

Implementing US federal tax reform

Five areas of potential complexity for
business taxpayers





Now that federal tax reform has been signed into law, businesses should turn their full attention to the challenges of implementing it. Significant tax implications will arise not only this year but beyond and will affect various business functions and decisions.

The changes to the new federal tax law are numerous, and business decision-makers and advisors have to consider the many technical details and uncertainties that exist. They also need to pay attention to effective dates, transitions and phase-in rules for different provisions and any forthcoming IRS guidance. Outlined below are five broad areas that may pose implementation challenges for businesses and questions to consider for each.

1

Tax accounting



Enactment of tax reform has significant implications for organizations' effective tax rates, income tax account balances and disclosures. These tax accounting effects and complexities span a number of the law's provisions. The Securities and Exchange Commission (SEC)'s Staff Accounting Bulletin (SAB) 118 provided some relief for companies that have not completed their accounting for the income tax effects of the new law in the period of enactment (the period that includes December 22, 2017).¹

By issuing the SAB, the SEC staff acknowledged challenges companies may face in accounting for the effects of the new law by their financial reporting deadlines. The Financial Accounting Standards Board (FASB) staff posted views in the form of Q&As on January 22, 2018 on implementation issues, including accounting for the base erosion anti-abuse tax (BEAT), accounting for global intangible low-taxed income (GILTI), and no discounting for the transition tax liability or future refunds for AMT credits.²

While the SEC and FASB have provided some guidance, there are still many complexities to consider. Internal controls will need to be revisited to make sure accounting implications of the transition and future tax provision calculations are accurately recorded in financial statements. Key areas to consider include calculation of the one-time transition tax (see below for more on that topic), assertions for unremitted earnings and outside basis differences after enactment, assessing the realizability of deferred tax assets for temporary differences and carryforwards, policy elections and calculating taxes with respect to GILTI and minimum taxes.

For those companies that file under International Financial Reporting Standards (IFRS) with regulatory bodies other than the SEC, timing and controls around accounting for the enactment may differ and require additional considerations.

Key tax accounting questions include:

01

What is the company's plan regarding SAB 118; which aspects of the Act will be accounted for as final versus which aspects will be reported as provisional?

02

What is the company's anticipated estimated effective tax rate on operations under the new tax regime beginning in 2018?

03

What changes will the company need to incorporate into its internal controls to address the provisions of the new tax regime, e.g., accounting for BEAT and GILTI in the future?

¹ See Tax Alert 2018-0021, "SEC staff provides guidance on accounting for the effects of US tax reform," January 4, 2018.

² See Tax Alert 2018-0129, "FASB staff to publish its views on tax reform accounting issues, FASB proposes guidance on related issue," January 18, 2018.

2 International tax

The new tax law shifts the United States from a worldwide to a territorial system of international taxation, potentially affecting many existing business structures and their supply chains. Among the key elements of the new system are a transition tax on deferred foreign earnings, new anti-base erosion provisions to protect the new territorial tax system and a reduced rate of taxation on certain income earned by US corporations from intangible property exploited outside the United States.³

The first guidance issued under the new tax law, IRS Notice 2018-07, and subsequent IRS Notice 2018-13, primarily addresses issues under the transition tax. More guidance is expected, but, in the meantime, some implementation questions include:

01

What processes should companies implement to correctly calculate the new taxes, inclusions in gross income and corresponding deductions (i.e., transition tax, BEAT, GILTI, foreign-derived intangible income (FDII) and the corresponding deductions)?

02

How can taxpayers avoid potential double counting of earnings and profits for purposes of the transition tax?

03

What is considered cash and cash equivalents for purposes of the transition tax?

04

How should the transition tax be calculated when foreign subsidiaries have different tax year-ends?

³ See Tax Alert 2017-2166, "US House and Senate release the Conference Report on the Tax Cuts and Jobs Act (H.R. 1)," December 20, 2017.

3

Pass-through entities



The law dramatically changes how pass-through income is taxed.⁴ Effective for tax years beginning after December 31, 2017 and before January 1, 2026, individual owners of certain pass-through entities can deduct 20% of domestic "qualified business income" (QBI) from a partnership, S corporation or sole proprietorship (qualified businesses), subject to certain limitations.⁵ Above a certain income threshold,⁶ the law caps the amount eligible for the 20% deduction based on W-2 wages and fixed asset purchases. The deduction does not apply to income from "specified service businesses,"⁷ unless the taxpayer's income is below the income thresholds. Additionally, the new law limits the ability of taxpayers other than C corporations to use a current-year "excess business loss" against other income (also effective for tax years beginning after December 31, 2017 and before January 1, 2026). In accounting for the pass-through deduction, the following implementation questions, among others, should be considered:

01

Is the 20% deduction available, considering the service-business exclusion and wage/basis limitation?

02

Given the income tax rate difference between a C corporation and an individual, would converting a pass-through to a C corporation make sense?

03

How would converting a pass-through to a C corporation affect future mergers, sales or other monetization transactions?

04

Would a hybrid structure with a C corporation and a pass-through make sense given the source of income, distribution plans and potential monetization transactions?

05

How might a conversion affect the company's accounting methods and trigger deferred income?

06

In light of the law's international tax changes, would converting from a pass-through be beneficial?

⁴ See Tax Alert 2017-2174, "Partnership considerations of the tax reform Conference Agreement," December 21, 2017.

⁵ QBI for a tax year is the net amount of domestic qualified items of income, gain, deduction and loss with respect to a taxpayer's qualified businesses.

⁶ The limit starts being phased in at an income threshold of \$157,500 for individuals and \$315,000 for married taxpayers filing jointly (indexed annually) and is fully phased in at income of \$207,500 for individuals and \$415,000 for married taxpayers filing jointly.

⁷ These include specified service trades or businesses, such as accounting, law, health, several other professions or service businesses related to investing, but do not include engineering and architectural businesses. The benefit starts being phased out at an income threshold of \$157,500 for individuals and \$315,000 for married taxpayers filing jointly (indexed annually for inflation) and is fully phased out at income of \$207,500 for individuals and \$415,000 for married taxpayers filing jointly.

4 Compensation

The new law expands the Section 162(m) \$1m deduction limit that applies to compensation paid to top executives of publicly held companies for tax years beginning after December 31, 2017.⁸ Private companies that issue public debt, as well as foreign private issuers, are now subject to the limitation, as well as entities that are required to file certain other SEC reports. Chief financial officers (CFOs) had previously been excluded from the category of "covered employees" under Section 162(m), but now they are explicitly included. The new law eliminates performance-based compensation exceptions and extends the deduction limitation to deferred compensation paid to all executives who previously held a covered employee position. For implementation purposes, there is a transition rule for compensation provided pursuant to a written binding contract in effect on November 2, 2017 and not modified materially thereafter.

The law also eliminates employer deductions for a variety of employee fringe benefits and work-related expenses, such as membership dues, commuting expenses and employer-provided moving expenses. A bar on deductions for business entertainment may also have an impact on business policies affecting employees.

These changes to the tax treatment of executive compensation paid by companies and to fringe benefits raise the following questions:

01

What companies are pulled into the new definition of "publicly held" for purposes of the \$1m deduction limit? Which compensation awards that were exempt from the \$1m deduction limit under the old law may continue to be deductible under the binding contract exception?

02

How will compensation programs be structured going forward?

03

With CFOs and a growing number of employees added over time to the "covered employee" group, what changes will a company have to make to track the members of this group of employees, and should a company consider changes to its executive compensation programs?

04

What changes should be made to existing policies and benefit programs to account for the law's changes to the deductibility of fringe benefits?

⁸ See Tax Alert 2017-2160, "Conference Agreement on the 'Tax Cuts and Jobs Act' includes significant executive compensation and employee benefits provisions," December 20, 2017.



5 State taxation

Every state that has an income tax relies in some way, shape or form on the Internal Revenue Code (IRC) to determine the state tax base. Some use the taxpayer's determination of federal gross income, adjusted gross income or taxable income as their starting point with specific subtractions or adjustments, while others incorporate specific IRC provisions. Most importantly, the 50 states differ on how, when and whether they will conform to the federal tax laws.

Now that the federal tax law has changed, attention will turn to the states. Businesses should monitor state legislative and administrative responses to federal tax conformity over the next few years, understand the impact on their multistate tax liabilities and consider the steps they should take to respond to forthcoming state tax law changes.⁹

Among the key questions to ask:

01

Should a business join in the state legislative IRC conformity discussions that are bound to unfold over the coming months?

02

Which of the business's legal entities own the foreign subsidiaries that will be subject to the federal transition tax, GILTI, FDII and BEAT, and in which states might they be subject to those taxes?

03

Will the states in which the businesses operate administer these international tax provisions in the same way the federal government will? Would these provisions conflict with the states' existing base erosion provisions (such as their related-party addback and tax haven rules), and might these states even be prohibited by the US and state constitutions, as well as statutory limitations, from taking the federal government's approach?

04

How will the states conform to the new 30% business interest expense limitation rule? If the limitation is determined on a federal consolidated basis, will the states follow the federal allocation among the business's legal entities or determine a limitation at the individual entity level instead? What is the state tax impact on the business's existing debt structure, including on existing intracompany debt, and what other limitations do those states impose on interest deductibility?

05

Which state and local governments will provide the best credits and incentives to reinvest the earnings the business may plan to distribute from foreign subsidiaries in response to the dramatic reduction in the federal tax rate? How can a business identify those opportunities?

⁹ See Tax Alert 2017-2171, "Final federal tax reform bill has state tax implications," December 21, 2017.



Conclusion

These questions provide a glimpse into some of the complexities businesses face as they acclimate to the new federal tax landscape and begin to understand and respond to the new law. More issues will emerge as the new tax policies are applied to real-world situations that tax policymakers may not have anticipated.

Businesses should carefully analyze the law's provisions and consider strategies in response to its large-scale changes. While remaining alert for further guidance, businesses must assess how their tax situations may have changed and begin addressing those changes head-on by modeling the applicable provisions and educating stakeholders and policymakers. Tax reform will continue to provide much for businesses to digest in the months ahead, not only at the federal level, but globally and at the state and local levels as well.



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SCORE no. 00935-181US

1801-2578456

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