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Financial Statement Impact of Potential Tax Reform

Since the election, President Trump and Republican lawmakers have been calling for a comprehensive tax reform overhaul. There are two items in particular that are intended to be addressed: high tax rates and a worldwide (international) taxing regime. The United States currently has one of the highest tax rates than any developed country—and by a significant margin. Additionally, the United States imposes income tax on a worldwide system (albeit deferred), while most other countries impose a territorial tax system, only taxing earnings generated within their borders.

Over the past year, two tax reform proposals have been released—the House GOP Blueprint and President Trump's tax proposal. In late July, the largest projected revenue raiser, a controversial change on imports/exports called the Border Adjustment Tax, was officially dropped from the House plan by the Ways and Means Committee. The "Big Six" group of Administration and congressional negotiators issued a statement on that issue:

> A tax reform bill is expected to be released in September. Taxpayers should be familiar with proposed changes and how they may be impacted.

"While we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform," said the joint statement by House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), Treasury Secretary Steve Mnuchin, National Economic Council Director Gary Cohn, Senate Finance Committee Chairman Orrin Hatch (R-UT), and House Ways and Means Committee Chairman Kevin Brady (R-TX).

On March 26, 2017, the White House released a one-page outline for its plans on tax reform as it continues to work with Congress and prepare an actual bill, a draft of which is expected shortly after Labor Day. The outline proposed by the White House followed the GOP Blueprint in many respects, but was very light on the details.

Republican tax negotiators believe they are closing in on an agreement to reform the U.S. tax code, but remain very much at odds over whether reform would be permanent or expire after a period of years. At this point, there are lots of discussions on how to tackle tax reform given the overall issue of revenue neutrality, given U.S. deficit constraints. We will provide a more updated report as that unfolds, until then this is our analysis of the prior two tax proposals:

PROVISION	CURRENT LAW	HOUSE REPUBLICAN BLUEPRINT	PRESIDENT TRUMP PROPOSAL
Corporate Tax Rate	35%	20%	15%
Alternative Minimum Tax (AMT)	20%	Repeal	Repeal
Cost Recovery	Deduct investment over life (MACRS)	"Full Expense" for tangible and intangible assets	Manufacturers may elect to "Full Expense"
Interest	Deductible	Can only deduct against interest income. Can be carried forward.	"Full Expense" manufacturers cannot deduct
Net Operating Losses (NOL)	20 year carry forward	Limited to 90% of TI; indefinite carry forward; increased interest for inflation	Not Stated
Taxing Regime	Worldwide	Territorial with 100% dividend exemption	Not Stated
Mandatory Repatriation	Currently not mandatory; taxed at 35%	8.75% on cash and equivalents; 3.5% on non-cash assets. Payable over 8 years.	Taxed at 10%

Corporate Tax Rates. Deferred tax assets and liabilities are measured and recorded on a company's balance sheet at the enacted tax rates expected to apply when the temporary differences are settled. Any change in the statutory rate for future periods would require taxpayers to revalue the deferred tax assets and liabilities for the rates that will be in effect when the temporary differences reverse. This change would be reported as a tax expense on the income statement and would be considered discrete if occurring during an interim reporting period. A phasing-in to enacting a reduced tax rate would give rise to further complications and would require consideration of the period in which the temporary differences are expected to reverse. In such a scenario, there are two methods that can be used: 1) The company can forecast its future income to determine which period it will reverse and use the appropriate rates, or 2) The company can use the highest enacted rate.

Cost Recovery/AMT/Interest. Changes to how companies record capital expenditure can give rise to significantly new deferred tax assets and liabilities. This is currently one of the bigger deferred items that a company has due to bonus depreciation allowances in recent years. Additionally, the removal of AMT may also have some offsetting benefits that are generally available to taxpayers with a large AMT exposure, such as AMT Credits. Taxpayers in industries with significant AMT exposure (e.g. mining industry) should review how all of these changes taken together would impact their tax calculations. Finally, any limitations on the deductibility of interest expense could significantly increase the reported effective tax rate of affected companies.

Net Operating Losses (NOL). Start-ups and companies that have gone through periods of reorganization usually carry significant NOL's to be used in future periods. Any changes to these rules can add a layer of complexity depending on whether this will be a prospective change (apply only to newly generated NOLs) or a retroactive change (apply to all carry-forwards available). Very frequently, NOL's are accompanied by valuation allowances. It is important to note that in general, tax planning strategies cannot be taken into consideration when determining future sources of taxable income in a jurisdiction where NOL's never expire. The rationalization is that a tax planning strategy is a plan that the company can use to avoid losing an expiring benefit. But if that benefit never expires, then a tax planning strategy would be futile.

Taxing Regime. Currently, U.S. taxpayers are subject to tax on their worldwide earnings. Generally, these earnings can be deferred, but in certain scenarios, subpart-F would eliminate the deferral and make those earnings taxed immediately. Moving to a territorial system would mean that taxpayers would only be subject to U.S. taxes on the earnings generated in the U.S. This would eliminate the need to provide for U.S. taxes on foreign earnings, regardless of whether the company has asserted that foreign earnings will remain overseas. One word of caution, however; there will likely be rules to prevent the movement of passive income outside U.S. taxing jurisdiction, and at least one idea that has been floated is to provide some sort of limitation or "toll charge" on the exporting of intangible property income. It is also possible that the U.S. tax deductibility of interest expense for taxpayers, which benefit from the territorial system, will be limited in some manner.

Repatriation. Taxpayers are not subject to U.S. tax on foreign earnings until they repatriate those earnings to the U.S. There is currently no requirement to repatriate such earning, but moving to a territorial taxing regime would require all taxpayers with offshore earnings to repatriate those accumulated earnings at a favorable tax rate. All of the current proposals include a provision to require repatriation of these earnings on favorable terms. The actual tax rate and timeframe for this repatriation are a matter of discussion. Indeed, the White House proposal did not include details on what this rate would be. Additionally, depending on the details, it is unclear to what extent foreign tax credits would be available.

What Does CohnReznick Think?

There is currently a great deal of uncertainty around what will ultimately be the final changes agreed upon in Washington, D.C. The White House is planning to release a preliminary bill around Labor Day for markup. Companies should understand and closely follow these discussions, while anticipating how any changes may affect their cash-flows and financial statements.

At CohnReznick, we are proactively working with our clients to model-out and quantify how these potential changes can impact a taxpayer's calculations and financial statements.

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