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IFRS in Focus

Accounting for the effects of the U.S. tax reform legislation under IFRS

Contents

On 22 December 2017, the U.S. tax legislation commonly known as the Tax Cuts and Jobs Act (the "Act") was signed into law by the president. As a result, recognition of the tax effects of the Act is required in the interim and annual periods that include 22 December 2017.

Accounting for the effects of the Act under IAS 12 *Income Taxes* will present significant challenges for some entities. These could arise in determining how an aspect of the Act applies to the entity's specific facts and circumstances, in gathering data to quantify that application or a combination of the two. Nevertheless, all entities should make their best estimate of all effects of the Act in their financial statements and provide disclosures regarding significant judgements and estimation uncertainties as necessary. As new information becomes available or understanding of the Act is refined in subsequent periods those estimates should be revised.

The Act is a wide-ranging, complex piece of legislation that makes many changes to the Internal Revenue Code. This IFRS in Focus highlights the financial reporting effects of some of its most significant, widely-applicable provisions.

- A change in the corporate tax rate to 21 per cent compared to a maximum of 35 per cent.
- Modifications to the availability of net operating loss (NOL) carryforwards.
- The imposition of a Deemed Repatriation Transition Tax.
- The introduction of:
  - Global Intangible Low-Taxed Income (GILTI) provisions under which, in certain circumstances, income of certain foreign subsidiaries is included in the taxable income of its U.S. shareholder.
  - Base Erosion Anti-Abuse Tax (BEAT) payable by corporations earning profits in lower tax-rate jurisdictions.
  - New deductions related to foreign-derived intangible income and GILTI.
- The repeal of the Corporate Alternative Minimum Tax (AMT).

For more information please see the following websites:

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Change in Corporate Tax Rate

The Act reduces the corporate tax rate to 21 per cent, with effect from 1 January 2018. Because IAS 12.47 requires that deferred tax assets and liabilities (DTAs and DTLs, respectively) be measured at the enacted or substantively enacted tax rates that are expected to apply to the period when the asset is realised or the liability settled, entities must adjust the DTAs and DTLs in their financial statements for reporting periods ending on or after 22 December 2017.

For calendar year-end entities, what is the impact of the change in the corporate tax rate on DTAs and DTLs that exist as of the enactment date?

DTAs and DTLs that exist as of the enactment date (22 December 2017) and are expected to reverse after the Act's effective date (1 January 2018, for calendar year-end entities) should be adjusted to the new statutory tax rate of 21 per cent. Any DTAs and DTLs expected to reverse before the effective date would not be affected by the new statutory tax rate.

If some deferred tax balances are attributable to items previously recognised outside profit or loss (i.e., in other comprehensive income (OCI) or directly in equity), how should the adjustment for the effect of the tax rate change be presented?

As required by IAS 12.58 and 60(a), the effect of the change in tax rate on these items should be recognised either in OCI or directly in equity consistent with the recognition of original amount. This is sometimes referred to as "backwards tracing". In exceptional situations, if it is difficult to determine the amount of deferred tax that relates to items recognised outside profit or loss, IAS 12.63 permits use of a reasonable pro rata allocation.

The effect of backwards tracing means that the total tax expense (income) for the year will be the same whether or not a specific calculation of the effect of the Act on DTAs and DTLs is performed at the enactment date or this effect is incorporated in the measurement of DTAs and DTLs as at year-end.

Are the calculations for entities with a reporting and fiscal year-end other than 31 December (a "non-calendar year-end entity") the same as those that would be performed by a calendar year-end entity?

Not exactly. Given the mechanics of Internal Revenue Code (IRC) Section 15, we believe that the change in tax rate resulting from the Act will be administratively effective for a non-calendar year-end entity at the beginning of the entity's next fiscal year. In the current period (i.e., the period that includes the date of enactment), the tax rate applicable to the entity will be the "blended tax rate" (see below).

The applicable tax rates to be used in measuring deferred tax assets and liabilities for reporting periods post enactment date are, therefore, as follows:

- For balances expected to reverse after the enactment date and within the current fiscal year, the applicable rate is the "blended tax rate".

- For balances not expected to reverse within the current fiscal year, the applicable rate is the new statutory tax rate of 21 per cent.

What is meant by the "blended tax rate" and how is it calculated?

In accordance with IRC Section 15, the blended rate is based on the applicable rates before and after the change and the number of days in the period within the taxable year before and after the effective date of the change in tax rate.

This calculation is not affected by the timing of income generated during the year and is illustrated below for an entity with a 31 March 2018 year-end.

	Tax rate	Days under tax rate	Tax ratio	Tentative tax rate
Effective rate before enactment (1 April 2017 to 31 December 2017)	35%	275	75.34%	26.37%
Effective rate after enactment (1 January 2018 to 31 March 2018)	21%	90	24.66%	5.18%
Domestic federal statutory tax rate (blended tax rate)		365		31.55%

How would a non-calendar year-end entity reflect the effect of the changes in tax rate and laws in its interim financial statements, prepared in accordance with IAS 34, for periods within the annual period that includes the date of enactment?
When preparing the tax estimate to be included in an interim period, the tax expense is based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Therefore, as for other changes in estimates, amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period if the estimate of the annual income tax rate changes. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with IAS 34.28.

IAS 34 does not provide clear guidance on how to deal with a change in tax rate that has an effect on a deferred tax balance carried forward or arising during the interim period but which is not expected to be reversed in the current financial year. Accordingly, as an accounting policy choice, an entity may either:

- Include the effect of the change in a deferred tax balance as a result of a change in tax rate in estimating the average annual income tax rate, consequently spreading the effect throughout the financial year; or

- Recognise the effect of the change in tax rate in full in the period in which the change in tax rate occurs.

What rate should a non-calendar year-end U.S. entity use as the applicable tax rate when explaining the relationship between tax expense (income) and accounting profit, as required by IAS 12.81(c)?
The U.S. entity should use the blended tax rate as explained above.

Modification of Net Operating Loss Carryforwards

The Act modifies aspects of the tax law regarding net operating loss (NOL) carryforwards. Under previous tax law, NOLs generally had a carryback period of two years and a carryforward period of 20 years. The Act eliminates, with certain exceptions, the NOL carryback period and permits an indefinite carryforward period. The amount of the NOL deduction is limited to 80 per cent of taxable income, which is computed without regard to the NOL deduction.

In general, the amendments to carryback and carryforward periods and the limitation on NOL utilisation (tied to 80 per cent of taxable income) apply to losses arising in taxable years beginning after 31 December 2017.

How does the change in NOL utilisation affect the recognition of related deferred tax assets?
When considering future taxable income to justify the recognition of a DTA, an entity should look, among other things, to the future reversals of existing taxable temporary differences in periods prior to expiry of the NOL. Because losses arising in taxable years beginning after 31 December 2017 will not expire, the pool of taxable temporary differences that may be available to justify recognition of the resulting DTAs may be expanded and include, for example, the taxable temporary difference associated with an indefinite-life asset.

This would also generally apply to the recognition of a DTA arising from a deductible temporary difference that is scheduled to reverse into an NOL with an unlimited carryforward period.

However, the Act restricts the ability to use NOLs arising in taxable years beginning after 31 December 2017 to 80 per cent of taxable income in the year, and so only 80 per cent of the taxable temporary differences could serve as a source of taxable income. Where there are insufficient taxable temporary differences to support the recognition of a DTA in respect of NOLs, such that the recognition of the DTA relies on the existence of taxable profits in future periods, this limitation in use may extend the periods over which taxable profits need to be forecast. In such circumstances, an entity may be limited in its recognition of a DTA in respect of NOLs by the period over which it can reliably forecast taxable profits to be probable.

Deemed Repatriation Transition Tax (IRC Section 965)

The Act moves the United States from a worldwide tax system to a participation exemption system by giving corporations a 100 per cent dividends received deduction for dividends distributed by a controlled foreign corporation (CFC).

As a transition to this new system, the U.S. shareholder of a specified foreign corporation (SFC) must include in gross income, at the end of the SFC's last tax year beginning before 1 January 2018, the U.S. shareholder's pro rata share of certain of the SFC's undistributed and previously untaxed post-1986 foreign earnings and profits (E&P). The inclusion generally may be reduced by foreign E&P deficits that can be properly allocated to the U.S. shareholder. In addition, the mandatory inclusion may be reduced by the pro rata share of deficits of another U.S. shareholder that is a member of the same affiliated group. A foreign corporation's E&P are taken into account only to the extent that they were accumulated during periods in which the corporation was an SFC (referred to below as a "foreign subsidiary"). The amount of E&P taken into account is the greater of the amounts determined as of 2 November 2017 or 31 December 2017, not reduced by dividends (other than dividends to other SFCs) during the SFC's last taxable year beginning before 1 January 2018.

The U.S. shareholder's income inclusion is offset by a deduction designed to generally result in an effective U.S. federal income tax rate of either 15.5 per cent or 8 per cent. The 15.5 per cent rate applies to the extent that the SFCs hold cash and certain other assets, and the 8 per cent rate applies to the extent that the income inclusion exceeds the aggregate foreign cash position.

The Act permits a U.S. shareholder to elect to pay the net tax liability interest free over a period of up to eight years.

In its consolidated financial statements, an entity that holds subsidiaries, branches, associates and interests in joint arrangements (referred to herein as "investees") may need to recognise DTAs and DTLs at two different levels. First, it will need to apply the principles of IAS 12 with respect to the temporary differences related to assets and liabilities of its investees and recognise any resulting DTAs and DTLs along with the other assets and liabilities of its investees (e.g., on the same line as its own as part of the consolidation of its subsidiaries or as part of the carrying amount of investments accounted for under the equity method). These are sometimes referred to as "inside basis" differences. In addition, the entity is required to identify temporary differences arising from differences between the carrying amount of each investee in its consolidated financial statements (e.g., the net assets of subsidiaries or carrying amount of investments accounting for under the equity method) and the tax base of the investments held by entities with the consolidated group. This second level of temporary differences is sometimes referred to as "outside basis" differences. Outside basis differences generally arise in consolidated financial statements because the profits of an investee have been recognised (whether by consolidation or the equity method) but the tax base of the investment remains unchanged. IAS 12 imposes particular conditions on the recognition of deferred tax assets and liabilities in respect of outside basis differences.

- DTLs in respect of taxable outside basis differences are not recognised if the entity is able to control the timing of the reversal of the temporary difference and it is probable that this reversal will not arise in the foreseeable future.

- DTAs in respect of deductible outside basis differences are recognised only if it is probable that the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilised.

The deemed repatriation transition tax and the global intangible low-taxed income inclusion (see below) may result in an entity having to recognise a liability associated with outside basis differences that were previously not recognised under IAS 12. In particular, the deemed repatriation transition tax will increase the tax base of the investee which may trigger the immediate reversal of outside basis differences related to undistributed earnings in foreign investees.

Should an entity that is required to include post-1986 foreign earnings in its current-year taxable income but elects to pay the one-time deemed repatriation transition tax (under IRC Section 965) over a period of up to eight years classify the tax as a deferred tax liability or a current/non-current income tax payable?

In the period of enactment, the entity should recognise a current/non-current income tax payable for the transition tax due.

IAS 1 provides general guidance on the classification of accounts in statements of financial position. An entity should classify as a current liability only those cash payments that must, or are expected, to be made within the next 12 months to settle the transition tax. The instalments that the entity expects to settle beyond the next 12 months should be classified as a non-current income tax payable.

If an entity elects to pay the one-time deemed repatriation transition tax over an eight-year period, should the income tax payable be discounted?

Yes. While IAS 12.53 prohibits discounting of DTAs and DTLs, the measurement of current tax amounts is not subject to this prohibition. Accordingly, if the payment extends beyond the current period, the liability should be recognised at a discounted amount, if the effect of discounting is material.

Following the Act's establishment of a participation exemption system of taxation, may an entity nonetheless be required to recognise a deferred tax asset or liability as a result of a difference between the tax base and the carrying amount of a U.S. parent investment in a foreign entity (the "outside basis differences")?
Yes. Even under the new tax system, an entity may still be subject to income tax on its foreign investments in the future (e.g., foreign exchange gains or losses on distributions, capital gains on sale of investment, foreign income taxes, and withholding taxes) and if so, it will need to consider whether it needs to recognise any deferred taxes as a result of differences between the tax base and the carrying amount of foreign investments, using the requirements of IAS 12 with respect to outside basis differences explained above.

Should an entity consider the one-time deemed repatriation income inclusion to be a source of income when analysing the realisation of deferred tax assets in the year of the inclusion?
Yes, but in making that consideration the entity should verify that the one-time deemed repatriation income inclusion coincides with the timing of the deductions and other benefits associated with the DTAs and that it constitutes a source of taxable profits against which the DTA can be utilised (i.e., the taxable profit is of the appropriate type as per IAS 12.27A).

Global Intangible Low-Taxed Income

Although the Act generally eliminates U.S. federal income tax on dividends from foreign subsidiaries of domestic corporations, it creates a new requirement that certain income (i.e., GILTI) earned by controlled foreign corporations (CFCs) must be included in the gross income of the CFCs' U.S. shareholder in the period it arises. GILTI is the excess of the shareholder's "net CFC tested income" over the net deemed tangible income return (the "routine return"), which is defined as the excess of (1) 10 per cent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment of each CFC with respect to which it is a U.S. shareholder over (2) the amount of certain interest expense taken into account in the determination of net CFC-tested income.

A deduction is permitted to a domestic corporation in an amount equal to 50 per cent of the sum of the GILTI inclusion and the amount treated as a dividend because the corporation has claimed a foreign tax credit as a result of the inclusion of the GILTI amount in income ("IRC Section 78 gross-up"). If the sum of the GILTI inclusion (and related IRC Section 78 gross-up) and the corporation's foreign-derived intangible income (FDII) exceeds the corporation's taxable income, the deductions for GILTI and for FDII are reduced by the excess.

As a result, the GILTI deduction can be no more than 50 per cent of the corporation's taxable income (and will be less if the corporation is also entitled to an FDII deduction).

> The reversal of existing inside basis differences in a foreign investee (determined under U.S. tax rules) may result in taxable income in the year of reversal that would cause the entity to be subject to a GILTI inclusion in that year. This taxation of the entity, as a result of the GILTI inclusion, may result in an increase in the tax base of the foreign investee (from the perspective of the U.S. shareholder) and consequently in the reduction of an existing taxable outside basis difference.

How should an entity account for the effect of the GILTI on its tax amounts?
As noted above, a DTL in respect of taxable outside basis difference is not recognised if the entity is able to control the timing of the reversal of the temporary difference and it is probable that this reversal will not arise in the foreseeable future. A question arises as to whether the reduction of the outside basis difference that be arise as a result of a GILTI inclusion should be considered as a probable reversal of the outside basis difference for which a DTL needs to be recognised.

IAS 12 does not provide clear guidance on whether (and how) certain aspects of the GILTI may affect the recognition of DTLs related to the outside basis differences from foreign investees. For example, under IAS 12, the recognition of a DTL with respect to a taxable outside basis from investees is assessed investee by investee, whereas for tax purposes, GILTI is established by aggregating income from foreign investees.

There may also be significant practical difficulties in applying the principles of IAS 12 to the GILTI. In particular, the computation of GILTI is subject to future and contingent events that may render the estimation of whether, and to what extent, an entity will have a GILTI inclusion in a specific future year (when existing inside basis differences are scheduled to reverse) subject to a high level of uncertainty for certain entities.

Deduction for FDII

In addition to the immediate inclusion of GILTI, the Act allows a domestic corporation a deduction for a portion of the foreign-derived intangible income (FDII) and GILTI. The amount of the deduction is dependent, in part, on U.S. taxable income. The percentage of income that can be deducted is reduced in taxable years beginning after 31 December 2025.

How should entities account for the FDII deduction and the GILTI deduction?

The amount is a current income tax benefit that should be only recognised in the period in which the entity receives the FDII and/or GILTI deductions.

Base Erosion Anti-Abuse Tax (BEAT)

For fiscal years beginning after 31 December 2017, a corporation is potentially subject to tax under the BEAT provision if the controlled group of which it is a part has sufficient gross receipts and derives a sufficient level of "base erosion tax benefits." Under the BEAT, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation's modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5 per cent for taxable years beginning in 2018, 10 per cent for years beginning after 2018 and before 2026, and 12.5 per cent for years after 2025. However, the fixed percentage is 1 percentage point higher for banks and securities dealers (i.e., 6, 11, and 13.5 per cent, respectively).

What tax rate should entities that are subject to the BEAT provisions use to measure deferred tax amounts?

Because the amounts that may be payable under the BEAT provisions is based on a notion of taxable profit, it is an income tax within the scope of IAS 12 and accordingly, it may affect the tax rate used in the measurement of DTAs and DTLs.

In assessing how the BEAT provisions may affect the tax rate to be used in measuring deferred tax amounts, we would expect an entity to consider the following elements:

- The BEAT provisions are designed to be an "incremental tax," and accordingly an entity can never pay less than its statutory tax rate of 21 per cent.
- The entity may not know whether it will always be subject to the BEAT tax.
- It is expected that most (if not all) taxpayers will ultimately take measures to reduce their BEMTA exposure and therefore ultimately pay taxes at or as close to the regular rate as possible.

Accordingly, we believe that in many circumstances, entities may conclude that deferred taxes should be measured at the 21 per cent statutory tax rate, with any payment of incremental BEAT reflected as a period income tax expense.

Corporate AMT

The corporate AMT has been repealed for fiscal years beginning after 31 December 2017. Entities with AMT credit carryforwards that have not yet been used may claim a refund in future years for those credits even though no income tax liability exists. Entities can continue using AMT credits to offset any regular income tax liability in years 2018 through 2020, with 50 per cent of remaining AMT credits refunded in each of the 2018, 2019, and 2020 fiscal years and all remaining credits refunded in fiscal year 2021.

What is the impact of this change on the recognition of an asset with respect to AMT credit carryforwards?

Since the AMT credit will now be fully refundable regardless of whether there is a future income tax liability before AMT credits, the benefit of the AMT credit will be realised. Therefore, entities will need to recognise an asset with respect of AMT credit carryforwards for which recovery was not previously probable (and therefore did not qualify for recognition as a DTA).

Other issues

Does the initial recognition exception in IAS 12 apply to temporary differences that arise as a result of the Act?

No. IAS 12. 24 and 15(b) provide exceptions from the general requirement to recognise a DTA (subject to the expected availability of future taxable profits) or DTL for all temporary differences that arise on the initial recognition of an asset or a liability in a transaction which (1) is not a business combination, and (2) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss). Therefore, it can only be applied when an asset or a liability is first recognised.

Accordingly, when additional temporary differences arise as a result of the introduction of a new tax, and not when an asset or a liability is first recognised, the deferred tax effect of the additional temporary differences should be recognised. The deferred tax effect of any additional temporary difference arising in such circumstances will be recognised (subject to the general recognition criteria in IAS 12 for deferred tax assets) and presented as required by IAS 12.58.

How is uncertainty around the effect of the Act reflected in the financial statements?

As discussed above, there are many aspects of the Act which could provide challenges of interpretation, data collection or both.

Where this is the case, entities should consider the guidance in IFRIC Interpretation 23 *Uncertainty over Income Tax Treatments* on circumstances where the application of tax law is uncertain. This interpretation provides a framework for considering uncertainties, but it is important to note that neither IFRIC 23 nor IAS 12 itself permit either accounting on the basis of superseded tax law or omitting an element of tax on the basis of the practical difficulty of gathering data. In all cases, best efforts should be made to account for the effects of all relevant aspects of the Act.

What disclosure should be made in respect of the effects of the Act?
The quality of disclosures on income tax is already an area of regulatory focus, particularly around the effective tax rate reconciliation required by IAS 12.81(c). This should provide clear information about the key factors affecting the effective tax rate and its sustainability in the future. Proper identification and explanation of significant effects of the Act in this reconciliation will assist in a user's understanding of how the effective tax rate has changed and to distinguish between 'one-off' effects of the Act's introduction and effects that are expected to recur.

Entities should also consider how the process of accounting for the Act should be reflected in the disclosures required by IAS 1 on:

- the most significant judgements made in applying the entity's accounting policies; and

- the major sources of estimation uncertainty (including assumptions made about the future) that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities in the next financial year.

As for other disclosures made under these requirements, the disclosures provided should be clear and entity-specific and, when appropriate, should include quantitative information on, for example, the carrying amounts of assets and liabilities subject to measurement uncertainty.

How should the effects of the Act be reflected in the reporting of financial performance and any non-GAAP measures presented outside the financial statements?
As discussed in the Deloitte IFRS in Focus Closing Out 2017, the presentation of additional line items in a statement of profit or loss and the use of 'non-GAAP' figures (sometimes referred to as, for example, 'Alternative Performance Measures') is the subject of differing requirements from regulators in different jurisdictions. The effects of the Act on such measures (for example, whether they are or are not included in an 'adjusted EPS' or 'underlying net profit' figure) should be considered in light of both relevant regulatory guidance and the entity's existing policy on which additional items are presented and how those items are calculated.

If you have any questions about these issues, please speak to your usual Deloitte contact or get in touch with a contact identified in this IFRS in Focus.

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