciation limit in years through 2017, 40 percent in 2018, and 30 percent in 2019.

The Act has also created two new types of R&D credits: one for eligible small businesses and one for qualified small businesses. Eligible small businesses will be allowed to utilize the research credit even if they are subject to the Alternative Minimum Tax (AMT) and qualified small business will be allowed to utilize, for up to five years, the research credit against the employer portion of payroll tax (i.e., FICA tax) not exceeding $250,000 per year. These new research credits are available for credits generated in tax years beginning after 2015.

This Alert will highlight some of the Act’s more significant income tax accounting implications accounted for under ASC 740 Income Taxes.

**INCOME TAX ACCOUNTING IMPLICATIONS**

**Recognition Period of the Effects of Law Changes**
Current and deferred taxes are determined based on provisions of tax laws that are presently enacted as of the balance sheet date. The effects of future changes in tax laws may not be considered until they are enacted. Therefore, the effects of changes in tax laws, including retroactive changes, are accounted for in the period in which the legislation is enacted using temporary differences and currently taxable income existing as of the enactment date. The Act is considered enacted on the date the president signed it into law, which is in the fourth quarter 2015 for calendar year reporting entities and in the period which includes the enactment date (i.e., December 18, 2015) for reporting entities with other fiscal years.

Upon reinstatement of expired tax provisions, current and deferred taxes are re-measured for financial reporting purposes in the reporting period that includes the enactment, and the cumulative effect, including any effect on valuation allowance, is included as a tax expense or benefit from continuing operations in the period of enactment.

Therefore, calendar-year public entities will recognize an adjustment in the fourth quarter results of their 2015 fiscal year. Public entities with other fiscal years will recognize an adjustment in interim periods that include the enactment date. For example, a public entity with a June 30 fiscal year will adjust the estimate of the annual effective tax rate from continuing operations in the second interim period to reflect the reinstatement of the R&D credit to the beginning of the fiscal year which ends on June 30, 2016. Additionally, it might also recognize a discrete period benefit (i.e., second interim period) to reflect the R&D credit for the first six months in 2015 which can be claimed on the tax return for the fiscal year ending June 30, 2015.

**The Cumulative Adjustment from the PATH Act**
The many provisions of the Act and the omnibus will have varying effects on reporting entities depending on the nature of their business and the significance of certain income tax provisions included therein. Generally, income tax benefits that reduce the effective tax rate include the R&D credit, the two exceptions to Subpart F income inclusion for active financing income and active intercompany income (assuming the reporting entity is reinvesting foreign earnings indefinitely), and several other income tax credits (e.g., energy credits including the production/investment tax credits for wind energy). Certain provisions, such as the election under Code Section 179 to expense the cost of property placed in service and the bonus depreciation election under Code Section 168(k) will impact both current and deferred taxes, but would expect to be tax rate neutral.

**Accounting Treatment for New R&D Credit Rules**
The Act also made two important changes to the R&D credit that would benefit certain small and/or startup businesses effective for tax years beginning in 2016.
The Small Business R&D Credit Offset to AMT and Regular Tax

Eligible small businesses, defined as privately-held businesses having average gross receipts of $50 million or less for the three preceding tax years, may now use their R&D credit to offset their AMT and regular tax liability when they are subject to the AMT.\(^1\) Prior to this change, businesses could only use the R&D credit to offset their regular tax liability, if their regular tax was higher than tentative minimum tax (TMT) (the AMT law is summarized below).

A taxpayer’s annual net income tax liability is the sum of regular income tax liability plus AMT (both regular tax and AMT are determined after any available foreign tax credits). The AMT paid is generally available as an AMT credit carryforward to offset future regular tax liability (AMT is effectively a prepayment of regular tax liability). Therefore, the AMT credit carryforward generally yields a deferred tax asset (DTA).\(^2\) The recognition of a current expense for AMT and a deferred tax benefit for the AMT credit carryforward is tax rate neutral (current expense and deferred benefit offset each other), absent a valuation allowance.

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**THE ALTERNATIVE MINIMUM TAX**

AMT is an alternative method of calculating a taxpayer’s tax liability and is designed to ensure that taxpayers do not avoid tax liability altogether through the use of deductions and credits. A taxpayer is subject to the AMT when the regular tax liability is less than the Tentative Minimum Tax (TMT). For corporations, TMT is 20% of a taxpayer’s Alternative Minimum Taxable Income (AMTI), calculated based upon certain tax preferences and adjustments to regular taxable income or loss (the corporation regular tax is 34% for regular taxable income of $10 million or less and 35% for taxable income exceeding $10 million).

If a taxpayer’s regular income tax liability is greater than TMT, AMT will be zero and the taxpayer will pay the regular income tax liability minus any allowable credits. However, if a taxpayer’s regular tax liability is less than TMT, the taxpayer will pay the sum of AMT plus the regular income tax liability, minus any allowable credits. Note that the TMT is determined after any available foreign tax credits (IRC Section 55(b)(1)(B)).

Generally, most general business credits including the R&D credit cannot be used to offset regular tax liability if the company is subject to AMT. However, certain “specified credits” that fall within the general business credit have a separate limitation, in which the TMT is deemed to be zero, which results in a taxpayer being allowed to utilize these credits to offset both the AMT and the regular tax even when the taxpayer is subject to the AMT.

Prior to the Act, the R&D Credit generated by eligible small businesses (as defined) was not a “specified credit” which means the utilization of R&D credit to offset regular tax was subject to an overall limitation for all general business credits. The Act makes the R&D credit (of an eligible small business) a “specified credit” under IRC section 38(c)(4)(A)(ii)(I), and therefore the R&D credit is now available to offset both AMT and the regular tax, even when the eligible small business is subject to the AMT.

The determination of net income liability is summarized as follows:

- Regular tax is calculated net of any available foreign tax credits.
- TMT is calculated net of any available foreign tax credits (with certain differences in calculation of foreign tax credits than under regular tax).
- AMT is the excess, if any, of TMT over regular tax.
- A single overall limitation for all general business credits is determined and the allowable amount is subtracted from the regular tax (but not below TMT).
- A separate limitation for “specified credits” is determined and the allowable amount is subtracted from the regular tax and the AMT.

The overall limitation on utilizable general business credits is the following:

Excess of Net Income Tax Liability (regular + AMT) over the greater of (1) TMT or (2) 25% of regular tax exceeding $25,000. However, for “specified credits”, the TMT in the limitation is assumed to be zero.

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\(^1\) This was previously only allowed once, temporarily in 2010
\(^2\) ASC 740-10-30-10 and ASC 740-10-30-5(d)
The following example illustrates the accounting, pre- and post-PATH, for the R&D credit, AMT expense and the AMT credit carryforwards for a calendar year reporting entity, assuming no valuation allowance.  

Facts:
Company X, a U.S. reporting entity, has pretax income of $600,000 in the current year and one fixed asset with a cost basis of $1,000,000 which will be depreciated on a 5-year straight line method for book and AMT purposes (annual book depreciation of $200,000). Company X elects to take accelerated (MACRS) depreciation for tax, which would result in additional $300,000 of tax depreciation for illustrative purposes (i.e., regular tax depreciation is $500,000 per year for illustrative purposes). Company X has qualified research activities and expenditures and has calculated an R&D credit for the current year of $90,000. Additionally, it has an R&D credit carryforward of $25,000. Included in pretax income is $100,000 of tax-exempt interest income from specified activity bonds.

The regular taxable income for the current year is $200,000 (pretax income of $600,000 less tax-exempt interest of $100,000 less accelerated tax depreciation adjustment of $300,000). Regular tax is $68,000 (taxable income of $200,000 multiplied by 34% federal rate). For AMT purposes, the accelerated depreciation is replaced with regular depreciation, and the tax-exempt interest is added back, resulting in AMT taxable income of $600,000 and TMT of $120,000 (AMTI of $600,000 times 20% which is the alternative minimum tax rate for corporations). Consequently, the TMT of $120,000 exceeds the regular tax of $68,000 resulting in AMT of $52,000 (the difference between TMT of $120,000 and regular tax of $68,000).

Company X is assumed to be an eligible small business, as defined in the law, for illustration purposes.

No Valuation Allowance Scenario:
Based on all available positive and negative evidence, Company X concludes that the deferred tax assets are more likely than not realizable and a valuation allowance is not required.

The journal entries (JE) below reflect Company X’s income tax accounting:

Debit: Current Tax Expense (Regular) $68,000
Credit: Income Tax Payable (Regular) $68,000
(JE to recognize current regular tax expense)

Debit: Current Tax Expense (AMT) $52,000
Credit: Income Tax Payable (AMT) $52,000
(JE to recognize current AMT tax expense)

Debit: AMT Credit DTA $52,000
Credit: Deferred Tax Expense (AMT) $52,000
(JE to recognize the AMT credit)

Debit: R&D Credit DTA $90,000
Credit: Deferred Tax Expense $90,000
(JE to recognize the R&D credit)

Debit: Deferred Tax Expense $102,000
Credit: Deferred Tax Liability (DTL) $102,000
(JE to recognize deferred tax at 34% for taxable temporary difference of $300,000 due to accelerated tax depreciation)

Note: income tax payable is reduced when a tax payment is made.

As noted above, pre-PATH, Company X would not be able to utilize the R&D credit in the current year due to the overall limitation onutilizable general business credits when TMT is higher than regular tax (i.e., the credit cannot be used in a tax year in which Company X is subject to AMT). This is because the overall limitation is zero as illustrated for this example: Excess of net regular tax of $120,000 (regular tax of $68,000 plus AMT of $52,000) over the greater of (1) TMT of

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3 This example is for illustrative purposes only. Federal tax rate of 34% is used as taxable income is under $10,000,000. It is also assumed no state income tax applies, for simplicity.
$120,000 or (2) $10,750 which is 25% times (regular tax of $68,000 less $25,000). Under this scenario, the R&D credit carryforward would be available to offset future regular tax to the extent that Company X’s regular tax exceeds TMT.

Company X’s net tax expense is $80,000: pretax income of $600,000 less non-taxable interest income of $100,000 (or $500,000 multiplied by 34 percent), which is $170,000 of tax expense before the R&D credit benefit of $90,000 and a net tax expense of $80,000 (current tax expense of $120,000 offset by a deferred tax benefit of $40,000). Its effective tax rate for the year is approximately 13 percent (net tax expense of $80,000 divided by pretax income of $600,000).

The components of deferred taxes as of the end of the current year include a DTA of $52,000 for AMT credit carryforward, a DTA of $115,000 for the R&D credit carryforward ($25,000 from prior periods plus $90,000 from the current year), and a DTL of $102,000 for fixed asset basis difference (resulting in a net DTA of $65,000).

Company X’s Effective Tax Rate Reconciliation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax at 34%</td>
<td>$204,000</td>
</tr>
<tr>
<td>Tax-exempt Interest</td>
<td>($34,000)</td>
</tr>
<tr>
<td>R&amp;D Credit</td>
<td>($90,000)</td>
</tr>
<tr>
<td>Effective Tax</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

As illustrated above, pre-PATH Act, an eligible small business corporation would incur a current cash outlay for both regular tax and AMT. The offset to current tax expense is a deferred tax benefit for an AMT credit and an R&D credit carryforward that can be used in future years, when regular tax exceeds TMT, to offset regular tax (note: regular tax cannot be reduced below TMT). The AMT DTA is evaluated with all other DTAs for valuation allowance requirements.

Starting in 2016, under the PATH Act, Company X is able to use its R&D credits to offset both AMT and regular tax, even when its TMT is higher than regular tax, thereby preserving cash.

In this example, Company X would utilize $25,000 of the R&D credit carryforward and $90,000 of the R&D credit originated in the current year to offset the AMT expense of $52,000 and the regular tax expense of $68,000 up to the limitation amount. For this illustration, the R&D credit carryforward is assumed to have been generated after the Act’s effective date for “specified” R&D credit (i.e., tax years starting in 2016).

The “specified credit” limitation using the numbers above and TMT is deemed to be zero is the following:

Excess of net income tax of $120,000 (regular tax of $68,000 plus AMT of $52,000) over the greater of (1) TMT of zero or (2) $10,750 which is 25% times (regular tax of $68,000 less $25,000). The limitation is therefore $109,250.

Company X is able to offset $109,250 of AMT and regular tax with R&D credits. That is, AMT of $52,000 and the regular tax of $68,000 are offset to $10,750. The R&D credit carryforward is $5,750 (total R&D credit of $115,000 less R&D utilization of $109,250).

It should be noted that Company X is entitled to an AMT credit carryforward of $52,000.

Company X’s total tax expense is still $80,000 with an effective tax rate of approximately 13 percent. Total tax expense consists of a current tax expense of $10,750 and a deferred tax expense of $69,250 arising from four items: a deferred benefit of $5,750 for current year R&D credit, a deferred benefit of $52,000 for AMT credit, a deferred expense of $25,000 for current-year utilization of the prior-year R&D credit carryforward, and a deferred expense of $102,000 for the fixed asset difference. Note, utilizing R&D credits that originate and are utilized in the current year is tax rate neutral, as the benefit from the credit offsets a current tax expense (in this example, $84,250 of current year R&D credit offsets an equivalent amount of current tax expense).

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4 The determination of the allowable credit, which is also illustrated in this example, is not straightforward and requires comparison of total tax liability (regular plus AMT) to a specified formula provided in the tax law and IRS Form 3800.

5 Note: this new credit is effective for R&D credits generated in tax years beginning in 2016 and onward. Therefore, any R&D credit carryforward from pre-2016 years cannot offset AMT and regular tax in any year the taxpayer is subject to the AMT (except for 2010, where the benefit was temporary).

6 As shown in this limitation formula, the full amount of regular tax cannot be offset by R&D credit once regular tax exceeds $25,000.
The following journal entries would be made (note - reporting entities may have different JE systems and this example is only illustrative based on Company X’s journal entries system as presented in this example):

Debit: Current Tax Expense $10,750
Credit: Income Tax Payable $10,750
(JE to recognize current tax expense)

Debit: AMT Credit DTA $52,000
Credit: Deferred Tax Expense (AMT) $52,000
(JE to recognize the AMT credit)

Debit: R&D Credit DTA $5,750
Credit: Deferred Tax Expense $5,750
(JE to recognize current-year R&D credit carryforward)

Debit: Deferred Tax Expense $25,000
Credit: R&D Credit DTA $25,000
(JE to recognize utilization of R&D credit carryforward)

Debit: Deferred Tax Expense $102,000
Credit: Deferred Tax Liability (DTL) $102,000
(JE to recognize deferred tax at 34% for taxable temporary difference of $300,000 due to accelerated tax depreciation)

Valuation Allowance Scenario:
When an entity incurs the AMT while it also maintains a valuation allowance on deferred tax assets, the AMT expense increases the effective tax rate since the AMT credit is offset by a valuation allowance. The change made by the Act may have a favorable impact on the tax expense of eligible small businesses as the R&D credits are available to offset both the AMT and the regular tax, potentially eliminating the AMT expense as shown in the example above. Furthermore, when an eligible small business is expecting to incur AMT due to significant adjustments and preference items, the Act change might accelerate the utilization of R&D credits that would otherwise expire unused.

The Election to Treat R&D Credit as Payroll Tax Credit Available to Offset Payroll Tax
The Act also allows qualified small businesses to elect, pursuant to IRC sections 41(h)(1) and 3111(f)(1), to apply a portion of their research credit (capped at $250,000 per year) as a payroll tax credit against their payroll tax liability (i.e., FICA tax), rather than income tax liability. The payroll tax offset is an amount specified by the entity that cannot exceed the smallest of (1) $250,000, (2) the R&D credit determined for the current year, and (3) the business credit carryforward under IRC section 39 to the following year. That is, the payroll tax offset is limited to the general business credit carryforward to the following year that would be available if the payroll tax offset were not available. Therefore, a payroll tax offset would be limited to the R&D credit after any offset of regular tax and AMT (said another way, a payroll tax offset would be available only when the R&D credit exceeds the pre-credit tax liability).

To qualify, an entity’s gross receipts for the taxable year must be less than $5 million, and the entity must not have had gross receipts for any taxable year before the five taxable year period ending with the taxable year. A qualified small business can be a corporation (including an S corporation) or a partnership that meets the gross receipts requirements in any year. This election can only be made during a five-year period, and the election must be made on or before the due date (including extension) of originally filed returns. The payroll tax offset is made on Form 941.

The Act authorizes the Department of Treasury to issue regulations requiring recapture of R&D credits utilized as offset to payroll tax including the filing of amended returns when an adjustment to the payroll tax portion of the research credit is necessary.

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7 Payroll tax includes two components: (1) social security tax of 6.2% and (2) Medicare or hospital insurance (HI) tax of 1.45%. Under this change, R&D credits would be allowed, by election, to be treated as payroll tax credits to offset the social security payroll tax component (but not the Medicare or HI or the employee portion of payroll tax that the employer is required to withhold).

8 There are many general business credits listed in IRC section 38, and the order of absorption is prescribed in IRC section 38(d) which follows the order in which the credits appear in IRC section 38(b) (the R&D credit coming fourth).

9 Individuals carrying active trade or business may also qualify if they meet the gross receipts test and requirement.
This change is beneficial to startups and small businesses with no current income tax liability (due to losses) that also generate R&D credits that would otherwise be carried forward into future periods and which would require income tax liability. Assuming the requirements and limitations are met, a company can use its R&D credits to offset payroll tax expense recognized in operating income.

Qualified small business reporting entities would need to determine whether the R&D credit is an income tax benefit accounted for under ASC 740 or as an item of pretax income (i.e., reduction of payroll tax expense) accounted for under a different accounting standard in the Codification.\(^\text{10}\)

The Master Glossary definition of “income tax” in ASC 740 states the following: “Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.” In fact, Topic 740 does not apply to franchise tax based on capital or to certain withholding taxes for the benefit of the owners.\(^\text{11}\) The standard also explains that when the reporting entity incurs an excise tax which is independent of taxable income - i.e., the tax is due on a specific transaction regardless of whether there is any taxable income for the period in which the transaction occurs, the tax is not an income tax and it should be recognized as an expense in pretax income.\(^\text{12}\) The employer’s portion of FICA taxes (i.e., payroll tax) is based on the employees’ income and not the reporting entity’s income, making it clear that payroll tax is not an income tax.

However, ASC 740 does not specifically address the accounting for income tax credits that are also available, by election, to offset payroll tax (i.e., dual purpose tax credits). Generally, refundable tax credits (i.e., credits that can be refunded for cash) are not considered income tax credits, even when the reporting entity is currently paying income tax and can utilize the credit to offset income tax liability.\(^\text{13}\)

This new qualified small business R&D credit is not refundable. However, a qualified small business with currently minimal or no regular and AMT income tax liability has an option to either use the credit to offset income tax liability during a 20-year R&D credit carryforward period, assuming the entity would owe income tax during the carryforward period, or use the credit to offset payroll tax (up to $250,000 per year for five years).

Therefore, the accounting question is how to consider the ability to utilize current year R&D credits (after reducing net income tax, if any) to reduce payroll taxes. Two approaches are considered in this alert, pending the issuance of clarifying regulations and emerging practice.

One approach is to account for the benefit consistent with the chosen annual election and management’s expectation concerning the manner in which a credit carryforward is expected to be monetized.\(^\text{14}\) For example, if a qualified small business generates current-year R&D credit of $200,000 when its pre-credit tax is $130,000, the entity can elect to treat $70,000 as payroll tax credit available to offset payroll tax liability on Form 941 (assuming the entity has no general business credit carryforward). Under this approach, the entity would recognize $130,000 as income tax benefit (the offset to current-year income tax) and $70,000 as pretax income benefit (the offset to payroll tax). If the entity does not owe income tax in the current year, it can elect to utilize up to $200,000 of the current-year R&D credit as an offset to payroll tax. If payroll tax is less than $200,000, the entity would consider the manner in which it is expecting to monetize the R&D credit carryforward. If the R&D credit carryforward is expected to offset future income tax, it would be accounted for as income tax benefit and any DTA carryforwards amount would be evaluated for a valuation allowance. Note, that if the recognition requirements in Topic 740 are met, a deferred tax asset for an R&D credit carryforward must be recognized (under Topic 740) regardless of the income statement presentation of the benefit (i.e., pretax income or income tax benefit).\(^\text{15}\)

Another approach is to treat the R&D credit generated during the five year period up to $1,250,000 as a non-income tax benefit (i.e., an item of pretax income).

There are unique considerations which might favor the first approach.

\(^{10}\) The Codification encompasses all of the U.S. Generally Accepted Accounting Principles (GAAP) standards including the ASC Topic 740 Income Taxes.\(^\text{11}\) ASC 740-10-15-4.

\(^{12}\) ASC 740-10-55-75.

\(^{13}\) There is no authoritative guidance in the standard. However, refundable tax benefits have in recent years emerged in many permutations and countries (e.g., the French employment tax credit) and various interpretive guidance and practice have emerged to treat such benefits as non-income tax benefits.

\(^{14}\) By analogy to ASC 740-10-55-23 which explains that measurement of deferred income taxes are based on tax elections expected to be made in future years.

\(^{15}\) ASC 740-10-55-35.
The election is only available during a five-year period and the law, as currently written, limits the optionality to the R&D credits that are not otherwise used to reduce net income tax expense. Recognition of the maximum credit amount (i.e., $1,250,000) in pretax income would potentially result in having to reclassify unused credits to income tax after the five year period (a qualified small business would need to report about $20.2 million in payroll expense to owe $1,250,000 of FICA payroll tax during the five year period). Further, R&D credit utilized on the income tax return to offset income tax liability would necessitate complex accounting to gross up income tax expense and reclassify the benefit into pretax income.

It should be noted that an election to offset payroll taxes does not affect the payroll expense amount allowable as a deduction (i.e., a taxpayer that elects to offset its payroll tax liability is not required to include such offset into income for tax purposes). Therefore, recognition of the R&D credit offset in pretax income (i.e., offset to payroll tax expense) would result in a book-to-tax adjustment (i.e., an “M-1” adjustment in Form 1120) to reflect a deduction for payroll tax expense without an offset (i.e., the R&D credit benefit is not taxable income and is thus removed from pretax income when it is recognized as a payroll tax expense offset). Finally, if a payroll tax offset is elected, the entity is required to follow the rules in IRC section 280C and reduce deductible qualified R&D expenditures to the extent of the R&D credit (or elect a reduced credit rate).

**HOW BDO CAN HELP**

BDO can assist clients with the evaluation of the significance of the accounting impact of the Act’s tax extenders including appropriate disclosures that should be included in financial statements.