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Accounting for Income Taxes after a Sweeping Tax Reform

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SPECIAL REPORT

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The uncertainties inherent to tax law make the tax provision one of the most complicated accounting areas in the FASB Codification. The tax provision is a complex and significant accounting estimate under US GAAP. Furthermore, tax legislation is subject to constant changes, at times of limited scope, but at times very broad. As a result, not long after the US federal income tax system was introduced, the FASB established a framework for the financial accounting and reporting of income taxes.

An entity must apply significant management judgment throughout the entire framework in Topic 740, Income Taxes. At one end of the framework, an entity must use judgment to determine whether it can even recognize a tax position on the US GAAP financial statements or whether it must report an uncertain tax position. At the other end of the framework, if an entity reports a gross deferred tax asset because of an expected tax benefit, the entity must perform another exercise to determine whether the benefit must be reduced further because the entity does not expect to realize all or some of the associated tax benefits — and the entity must perform this exercise at every reporting date until the benefit is utilized or expires. In between the financial reporting framework are measurement steps with guidance on how to account for the uncertainties that are inherent in tax law.

Although Topic 740 addresses how an entity accounts for changes in tax laws and rates, the guidance is largely theoretical and remained unchanged for decades. Many stakeholders believe that the guidance, when written, did not necessarily contemplate the major effects of a sweeping tax reform. The enactment of the Tax Cuts and Jobs Act (TCJA) — the first major tax legislation enacted in more than thirty years — only adds another layer of complexity. To complicate matters further, the President signed the TCJA into law on December 22, 2017. This did not give practitioners much time to assess their interpretation of the new law. It also left preparers scrambling to account for the effects of the enacted changes in their US GAAP financial statements for the period ended December 31, 2017. Fortunately for preparers of the financial statements, the FASB and SEC released guidance shortly after the enactment to help entities apply the financial accounting framework in Topic 740 to the legislative tax developments, and still comply with US GAAP financial reporting requirements. Both regulatory bodies continue to monitor entities' implementation of the tax reform and other developments in the US corporate tax landscape.

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This special report discusses the primary objectives of Topic 740 and how an entity determines the total income tax provision for financial reporting purposes. It summarizes the complexities of preparing the deferred income tax provision, and because the enacted tax law changes affect entities to varying degrees, the special report highlights the income tax accounting implications brought on by the TCJA that affect most US corporate entities. Because the accounting for income taxes is a critical accounting estimate, this special report provides a deep dive into the disclosures that are required under Topic 740 and includes a discussion of the FASB and SEC developments following the enactment of the TCJA.

Scope

Conceptually, any type of income-producing activity can have a tax effect. The definition of income, though, may be different between accounting and tax. Some items may not be recognized at the same time for tax and book purposes. In some cases, an item might affect only the tax return but not the financial statements, and vice versa. Moreover, an entity's legal form can also affect the tax regime under which the entity finds itself, which has accounting and reporting consequences. Determining whether an entity is within the scope of the FASB guidance in Topic 740, Income Taxes, already is a complicated task and calls for tax specialists. As a general rule, however, any entity that presents US GAAP financial statements is subject to Topic 740.

Observation: Scope. The FASB guidance on accounting for income taxes applies to all domestic and foreign entities, whether they are consolidated or combined under US GAAP. The income tax accounting rules in Topic 740 also apply to equity-method investees and not-for-profit reporting entities.

The nature of a transaction, the tax attributes of the assets and liabilities involved in the transaction, and jurisdictional tax laws can result in significant differences between an entity's reporting of a transaction (or event) for tax and book purposes. The amount of tax due and when that tax will be due depends on many facts and assumptions — such as type of income that was generated, when an entity expects to recover or settle a specific asset or liability, and whether taxing authorities in the respective jurisdiction will accept or reject the entity's position. Topic 740 requires an entity to consider all of these facts and assumptions and record the current and future tax consequences of an event or transaction. Therefore, it is important that accountants have a solid understanding of the financial accounting rules in Topic 740 and communicate effectively with tax specialists and practitioners to understand all of the current and future tax consequences of a transaction.

Primary Objectives of the FASB Guidance on Accounting for Income Taxes

US GAAP financial statements must reflect the current and future tax effects of all the income-related events, whether the transactions are recognized in the entity's financial statements or the entity's tax returns. Following that guiding principle, an entity must accomplish two primary objectives to comply with Topic 740:

- To record an amount of current taxes payable (or refundable) as of the balance sheet date; and
- To record deferred tax liabilities and assets for the future tax consequences of events or transactions that the entity has recognized in its financial statements or tax returns.

Illustration: Primary Objectives of Topic 740. Assume an entity is in a net tax-paying position as of the latest financial reporting date. Assume also that the entity has identified temporary differences that will result in future taxable income. For all intents and purposes, the entity must report current income taxes payable. The financial balance sheet must also report a balance for deferred tax liabilities (that is, an estimate of taxes that will be due when the entity reports the event or transaction on a future tax return).

US GAAP financial statements must reflect the current and future tax effects of all the income-related events, whether the transactions are recognized in the entity's financial statements or the entity's tax returns.

An entity complies with the primary objectives using a "balance sheet approach." Essentially, the total tax provision in any given year consists of two components — a current portion and a deferred portion. An entity computes each portion separately as of a point in time — the balance sheet date.

The balance sheet approach is also known as the "asset and liability method" of accounting for income taxes. Under this method, an entity computes its tax balance sheet and its US GAAP balance sheet. Differences are then sorted between permanent differences and temporary differences. Deferred tax assets and liabilities are computed on the identified temporary differences between the financial reporting values and tax bases of the entity's assets and liabilities. To derive the ending deferred tax balances, an entity must apply the enacted tax rates and laws that the entity expects to be in effect when each temporary difference is expected to reverse. For financial reporting purposes, the deferred tax provision is the change in the deferred tax balances from the beginning of the year to the end of the year.

The total income tax expense (or benefit) that the entity reports on the financial income statement is simply the sum of the two components, as shown in Figure 1.

Figure 1 — Total tax provision reported on the income statement

Current tax expense (benefit)
+ Deferred tax expense (benefit)
= Total tax expense (benefit)

Topic 740 provides strict guidance regarding new information that affects the measurement of a tax position.

The current tax provision is relatively straightforward. Management computes the amount of income taxes due (or refundable) on the current year tax return and records this amount as the current tax provision. The current tax expense (or benefit) contributes to the entity's liability (or receivable) for income taxes payable to (or refundable by) various taxing authorities. The cumulative balances on the financial statement include all income taxes payable or refundable, including amounts reported from prior year tax returns.

The deferred tax provision requires a significantly greater degree of effort, estimation, and uncertainty. Much of the complexity in accounting for income taxes involves the measurement of deferred tax expense and deferred tax balances as of the balance sheet date.

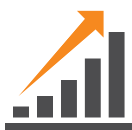
The deferred tax provision represents the entity's estimate of future tax effects arising from temporary differences, including net operating loss carrybacks and tax credit carryforwards. An entity must measure its deferred tax liabilities, deferred tax assets, and related valuation allowances at each reporting period. The entity then computes the change in the deferred tax accounts (net of any related valuation allowance) from the beginning of the year to the end of the year. The entity records the change in the net deferred tax balances as the deferred tax expense (or benefit) for the year.

The deferred tax provision is a complex calculation and relies heavily on management judgment. The entity prepares the deferred tax provision in a series of steps. Figure 2 summarizes the framework at a high level.

Observation: New Information and Subsequent Remeasurement of a Tax Position. An entity determines which filing positions it will take based on information that was available at the time the current and deferred tax provisions were calculated. By nature, the total tax provision is a critical accounting estimate and subject to change.

The tax provision reported on the financial statements is typically computed several months before the entity's actual tax return is filed. It is not uncommon for new information to surface between reporting periods. Topic 740 provides strict guidance regarding new information that affects the measurement of a tax position. Specifically, Topic 740 requires that the amount recorded for a tax position must be based on management's judgment about new information; remeasurement must not be based on a new assessment or new understanding of information that was available in a prior reporting period.

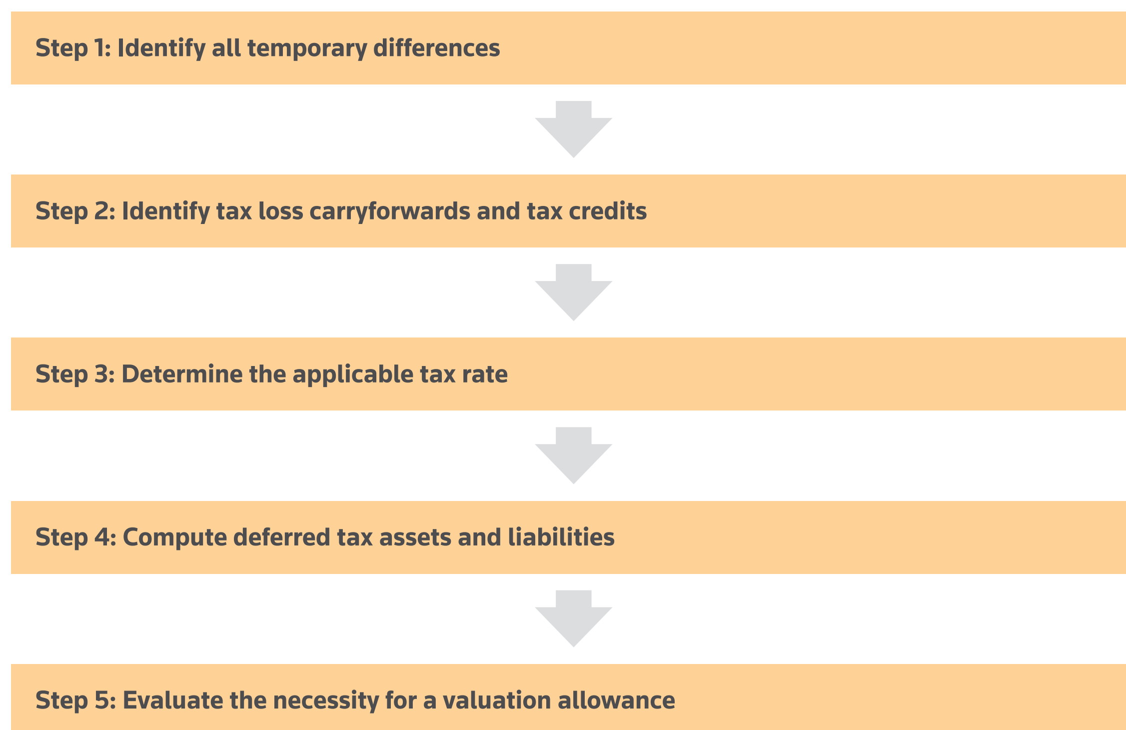
If management subsequently becomes aware of information that may affect a previously recorded tax position, the question management must answer honestly is whether the new information was "capable of being known" at the time the current and deferred tax provisions were measured in a previous reporting period. When it comes to critical accounting estimates, especially an entity's accounting for income taxes, there is a fine line between a change in estimate and an accounting error.



The Deferred Tax Provision in Five Complicated Steps

This section discusses each step of the framework for measuring the deferred tax provision, along with some of the relevant matters of judgment.

Figure 2 — Framework for measuring deferred tax balances



Step 1: Identify all temporary differences

An entity's initial step is to identify any differences between the amounts it has reported for book purposes and tax purposes, and to distinguish differences that are "temporary" in nature from those that are "permanent." In its simplest definition, a temporary difference reverses over time or at some point in the future, and when it does, the reversal will result in a future tax consequence. Permanent differences, on the other hand, never reverse. Therefore, permanent differences never result in future tax consequences.

As a general rule, under Topic 740, an entity must record deferred tax liabilities and assets to capture the future tax consequences of all identified temporary differences.

Illustration: Temporary Difference. An entity often uses different methods to calculate depreciation of property under the tax law and under US GAAP. In this case, the amount of depreciation recorded in each period for tax purposes and financial reporting purposes differs. Eventually, however, the difference reverses. In other words, ultimately, the total depreciation computed over the life of the property is the same under tax law and US GAAP.

Observation: GAAP Presumption. "Reverse" refers to an inherent presumption in GAAP that an entity will recover or settle the carrying values of the assets and liabilities it has reported on its balance sheet. Therefore, the notion that an identified temporary difference ultimately reverses follows suit.

There are two kinds of temporary differences — taxable and deductible. A taxable temporary difference generates future taxable income when it reverses. Therefore, an entity records a deferred tax liability when it identifies a taxable temporary difference.

In contrast, a deductible temporary difference reduces taxable income when it reverses. Therefore, an entity records a deferred tax asset (and related valuation allowance) when it identifies a deductible temporary difference or tax benefit.

The accounting guidance describes the types of common temporary differences that an entity may encounter and generally require the recognition of a deferred tax liability or asset.

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Figure 3 — Common types of temporary differences described in Topic 740

Action that creates a temporary difference	Description or example
Timing of reported revenue and gains	An entity reports revenue and gains on the tax return when it receives payment, which may be earlier than or after the period it reports the revenue or gains on the financial income statement, due to the accrual basis of accounting in GAAP. For example, a customer advances full payment for services that it will receive over a three-year period. For tax purposes, the entity reports the full payment as income in the year it was received. For book purposes, however, the entity does not report the full payment. Instead, the entity spreads the income over three years. The end result is that taxable income never equals book income in any of the reporting periods.
Timing of reported expenses and losses	An entity deducts qualified expenses and losses on the tax return when the item is paid or settled. For tax purposes, the entity might be able to report the item earlier or later than when it is required to report the expense or loss on the financial income statement, due to the matching principle in GAAP. Similarly, the end result is that taxable income does not equal book income in any given period.
Use of tax credits	Certain tax credits reduce the tax basis of a depreciable asset. Therefore, the tax basis of the asset will be lower than its book basis for financial reporting purposes. In the future, when the entity ultimately recovers the asset's carrying value, the amount it receives will be more than the asset's remaining tax basis. This will cause taxable income to be higher than pretax income. This basis difference (the excess of book over tax) is a taxable temporary difference.
Use of the deferral method for investment tax credits	An entity can use one of two acceptable methods to account for investment tax credits in the financial statements. Under the deferral method, an entity uses investment tax credits to reduce its cost basis in an acquired asset. This causes the book basis of the asset to be lower than its tax basis. In the future, when the entity ultimately recovers the asset's carrying value, the amount it receives will be less than the asset's remaining tax basis. This basis difference (the excess of tax over book) is a deductible temporary difference.

Action that creates a temporary difference	Description or example
Increasing an asset's tax basis because of indexing (inflation adjustments)	Local tax law may require an entity to adjust, or index, a depreciable asset's tax basis for inflation. Typically, the asset's book value for financial reporting purposes, however, is not indexed for inflation. After indexing, an entity performs certain tax calculations using the adjusted tax basis. For instance, the entity would use the indexed tax basis to determine future tax depreciation deductions or an amount of gain or loss upon sale of the asset. When the entity ultimately recovers the asset, the amount it receives may be less than the asset's remaining tax basis. In other words, the tax basis will be higher at recovery if the base was adjusted upward for inflation. This basis difference (the excess of tax over book) is a deductible temporary difference.
Use of the acquisition method to account for a business combination	The final determined tax bases of the net assets acquired in a business combination may differ from the final book values that the acquirer ultimately records when the acquisition method of accounting is complete. This is because the acquirer's respective tax bases in the net assets are determined by the tax laws of a particular jurisdiction, while the acquirer's book basis in the same asset or liability generally is based on fair value. Therefore, the accounting for a business combination can create both taxable and deductible temporary differences. These differences will result in future taxable or deductible amounts when the acquirer's new carrying values of the assets or liabilities are ultimately recovered or settled. In addition, the acquirer may inherit or assume certain pre-existing temporary differences and uncertain tax positions of the acquiree. In other words, all or some of the acquiree's pre-existing deferred tax balances may carry over to the acquirer or newly formed entity and result in temporary differences that must be measured.
Reporting an asset or liability on the income tax balance sheet, but not on the financial balance sheet	An entity may have an asset or liability that appears only on the income tax balance sheet (i.e., as a deferred tax deduction or deferred taxable income) and is not associated with a specific asset or liability on the financial reporting balance sheet. For example, on the tax balance sheet an entity would defer organizational costs and deduct those costs from taxable income in future years. For financial reporting purposes, however, the organization costs would never appear on the balance sheet because an entity would have to expense organizational costs as incurred, in accordance with GAAP. Topic 740 describes the recognition of revenue on long-term customer contracts as another situation that will create this type of temporary difference. These items are not to be confused with permanent differences. A permanent difference is a transaction or event that is reportable either in book income or taxable income, but never in both. Therefore, a permanent difference never results in a future tax consequence.

Observation: Preparing an Inventory of Temporary Differences and Determining a Pattern of Expected Reversals. In practice, an entity identifies all of its temporary differences by:

- Preparing a tax balance sheet and comparing the assets' and liabilities' tax bases to their respective carrying values on the GAAP balance sheet; and
- Reviewing a reconciliation of book income to taxable income.

An entity does not have to create an extensive schedule detailing when the temporary differences are expected to reverse; but an entity must have a general knowledge of its reversal patterns. Ultimately, an entity must have a reasonable and consistent method of anticipating reversals in order to estimate taxable and deductible amounts and determine future taxable income by year.

Observation: Income Taxes in Connection with a Business Combination. The accounting for a business combination is complex and can result in different tax consequences based on the structure of the deal and the respective jurisdictional tax law, among other factors. In some cases, a business combination may not change the remaining tax bases of the assets acquired and liabilities assumed. In other cases, an entity involved in a business combination may have the option of updating the tax basis of an item. In some jurisdictions, goodwill is taxable which would require a deferred tax balance, while in other jurisdictions goodwill is nontaxable.

The FASB guidance on accounting for business combinations is complex, and many of the provisions in the TCJA are targeted to multinationals or entities with foreign businesses. Entities that are involved in or contemplating a merger and acquisition are encouraged to review the guidance in Topic 805, Business Combinations, and consult with tax professionals to ensure that income tax amounts are planned and accounted for properly. A separate subtopic (Subtopic 805-740, Business Combinations–Income Taxes) includes tax-specific considerations for entities that are part of a business combination.

Observation: Applying the Effects of the TCJA to a Business Combination when an Entity's Accounting for the Transaction is Incomplete. Under Topic 805, an entity has one year from the acquisition date to complete its accounting for a business combination. Certain qualifying adjustments during this window are referred to as measurement period adjustments. There is a strict definition of a measurement period adjustment — it is an accounting adjustment that results from new information that has come to light about facts and circumstances that were present as of the acquisition date (typically about an asset acquired or a liability assumed). A measurement period adjustment may affect the acquirer's carrying value in an acquired asset or liability, or it may affect the total recorded purchase price for the transaction and result in a corresponding adjustment to the amount of goodwill that is generated from the business combination and recognized by the acquirer on the date of the acquisition.

If an entity currently has an open measurement period on a business combination, the change in tax rates (and any other effects brought on by enactment of the TCJA) is not a measurement period event. The effects of the TCJA are not measurement period adjustments because the new information (new applicable rates, for example) occurred after the acquisition date. Therefore, an entity that is still in the process of completing its accounting for a business combination must account for the change in tax rates (and any other effects) with an adjustment to current earnings as part of current income tax expense (and not to goodwill). The entity would account for the effects of the TCJA in line with the general guidance in Topic 740 regarding changes in tax rates and tax laws.

Mechanically, an entity would account for the effects of the TCJA on measurement period adjustments affecting the deferred tax balances arising from the acquisition by:

- First measuring the deferred tax effects using the applicable tax rates as of the acquisition date (e.g., 15% to 35%);
- Then remeasuring those deferred tax balances to reflect the new tax rate (e.g., 21%) as a component of income tax expense attributed to continuing operations.

Exceptions to the general rule for recording deferred taxes

When accounting for income taxes, the general rule is that an entity must record deferred tax liabilities and assets to capture the future tax consequences of all identified temporary differences.

When accounting for income taxes, the general rule is that an entity must record deferred tax liabilities and assets to capture the future tax consequences of all identified temporary differences. Topic 740 permits six limited exceptions for which an entity does not have to record deferred taxes for certain temporary differences. The guidance makes it clear that the limited exceptions are based on "when" the temporary differences are expected to reverse (not "whether" they will reverse).

Historically, the US tax system is based on a worldwide system of taxation. This means that all income is subject to US income taxes regardless of where it was earned (in the US or overseas). The US corporate tax landscape is largely shaped by multinationals with domestic and foreign operations. In general, the limited exceptions in Topic 740 that are most commonly encountered by multinationals involve:

- Nondeductible goodwill amortization;
- The indefinite reversal criteria (also known as "the APB 23 exception," or the assertion that foreign earnings are "permanently reinvested"); and
- Outside basis differences that extend indefinitely into the future.

Observation: "Inside" and "Outside" Basis Differences. An inside basis difference is the numerical difference between an asset or liability's book basis and tax basis that will result in future taxable income or a future tax deduction when it reverses (a temporary difference).

An "outside" basis difference refers to an entity's investment in a subsidiary. An outside basis difference is the numerical difference between the investment's carrying value for financial reporting purposes (which is eliminated in consolidation) and the entity's underlying tax basis in the investment (e.g., its tax basis in the stock of the subsidiary). Even though the book asset is eliminated in consolidation, under the general rule in Topic 740 an entity would still have to record deferred taxes for the basis difference unless it meets one of the limited exceptions.

Observation: The Indefinite Reversal Criteria in Topic 740. There is an exception in Topic 740 where an entity does not have to recognize a deferred tax liability until it becomes clear that the temporary differences will reverse in the foreseeable future. This is known by accountants and practitioners as the "indefinite reversal criteria," and it relates specifically to outside basis differences. Utilizing this exception, a US entity may (for an indeterminate time) avoid recording deferred taxes on foreign earnings by positively asserting that it has the intent and ability to "permanently reinvest" the earnings abroad.

Observation: The TCJA's Territorial Tax System. The TCJA moves the US tax system from a worldwide system of taxation to a hybrid territorial system.

Under the worldwide tax system, a US corporation was generally taxed on all income, whether the income was derived in the US or abroad through a foreign corporation. In general, if a US corporate shareholder earned foreign income through a foreign entity, the income was taxed only when the income was distributed as a dividend to the shareholder. Foreign tax credits were generally available to offset all of some of the tax levied on foreign-source income.

Under the TCJA, an entity is given an incentive to repatriate certain foreign-source earnings into the US (and boost the domestic economy) by receiving a 100% dividend exemption if it owns at least 10% of the foreign corporation's stock. In effect, the hybrid territorial system of taxation potentially allows an entity to repatriate certain earnings without incurring additional US taxes. The TCJA, however, has limitations on the use of this dividend exemption. In addition, the TCJA either disallows or limits certain foreign tax credits that were once available to corporate entities. Multinationals that intend to take advantage of the dividend exemption must consult their tax specialists for applicability and proper consideration in the total tax provision.

While the federal tax system has changed, the accounting rules in Topic 740 have not been amended to reflect a territorial tax system. Therefore, an entity may still have to record a deferred tax balance for certain foreign-source income unless it meets one of the limited exceptions in Topic 740.

Observation: The TCJA's One-Time Transition Tax on Foreign Earnings. The TCJA imposes a one-time mandatory repatriation tax which effectively recoups the tax on certain unrepatriated foreign earnings. This means that the US entity's taxable income for the current tax return must include its historical pro-rata share of the foreign affiliate's earnings that have not been previously taxed due to the worldwide system of taxation. The TCJA provides specific rules on how to calculate and pay the one-time transition tax. An entity must record two adjustments to its deferred tax provision as result of this provision:

- An adjustment to set up a deferred tax liability on prior years' undistributed foreign earnings; and
- An adjustment to remeasure existing deferred tax balances using the (lower) enacted tax rates.

After recording the one-time transition tax, an entity must assess any remaining outside basis differences that are related to its foreign subsidiaries. The entity may have to record deferred taxes for outside basis differences that do not meet any of the limited exceptions in Topic 740.

The TCJA generally repeals the ability to carry back an NOL and limits the maximum deduction an entity can claim for NOLs arising in 2018 and beyond.

Step 2: Identify tax loss carryforwards and tax credits

In this step, an entity considers the tax incentives that might be available to the entity, and how it plans to utilize any or all of the benefits.

Loss carryforwards typically include net operating losses (NOLs) and capital losses. Depending on the applicable tax law, an entity may be able to carryback or carryforward NOLs and capital losses to offset future taxable income.

Observation: The TCJA's Rules on Net Operating Loss (NOL) Carryforwards and its Repeal of NOL Carrybacks. The TCJA generally repeals the ability to carry back an NOL and limits the maximum deduction an entity can claim for NOLs arising in 2018 and beyond. Under the TCJA, the maximum deduction that an entity can claim for NOL carryforwards is limited to a percentage of the entity's taxable income. Despite the limitation in the amount that can be deducted, NOLs arising from 2018 and beyond have no expiration. That is, an entity can carry forward these NOLs indefinitely.

Changes in how NOLs can be utilized may significantly affect an entity's schedule of temporary differences and their previously expected reversals.

An entity may be able to carry back or carry forward tax credits to offset future taxable amounts. The availability of a tax credit carryforward depends on the applicable tax law.

Typical tax credits include, but are not limited to:

- Federal and state research and development (R&D) credits;
- Foreign tax credits (FTCs);
- Federal alternative minimum tax (AMT) credits;
- Investment tax credits; and
- Other types of credits.

Observation: The TCJA's Rules on Foreign Tax Credits. The TCJA provides a 100% dividend exemption on certain foreign-source income repatriated into the US by eligible corporate shareholders. The TCJA, therefore, either eliminates or limits certain foreign tax credits and deductions that an entity may have historically factored into its tax provision computations. Therefore, entities with foreign tax credit pools must consult tax specialists to validate certain US tax attributes for continued applicability.

An entity may be able to use existing foreign tax credits (and NOL carryforwards) to offset the TCJA's one-time transition tax.

Observation: The TCJA's Elimination of the Alternative Minimum Tax. Topic 740 includes accounting guidance on the effects of the alternative minimum tax (AMT) system, which was instituted by the US Tax Reform Act of 1986. The TCJA eliminates the alternative minimum tax for corporate entities. Therefore, entities that historically considered AMT credits into their deferred tax provision must consult tax specialists for continued applicability.

A great deal of uncertainty is inherent in Steps 1 and 2. Significant management judgment is required across a variety of factors, including, but not limited to, operating forecasts and projections, the timing of expected reversals, the utilization of loss carryforwards, and the availability of tax credits.

Step 3: Determine the applicable tax rate

Identifying the applicable tax rate requires an entity to determine how and when it expects the temporary differences to reverse.

After an entity has identified all of its temporary differences, available tax credits, and available loss carryforwards, the entity must apply an appropriate tax rate to compute the deferred tax provision. Identifying the applicable tax rate requires an entity to determine how and when it expects the temporary differences to reverse. It is not uncommon for many temporary differences to reverse over a course of several years.

When determining the appropriate rate to apply to the temporary differences, the entity must use the rate that will be in effect in the period of reversal based on enacted tax laws. The entity cannot use an effective tax rate, and even though the reversal may occur several years from now, the entity cannot consider the time value of money and discount any deferred tax balance.

Observation: Factors that Influence the Applicable Rate. The applicable tax rate is the rate that will be in effect based on enacted tax law. That is the rule of thumb and the conceptual guidance in Topic 740. In practice, however, a wide range of factors can influence this key input in the computation, making this determination one of the most challenging steps to apply. Some of the factors that can create challenges in determining the appropriate tax rate include applicable rate based on the type of income, the ordering effects of taxation which are set by jurisdiction, tax regimes that use graduated tax rates, tax holidays, and phased-in tax rate changes. These are just some of the surface level considerations that may affect how an entity determines the applicable rate for its various temporary differences. An entity must consult its tax department for a complete assessment of the factors to consider based on its particular facts and circumstances.

Observation: When and How to Account for Recently Enacted Rate Changes. Topic 740 requires an entity to remeasure its deferred tax liabilities and assets (to reflect new applicable tax rates) on the date of enactment. This means that an entity must record the full effect of enacted tax law changes (including the recognition of new deferred tax balances and the remeasurement of all existing deferred tax balances) entirely in the interim period in which the bill was signed into law. The entity cannot wait until the legislation's effective date to reflect the effects of any adjustment to deferred taxes in income, and the entity cannot allocate a portion of the tax effects to any other interim periods. Furthermore, based on the general guidance in Topic 740, these adjustments must be recognized as a discrete component of income tax expense and all of it attributed to income from continuing operations. Based on a filer's internal processes, it may be able to reflect the income tax accounting for some, but not all, of the provisions of a major tax legislation.

It is possible that the guidance in Topic 740 related to changes in tax laws and tax rates was conceived with modest changes in mind. The TCJA, however, is a major overhaul of the existing US federal tax system. Therefore, when the TCJA was signed into law on December 22, 2017, this provided entities with a short timeframe to analyze the law's full effects on the financial accounting for income taxes for the fourth quarter and calendar-year 2017, and to report a proper statement of financial profit and loss for that period.

Days after the enactment, on December 27, 2017, the SEC issued interpretative guidance to help entities cope with this massive legislation. Essentially, Staff Accounting Bulletin (SAB) No. 118 establishes a "measurement period approach" that is similar to the measurement period approach for a business combination where the accounting is incomplete.

SAB No. 118 is temporary guidance. The SEC issued the guidance solely to help entities (including private companies and not-for-profit entities) get through their accounting for the TCJA and still meet their filing duties for the investing public and other stakeholders. Therefore, when the one-year measurement period for most entities ends, this SEC interpretive guidance is largely obsolete.

In part, SAB No. 118 requires an entity to disclose the parts of the TCJA for which it could not determine reasonable estimates. The entity then would continue to account for those parts based on the enacted laws that were in effect immediately prior to the TCJA's enactment.

Step 4: Compute deferred tax assets and liabilities

The actual computation (step 4) depends on management's identification of all temporary differences and expected patterns of reversal (step 1), management's expected utilization of available tax loss carryforwards and tax credits (step 2), and management's determination of the applicable tax rate (step 3).

The calculation is relatively straightforward when a single tax rate is used during the reversal period. In realty, the basic calculation becomes more complex as any or all of the following scenarios occur (not an all-inclusive list):

- Multiple tax rates apply during the reversal period;
- New tax rates or regulations are enacted and expected to apply during the reversal period; or
- Special rates apply to different types of taxable income.

Each of the preceding steps relies on subjective forecasts, management projections, and how well the company interprets jurisdictional tax law (including the enacted TCJA) to fit its particular facts and circumstances. For example, the accuracy of the estimate depends on management's ability to schedule when and how the identified temporary differences will reverse. It also depends on management's skill in evaluating the merits of its uncertain tax positions, which may be challenged by taxing authorities, and potentially result in additional tax obligations.

Observation: The TCJA's Anti-Base Erosion Provisions. While the TCJA eliminates the alternative minimum tax (AMT) for corporate entities, it also establishes two new provisions. The FASB views one as another form of AMT for multinational corporations.

Base Erosion and Anti-Abuse Tax (BEAT)

In practice, many US corporations receive tax benefits (tax deductions) because of certain payments made to foreign affiliates (such as royalties and payments for services). Under the TCJA, if a US corporation continues this business practice, it may be required to pay a minimum income tax based on specific criteria (which includes attaining a certain level of gross receipts, and making a certain level of deductible related-party payments and certain types of payments). This minimum tax is the Base Erosion and Anti-Abuse Tax (commonly referred to by its acronym, BEAT). An entity that is subject to BEAT effectively excludes from its tax return certain payments that are otherwise deductible.

Although it is possible for an entity's liability under BEAT to be lower than its tax liability under regular, statutory rates, BEAT was designed to be a system of incremental taxation. An entity might have to pay more than its regular tax liability, but it will never pay less. Therefore, the FASB believes that to comply with BEAT as intended by the lawmakers, an entity must measure deferred tax assets and liabilities using regular statutory rates even if the entity expects to be subject to the BEAT for the foreseeable future and would otherwise benefit from a lower rate under BEAT.

Entities that historically pay royalties and other types of payments to foreign related parties must consult tax specialists to understand:

- Whether they may be subject to BEAT;
- The types of payments that are subject to BEAT;
- The applicable thresholds; and
- How to consider BEAT when calculating the total tax provision.

Global Intangible Low-Taxed Income (GILTI)

A US corporation may control an entity referred to as a Controlled Foreign Company (CFC) for US tax purposes. In general, CFCs are registered in and conduct business in foreign countries or jurisdictions with relatively low tax rates or relatively few tax consequences. In addition to being tax-advantageous, a CFC may be used by a US corporation to expand its global footprint. Despite good intentions, a CFC also has the potential to abuse the US tax deferral provisions; Congress, therefore, enacted a highly complex income inclusion provision referred to as Subpart F. Low-taxed income generated by intangible assets in foreign territories are subject to Subpart F.

The TCJA imposes an additional, current tax on global intangible low-taxed income (GILTI). As practitioners continue to interpret the new law, there are opposing views on whether it is appropriate to record deferred taxes on GILTI (similar to the rules for deferred taxes on existing Subpart F income) or include the tax as a component of current tax expense when incurred. Although the FASB has heard different takes from various stakeholders, the FASB believes that Topic 740, as written, does not indicate a particular way to account for GILTI. Therefore, an entity must establish (and disclose) its accounting policy related to GILTI. The FASB has indicated that it will continue to monitor the TCJA and other developments in tax legislation. The FASB may consider issuing further accounting or disclosure guidance related to GILTI and other tax laws that may evolve.

Topic 740 has not been amended to reflect the elimination of the AMT or the institution of BEAT and GILTI.

Topic 740 has not been amended to reflect the elimination of the AMT or the institution of BEAT and GILTI. Still, an entity must consider the applicability of these additional taxes when calculating its total tax provision.

Observation: Measurement Period Approach to Account for the Effects of the TCJA. Because the TCJA was enacted in December 2017, many preparers of financial statements had little time to reflect the effects of the TCJA in their 2017 financial statements. In response, the SEC issued Staff Accounting Bulletin (SAB) No. 118. This bulletin acknowledged that entities may have been unable to complete their accounting for the effects of the TCJA before issuing their 2017 financial statements.

SAB No. 118 granted entities a measurement period (if needed) to complete their accounting for the effects of the TCJA. The measurement period cannot exceed one year from the TCJA's enactment date.

If an entity accounts for any of the income tax effects of the TCJA using the measurement period approach in SAB No. 118, the entity must disclose:

- Areas where the entity has not completed its accounting under Topic 740;
- The reasons why the accounting is not complete;
- The additional information necessary to complete the accounting (including information that must be obtained, prepared, or reviewed);
- The amount of current and deferred taxes for which the entity has not completed its accounting;
- Provisional amounts recorded to reflect the entity's estimate of the income tax effects of the TCJA;
- For measurement period adjustments recorded during the reporting period:
  - A description of the adjustments;
  - The amounts of the adjustments;
  - The effects of the adjustments on the entity's effective tax rate; and
- When the entity completes its accounting for the income tax effects of the TCJA.

These disclosures are similar to the disclosures that an entity must provide when its accounting for a business combination under Topic 805 is incomplete.

CHECKPOINT SEARCH TIPS:

SECPlus Advanced: To quickly review EDGAR Form 10-K filings using SAB No. 118 to account for the effects of the TCJA, use SECPlus Advanced to run a "Selected Sections only" search with keyword.

Sample Search Terms:

- Keywords: 118 /p "tax cuts"
- Selected Sections only
- Form: 10-K
- Sections: Notes to Financial Statements
- Filing Date: Last 3 months

Step 5: Evaluate the necessity for a valuation allowance

If an entity records a gross deferred tax asset, the entity must reduce it by the amount of the tax benefit that it does not expect to realize. Ultimately, this depends on whether the entity believes it will generate sufficient taxable income to use all or some of the accumulated tax benefits.

Technically, an entity must recognize a valuation allowance when management concludes that it is "more likely than not" (more than a 50-percent probability) that all or some of the DTA will not be realized. This requires an entity to perform a recurring, periodic assessment of the deferred tax asset's realizability based on evidence that is available as of the measurement date. An entity must consider all types of evidence that is readily available, positive and negative.

An entity must consider all types of evidence that is readily available, positive and negative.

Negative information makes it difficult to conclude that a valuation allowance is not required. Topic 740 describes common examples of negative information that an entity may encounter (not an all-inclusive list):

- Cumulative losses in recent years or upcoming losses expected for an otherwise profitable entity;
- A pattern of unused net operating loss or tax credit carryforwards that have expired due to the entity's inability to generate sufficient taxable income to apply the loss or tax credit carryforwards;
- Uncertain circumstances or recent events that would have an ongoing adverse effect on future operations; and
- A significant deductible temporary difference that is expected to reverse in a single year.

Because the relevance of the available evidence may change from one period to the next, an entity must perform this assessment at each reporting date. The changes brought on by the TCJA may affect an entity's ability to utilize some of the benefits it has accumulated in prior years.

Observation: The TCJA's Rule that NOL Carryforwards Do Not Expire. Although NOL carryforwards do not expire under the TCJA, an entity cannot assume that it will fully realize the benefits of the carryforward. For example, an entity may still have to record a valuation allowance related to the NOL carryforwards if it projects an adverse trend in sufficient taxable income.

Observation: The TCJA's Limitations on the Interest Expense Deduction. The TCJA limits the amount of the tax deduction a US corporation can take for net interest expense above a certain level of adjusted taxable income. This limitation may influence an entity's capital spending and cash management activities. Interest expense affects management's operating income and budgeting process, and therefore, potentially, affects the entity's projections of future taxable income.

Presentation and Disclosure of Income Taxes

Topic 740 addresses how an entity must present its income taxes on the face of its financial statements. Although Topic 740 has presentation requirements for specific income tax related balances and activity, an entity also must adhere to the general US GAAP financial statement presentation requirements in Topic 210, Balance Sheet, and Topic 225, Income Statement. This section describes how an entity presents commonly used income tax-related accounts and activity on the financial statements. It also summarizes the disclosures that an entity must provide for a user of the financial statements to understand the organization's current and future tax consequences.

Observation: Relaxed Disclosure Requirements for Nonpublic Entities. Many of the disclosure requirements that public and nonpublic entities must provide for income taxes are the same. Nonpublic entities, however, generally receive some relief as they are not required to disclose certain quantitative information that is otherwise required for public entities. Figure 4 summarizes the disclosure requirements that only apply to public entities. For the areas listed in Figure 4, nonpublic entities are required to provide some disclosures, but the requirements are not as stringent as those for public entities.

Figure 4 — Specific disclosure requirements that apply only to public entities

Nonpublic entities generally receive some relief as they are not required to disclose certain quantitative information that is otherwise required for public entities.

Accounting area	Quantitative disclosure required for public entities only
Temporary differences and carryforwards	The tax effect for each type of temporary difference and carryforward
Differences between the statutory rate and effective tax rate	A numerical reconciliation (using dollars or percentages) of the entity's statutory tax rate to its effective tax rate
Unrecognized tax benefits	A table reconciling the beginning and ending balances of the entity's total unrecognized tax benefits; and The total amount of unrecognized tax benefits that, if recorded, would change the effective tax rate

Balance Sheet Reporting

Many companies prepare a classified balance sheet. As a general rule, entities must net their deferred tax balances by jurisdiction or different tax-paying components. Entities then aggregate the netted balances and present them as noncurrent assets or liabilities.

This section summarizes the specific reporting requirements for deferred income tax-related balance sheet accounts. In addition to the required presentation and disclosures for net deferred tax balances, an entity must present taxes payable or refundable as of the balance sheet.

Observation: Presentation of Income Taxes Payable or Refundable. Generally, income taxes payable is presented as a current liability, while income taxes refundable is presented as a current asset (receivable or prepaid asset). Entities typically use current classification because the amount due is either payable or receivable upon filing the return. Current classification is appropriate because the amount is expected to be settled, refunded, or utilized within one year or one operating cycle.

Furthermore, based on the reporting rules in Topic 740, an entity generally cannot offset a tax liability or amount due to a government body against cash or other assets on the balance sheet. In limited cases, however, an entity can offset assets against the tax liability.

Deferred tax assets and liabilities	
Presentation	**Required disclosures**
Noncurrent assets and liabilities on the face of the balance sheet Total deferred tax liabilities, total gross deferred tax assets, and their respective components (generally, presented in a table within the income tax footnote)	Disclosures about significant changes in the deferred tax balances, such as changes driven by: • Newly enacted tax laws or rates; • The tax status of an entity; • Assets acquired in or outside of a business combination; and • Adjustments to a valuation allowance for deferred tax assets. For the components of total deferred tax liabilities and total gross deferred tax assets: • Major types of temporary differences or carryforwards; • The estimated tax effect for each type that is responsible for a significant portion of deferred tax liabilities or deferred tax assets (before any valuation allowance); and • The amounts and expiration dates of net operating loss and tax credit carryforwards for tax purposes. Generally, disclosures about the components of total deferred tax liabilities and total gross deferred tax assets are provided in a table within the income tax footnote.

Caution: ASU No. 2018-02 — Stranded Tax Effects in Other Comprehensive Income. In February 2018, the FASB issued Accounting Standards Update (ASU) No. 2018-02, Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The ASU introduces presentation guidance for the statement of shareholders' equity, related to the enactment of the TCJA and changes in enacted tax rates.

The general guidance in Topic 740 regarding tax changes requires that corporate entities:

- Adjust all existing deferred tax balances to reflect the newly enacted rate of 21 percent; and
- Reflect the adjustment in income from continuing operations. This is true even for items that were originally recorded in other comprehensive income.

Many practitioners and preparers raised concerns to the FASB that, as a result of the requirements in Topic 740, the tax effects of the items initially recognized in other comprehensive income essentially become "stranded" in accumulated other comprehensive income. Banking and insurance entities may be the most affected by this rule due to the size of their asset portfolios and the significant amount of transactions that are accounted for through other comprehensive income. Constituents asked the FASB to consider an alternate way to record the tax effects of the TCJA, which would better reflect the tax effects of items initially recorded in other comprehensive income. The FASB responded by issuing ASU No. 2018-02.

The ASU offers an elective elimination of any stranded tax effects resulting from the enactment of the new rate. Under the new guidance, an entity can make an accounting policy election to reclassify the calculated tax effects of the deferred tax balances that remain in accumulated other comprehensive income to retained earnings.

ASU No. 2018-02 and the presentation guidance added to Topic 740 applies only to the tax effects of the TCJA. For any other change in tax law or tax rate, an entity must reflect the related adjustment to deferred taxes in income from continuing operations according to the general guidelines in Topic 740 for changes in tax laws or rates.

Valuation allowance	
Presentation	**Required disclosures**
Deduction from total gross deferred tax assets, generally presented in the income tax footnote	The net change in the valuation allowance during the year Any part of the valuation allowance for which future recognized tax benefits will be credited to shareholders' equity

Observation: Early-Warning Disclosures. The SEC expects an entity to discuss not only the past events that materially affected the results of operations; the SEC also expects an entity to provide "early-warning" disclosures, giving the users of the financial statements insight into the underlying critical assumptions that are reasonably expected to have a material effect on an entity's future reported results.

For instance, when preparing a tax return for the current year a company assumes a certain tax position and measures its deferred tax assets based on the merits of this position. If taxing authorities ultimately reject the position, it may require the entity to adjust its valuation allowance or record additional tax liabilities. The entity's explanation of the potential consequences of this position would be an example of an early-warning disclosure.

Unrecognized tax benefits	
Presentation	**Required disclosures**
This generally represents an additional tax that may be due if taxing authorities disagree with an uncertain tax position. Therefore, it generally is reported on the financial statements as a current liability.	The tax years that are still subject to examination by major tax jurisdictions A table that reconciles the beginning and ending balances of an entity's total unrecognized tax benefits The total amount of unrecognized tax benefits that would change the entity's effective tax rate if they were recognized The nature of the uncertainty surrounding the tax position and what could happen if it is reasonably possible that unrecognized tax benefits will change significantly in the next 12 months The total amounts of interest and penalties recognized in the balance sheet and income statement

Observation: Uncertain Tax Positions Resulting in Unrecognized Tax Benefits. An unrecognized tax benefit results from an uncertain tax position (UTP) that the entity has reflected on the tax return, but not on the financial statements because it failed to meet the "more-likely-than-not recognition criterion" in Topic 740. Consequently, the entity may be liable to pay additional income taxes if a tax authority disagrees with a tax credit, tax loss, or other tax position used to reduce the entity's taxes on its tax return. It is important for an entity to separately record and present any liabilities for unrecognized tax benefits from deferred tax liabilities.

Income Statement Reporting

Many companies simply present one line on their income statement for income taxes — total tax expense (or benefit). Many different factors and significant judgments, however, are involved in deriving this one reported figure.

This section summarizes the specific reporting requirements for activities that build up the total tax provision reported on the face of the income statement. The tax provision fluctuates from one reporting period to the next and can have a significant effect on an entity's operating results. It is paramount that an entity's financial statement footnote disclosures (and management discussion and analysis, or MD&A) explain how the tax provision affects its results and may have a material effect on future operations.

Income tax provision (benefit)	
Presentation	**Required disclosures**
Total tax expense (or benefit), current tax expense, and the significant components of income tax expense	The amount of total income tax expense (benefit) attributed to the various components of continuing operations, and the amounts of total income tax on discontinued operations, other comprehensive income, and shareholders' equity

Observation: Components of Income Tax Expense. The significant components of income tax expense can be disclosed either on the face of the financial statements or in the notes to the financial statements. The significant components might include:

- Current tax expense (or benefit)
- Investment tax credits (ITC)
- Government grants that reduce income tax expense
- Tax benefits due to net operating loss carryforwards and tax credits
- Tax expense due to allocating certain tax benefits directly to contributed capital
- Adjustments to deferred taxes for a change in tax law, rates, or tax status
- Adjustments to the valuation allowance's beginning balance due to new circumstances that change management's judgment about whether a deferred tax asset will be realized in future years
- Other components of deferred tax expense (or benefit)

An entity's income tax footnote must include a discussion of how the effects of changes in enacted tax rates and laws (including the TCJA) are reflected and included in current earnings from continuing operations. An entity's discussion of material uncertainties (within the MD&A) must include the effects of the enacted tax changes on future projections and the comparability of reported results.

Rate reconciliation	
Presentation	**Required disclosures**
An entity can present the required rate reconciliation using dollars or percentages.	A numerical reconciliation of the entity's statutory tax rate to its effective tax rate The nature and amounts of significant reconciling items

Observation: Disclosure Relief for Nonpublic Entities. All entities must explain significant differences between their statutory tax rate and their effective tax rate. A nonpublic entity, however, does not have to provide a numerical rate reconciliation — a material disclosure item for public entities that often requires significant effort to prepare and explain variances.

Interest and penalties	
Presentation	**Required disclosures**
Classify interest on income taxes as either income tax expense or interest expense Classify penalties as either income tax expense or another expense classification	The entity's policy for classifying interest and penalties on the underpayment of taxes

Accounting policies, significant estimates, and other relevant disclosures

Accounting policies	
Location	**Required disclosures**
The entity's accounting for income taxes generally is provided in the summary of significant accounting policies footnote.	The following is not an all-inclusive list: • A general description of its method of accounting for income taxes under Topic 740, including a general description of its types of temporary differences; • The entity's policy for classifying interest and penalties on the underpayment of taxes; and • Its method of accounting for investment tax credits (deferral method or flow-through method). Additional disclosures are required if the deferral method is used. In general, a change in accounting principle (including adoption of new accounting standards) can result in current and deferred tax consequences. An entity must disclose how a change in accounting principle has a material effect on its accounting for income taxes.

Significant estimates and other relevant disclosures	
Location	**Required disclosures**
Significant estimates and uncertainties surrounding its accounting for income taxes generally are provided in the income tax footnote to the financial statements.	The following is not an all-inclusive list: • Circumstances surrounding uncertain tax positions; • Circumstances when an entity does not recognize certain deferred tax liabilities; • The basis for recording (or not recording) a valuation allowance against related gross deferred tax; • Matters affecting comparability of the financial statements from one period to the next, such as notable changes in enacted tax laws, rates, or taxable status; • Disclosures when it is at least reasonably possible that a material change in estimate might occur in the near future; and • Subsequent events related to income taxes.

Observation: Focused Disclosures for Interim Reporting Purposes. Pretax income (or loss) and income tax provision (or benefit) are key financial reporting metrics. An entity's accounting for income taxes on an interim basis may create large fluctuations in the usual ratio of income tax provision (or benefit) to pretax accounting income (or loss). Therefore, an entity's disclosure objective at each interim reporting period is to enable the users of the financial statements to understand significant variations in this reported ratio. The objective is not to repeat the full annual disclosure required under Topic 740. In fact, representatives from the SEC have commented on numerous occasions that an entity must not provide redundant disclosures solely as an exercise to comply with financial disclosure requirements.

In particular, the interim reporting subtopic in Topic 740 has but one disclosure requirement. That is, entities must disclose in their interim financial statements the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if those reasons are not otherwise obvious from the financial statements or from the nature of the entity's business.

Beyond Income Taxes: The Effect of Tax Reform on Other Significant Areas of Accounting

The enactment of any major tax reform may also affect an entity's application of US GAAP to other accounting matters beyond Topic 740, Income Taxes. The following table summarizes some of the known potential effects of the TCJA on other important areas of financial reporting.

Goodwill impairment testing
An entity must perform a test for impairment of goodwill at least annually and whenever events or circumstances indicate that the fair value of a reporting unit may below its carrying amount. A change in tax law affects the measurement of an entity's deferred tax balances. Given the significant provisions in the TCJA, it is possible that the carrying values of a reporting unit shift so significantly that the enactment of the TCJA is an impairment indicator that would trigger an interim goodwill impairment test.
Investments in qualified affordable housing projects
The TCJA may affect a reporting entity that holds investments in qualified affordable housing projects to take advantage of low-income housing tax credits (LIHTC). The reduced corporate tax rates may have an adverse effect on the expected yield on investments in qualified affordable housing projects. Specifically, an entity must apply lower enacted tax rates to losses on existing LIHTC projects, resulting in a reduced value of deductible tax losses. A reduced value of deductible tax losses, in turn, may drive down the pricing for future LIHTC projects. Because investments in qualified affordable housing projects depend on available tax incentives and benefits, an entity is highly encouraged to consult tax specialists on the TCJA's direct and indirect effects on low-income housing tax credits. This understanding may affect an investor's expected benefits from flow-through entities, including investees in qualified affordable housing projects. An investor that holds investments for which valuation rests, at least in part, on the value of expected tax benefits must reconsider the recoverability of these investments and assess them for any potential impairment.
Hedging of foreign currency risk
Certain provisions of the TCJA may cause an entity to discontinue hedge accounting if it is no longer able to assess the probability of a forecasted transaction (i.e., whether the hedge remains highly effective or whether the hedge is now deemed ineffective because of certain enacted TCJA provisions). If an entity determines that the enactment results in an ineffective hedge, the entity must discontinue hedge accounting and report the effects immediately in current earnings. Reporting entities, therefore, are highly encouraged to consult tax specialists to understand the various provisions of the tax reform, and how the provisions may affect management's assessment of a particular hedging relationship's effectiveness. In addition, the move to a hybrid territorial tax system may affect entities that currently use after-tax hedging strategies or have investments in a foreign subsidiary.

Accounting for pension and postretirement benefits

Entities with defined pension and postretirement benefit plans must compute the effects of the TCJA's new tax rates on related deferred tax balances.

An entity must remeasure the deferred tax balances on the date of enactment, prior to performing its annual measurement as of December 31, 2017 and recording the tax effects of any changes in the plans' benefit obligations.

Accounting for share-based compensation

Some awards require performance conditions that are based on after-tax metrics (such as earnings per share and net income). As the tax effects of the TCJA come to light, this knowledge may affect an entity's vesting assumptions.

In addition, management may decide that it is in the company's best interest to modify the terms and conditions of an award with performance conditions that are based on after-tax metrics.

The lowered rates in the TCJA may also affect the entity's tax withholding requirements. Therefore, coordination between a company's tax department, payroll function, and third-party service providers is key.

Observation: Timing of the Annual Goodwill Impairment Test for 2017. Many calendar year-end entities use an annual testing date which may precede the enactment of a new law (e.g., an annual testing date of October 1 prior to the TCJA's enactment date of December 22, 2017). It would not be appropriate for those entities to use hindsight and consider the effects of the ultimate enactment when estimating the fair values and determining the carrying values of their reporting units. An entity can consider only market participant assumptions, events, facts, and circumstances that were present at of the measurement date.

For instance, if an entity's annual testing date for fiscal 2017 was before December 22, 2017, it would be considered an accounting error had the entity used adjusted income projections or updated forecasts of asset utilization that are driven by certain enacted provisions of the TCJA to execute its test.

If an entity's annual testing date preceded the enactment, the appropriate steps for the entity to take would have been to determine whether the TCJA is an impairment indicator, and (assuming the TCJA was deemed a triggering event) the entity would have undertaken another test for impairment as of December 22, 2017 — this time using information that was available and known to the entity at that time (e.g., the entity's understanding and interpretation of the provisions in the TCJA).

Observation: Fair Value Measurements. A major tax reform could have immediate effects on a company's net assets and long-term forecasts. The enactment of the TCJA, in particular, may have a significant effect on overall valuation of a business that operates or has investments across international borders. The enactment of a major law (especially one that influences management's long-term business and operating decisions) requires strong coordination between book and tax accountants who are responsible for preparing valuation models that use an income approach.

Observation: Disclosures Regarding Critical Accounting Estimates. These accounting areas typically are considered critical accounting estimates. An entity must consult with its tax specialists to understand the full accounting implications of a major tax reform on these other financial reporting areas. In addition to the required disclosures that are specific to the relevant GAAP applied, an entity must provide specific disclosures regarding its critical accounting estimates, such as the significant inputs and management judgments that went into the final reported estimates. An entity's application of the TCJA as it relates to these other areas of accounting would be included in the disclosure.

Observation: The Measurement Period in SAB No. 118 is Limited to an Entity's Accounting for the Tax Effects of the TCJA. The SEC is clear in stating that SAB No. 118 was issued specifically to address:

- The uncertainties and differing views about how the TCJA affects an entity's deferred taxes; and
- How the timing and complexity of the TCJA may create significant practical challenges in measuring and reporting income taxes under Topic 740.

Therefore, the measurement approach in SAB No. 118 does not extend to critical accounting estimates beyond the income tax provision. An entity, may not use SAB No. 118 to record provisional amounts for other critical accounting estimates under US GAAP — even if these other critical accounting estimates are affected significantly by the TCJA.

Pilar Garcia, CPA

Pilar Garcia is the Managing Editor of Catalyst: US GAAP. She is a Certified Public Accountant in New York and New Jersey, and has sixteen years of accounting and auditing experience. Ms. Garcia is a former senior manager in a Big Four accounting firm. She also worked in this Big Four's national office, specializing in financial reporting and SEC matters. Ms. Garcia has experience in a number of areas, including revenue recognition, business combinations, fair value measurements, and financial reporting under US GAAP and IFRS. She has participated on panels discussing technical subjects, such as SEC reporting and the new accounting models for revenue recognition and leases under US GAAP. Ms. Garcia has published materials on the new expected credit loss standard under US GAAP and accounting for income taxes, including the effects of tax reform on financial reporting. Ms. Garcia is a graduate of Rutgers Business School and the Newark College of Arts and Sciences.

Related Guidance

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CHECKPOINT LEARNING™ WEBINAR: INTRODUCTION TO ACCOUNTING FOR DEFERRED INCOME TAXES

An introduction to the topic of Accounting for Deferred Income Taxes (FASB ASC 740-10). Accounting objectives and the four basic principles applied to achieve those objectives will be covered.

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