The 2019 National Multistate Tax Symposium
State tax reboot—The age of Multistate

February 6-8, 2019
Agenda

• Taxes and credits within the scope of ASC 740
• Consequences of Wayfair – ASC 450
• Identifying and measuring deferred taxes
• Uncertain tax positions
• Leases: Accounting for income tax implications – ASC 842
• State income taxes and federal tax reform
• Other considerations
Taxes and credits within the scope of ASC 740
ASC 740-10-05-1

• The Income Taxes Topic addresses financial accounting and reporting for effects of income taxes that result from an entity’s activities during current and preceding years

Mastery glossary definitions

• Income taxes: domestic and foreign federal (national), state, and local (including franchise) taxes based on income

• “Income” is not defined but “taxable income” is defined

• Taxable income: the excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority

Application

• ASC 740 is applied for a particular tax-paying component of an entity and within a particular jurisdiction
Scope
Distinctions between income and non-income taxes

<table>
<thead>
<tr>
<th>Financial statement item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense</td>
<td>• Recognized for both income and non-income taxes</td>
</tr>
<tr>
<td>Deferred tax assets and deferred tax liabilities</td>
<td>• Recorded for income taxes only</td>
</tr>
</tbody>
</table>
| Uncertainties            | • UTBs related to income taxes (ASC 740)  
                           • Contingent liabilities related to non-income taxes (ASC 450) |
| Presentation             | • Income taxes reported below the line  
                           • Non-income taxes reported above the line |
| Disclosure               | • Different disclosure requirements for income vs. non-income taxes |
Scope

Examples of taxes not within the scope of ASC 740

• Gross receipts taxes

• Capital taxes

• Taxes withheld on behalf of and for the benefit of the recipient of the payment or distribution (i.e., dividends, interest, royalties, services, etc.), assuming the recipient is not a member of the consolidated financial group

Whether a tax is an “income tax” may not be obvious, e.g.,

• An increasing number of jurisdictions assess taxes based on gross receipts less certain current period deductions (e.g., Texas)

• The tax law may state that the tax is not an income tax (e.g., Texas), but the tax may still be within the scope of ASC 740
Is a credit an income tax item?

Overview

• Determining whether credits are within the scope of ASC 740 may not always be clear; generally, refundable credits are accounted for outside the scope of ASC 740 since monetizing the credits is not dependent upon taxable income, whereas nonrefundable credits are in the scope of ASC 740.

• Should consider
  – Purpose of the credit
  – Impact on tax basis
  – How the credit is computed
  – How and when the credit is refunded or monetized

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Flowchart:

1. Is the credit refundable?
   - Yes: Record in pretax income
   - No: Continue to the next step

2. Can the credit be monetized outside of the income tax system?
   - Yes: Consider consultation (depends on facts and circumstances)
   - No: Credit is an income tax credit within the scope of ASC740
Consequences of *Wayfair* – ASC 450
Overview of ASC 450

Loss contingencies related to numerous non-income taxes are covered by U.S. GAAP ASC 450:

• Excise Taxes
• Sales and Use Taxes
• Gross Receipts Taxes (Washington B&O; Ohio CAT; etc.)
• Payroll Taxes
• Capital Stock and Franchise Taxes
• Property Taxes
• Local Taxes
• Canadian GST/PST/Retail Sales Tax
• European Value Added Taxes
• Withholding Taxes
• Any other tax not encompassed in ASC 740 Income Taxes
Known obligations are “liabilities” – not loss contingencies. In general, transaction taxes tend to be liabilities rather than contingencies.

“Contingency” – “[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible gain ('gain contingency') or loss ('loss contingency') to an entity that will ultimately be resolved when one or more future events occur or fail to occur." (see ASC 450-20).
Overview of ASC 450 – When Recognizing a Liability is Appropriate

An estimated transaction tax liability shall be accrued by a charge to income (accrued liability) when payment is required by law, even if it is uncertain whether the taxing authority is aware of the obligation and will demand payment.

An estimated loss from a contingency is accrued only if both of the following conditions are met:

• It is PROBABLE that the liability has been incurred at the date of the financial statements, AND

• The amount of the liability is reasonably ESTIMABLE.

Probable = “likely to occur” (a higher likelihood than “more likely than not”).
When a loss contingency such as the uncertain incurrence of a transaction tax liability exists, the likelihood that the future event or events will confirm the incurrence of the liability can range from probable to remote:

• Probable: The future event or events are likely to occur (higher level of likelihood than more likely than not contained in ASC 740).

• Reasonably possible: The chance of the future event or events occurring is more than remote, but less than likely.

• Remote: The chance of the future event or events occurring is slight.
Estimation Methodologies

The liability recognized for transaction tax should be the best estimate of the probable amount due to the tax authority under the applicable law.

If the best estimate of the liability is a range, and if one amount in the range represents a better estimate than any other amount within the range, that amount should be recorded. (see ASC 450-20-30-1).

If no amount in the range is a better estimate than any other amount, an entity should use the minimum amount of the range for recording the liability. (see ASC 450-20-30-1).
Estimation Methodologies (cont’d)

Taxpayers are not allowed to consider audit selection in calculating/recognizing a liability for transaction taxes.

The likelihood of being identified ("audit lottery") if a company does not comply with the law (i.e., does not file a return, does not collect tax on taxable transactions) is not a valid reason for not recording liabilities as incurred.

Similarly, tax audit detection risk is not acceptable criterion on which to base an adjustment to a transaction tax liability.
Estimation Methodologies (cont’d)

“Shortcut” approaches may be appropriate.

– A detailed analysis should be performed for benchmarking purposes to test the “shortcut” approach.

Accrued liability must include amounts for interest and penalties.

Accrued liability should assume that tax audits will take place and that any exposure will be uncovered by the audit.
Estimation Methodologies (cont’d)

Settlement percentage expectation may be an acceptable criterion in limited circumstances where:

- There is reasonable documentation to support the estimate (i.e., product sold is not subject to tax, exemption certificate on file, etc.); and

- The methodology used in calculating the anticipated percentage settlement is documented and reasonable.

**NOTE:** this may be more relevant in certain industries and with certain types of transactions.

- For example, a construction contractor in New York might take an exemption for all of its consumable supplies because most of its supplies are used at job sites for exempt customers. However, some percentage of the supplies may be determined to be subject to sales tax.
Recap

Probability Standards:

• Probable – future event or events are likely to occur
• Reasonably possible – The chance of the future event or events occurring is more than remote but less than likely
• Remote – The chance of the future event or events is slight

An estimated loss from a contingency is accrued if it is probable and reasonably estimable.
Identifying and measuring deferred taxes
Measuring deferred taxes
ASC 740-10-30-5

- Deferred taxes are determined separately for each tax-paying component (tax return filing group) in each taxing jurisdiction
- DTAs and DTLs for temporary differences are measured using the applicable tax rate (ATR) (Enacted tax rate* x Apportionment factor)
- Apportionment factors can significantly impact the state ATR
  - As a shortcut, entities sometimes use PY apportionment factors and CY statutory rate
  - Apportionment percentages should be adjusted for significant operational changes (e.g., acquisitions or divestitures, internal restructurings and significant changes in business operations); this method may yield a reasonable estimate

* Note: Tax rate expected to apply when temporary differences reverse (generally marginal rates unless graduated rates have material impact)
State Applicable Tax Rate
Overview

Generally, state ATR should be:

- Calculated for each taxpaying component within the consolidated financial reporting group
- Applied to that taxpaying component’s temporary differences
- A shortcut may be acceptable if it does not result in a material difference (considerations include, but are not limited to):
  - Different filing groups (e.g., worldwide, consolidated, separate entity, unitary)
  - Aggregate apportionment factors could be significantly greater than or less than 100%
  - Different inventory of temporary differences
  - Whether/how states decouple from federal (e.g., depreciation)
  - Adjusted gross receipts tax regimes (e.g., Texas)
## Blended vs. separate company ATR
### Example 1

Reporting entity has two entities, X and Y, which file in separate states, and have temporary differences of $900 and $100, respectively

<table>
<thead>
<tr>
<th>Description</th>
<th>Entity X</th>
<th>Entity Y</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year taxable income</td>
<td>100</td>
<td>200</td>
<td>300</td>
</tr>
<tr>
<td>State tax rate</td>
<td>3%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>3</td>
<td>10</td>
<td>13</td>
</tr>
</tbody>
</table>

### Current blended rate calculation:

\[
\text{Blended state rate} = \frac{\text{[b]}}{\text{[a]}} \times 100\% = 4.33\%
\]

### Separate Company rate calculation:

- Separate company state rates: 3% and 5%
- Separate company temporary differences: 900 and 100
- Deferred tax assets: 27 and 5

\[
\text{Difference} = \text{[c]} - \text{[d]} = 43 - 32 = 11
\]
### Blended vs. separate company ATR

**Example 2**

Reporting entity has two entities, X and Y, which file in separate states, and have temporary differences of $900 and $100, respectively.

<table>
<thead>
<tr>
<th>Description</th>
<th>Entity X</th>
<th>Entity Y</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year taxable income</td>
<td>(100)</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>State tax rate</td>
<td>3%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

**Current blended rate calculation:**

Blended state rate = $\frac{[b]}{[a]}$ = 10.00%

Consolidated temporary differences = 1,000

Deferred tax assets - incorrect = 100 | [c] |

**Separate Company rate calculation:**

Separate company state rates = 3% 5%

Separate company temporary differences = 900 100

Deferred tax assets = 27 5 32 | [d] |

Difference = [c] – [d] = 68

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Effective tax rate (ETR) vs. ATR

Example

Assumptions

- Corp X apportions its income to State A that has an enacted statutory rate of 7%
  - Current pretax income is $1,000 and unfavorable temporary differences are $800
- Corp X is implementing an approach that will shift its third-party licensing function to a NewCo and, with it, $200 of book and taxable income
  - Corp X will continue to file in State A and NewCo will be required to file in a new state with a statutory rate of 2%

Question

- What is the ATR and ETR after planning?

<table>
<thead>
<tr>
<th>Before planning</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Description</td>
<td>Corp X</td>
</tr>
<tr>
<td>Pretax income</td>
<td>$1,000 [a]</td>
</tr>
<tr>
<td>Temp differences</td>
<td>800</td>
</tr>
<tr>
<td>State taxable income</td>
<td>$1,800</td>
</tr>
<tr>
<td>State tax rate</td>
<td>7%</td>
</tr>
<tr>
<td>Current tax expense – State</td>
<td>$ 126</td>
</tr>
<tr>
<td>Deferred tax expense – State</td>
<td>($ 56)</td>
</tr>
<tr>
<td>Total income tax expense – State</td>
<td>$ 70 [b]</td>
</tr>
<tr>
<td>ETR</td>
<td>= [b] ÷ [a] 7%</td>
</tr>
<tr>
<td>ATR to measure temps</td>
<td>7%</td>
</tr>
</tbody>
</table>
ETR vs. ATR

Example – Answer – ETR and ATR after planning

<table>
<thead>
<tr>
<th>Description</th>
<th>Corp X</th>
<th>NewCo</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income</td>
<td>$800</td>
<td>$200</td>
<td>$1,000 [a]</td>
</tr>
<tr>
<td>Temp differences</td>
<td>800</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>State taxable income</td>
<td>$1,600</td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>State tax rate</td>
<td>7%</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Current tax expense – State</td>
<td>$112</td>
<td>$4</td>
<td>$116</td>
</tr>
<tr>
<td>Deferred tax expense – State</td>
<td>($56)</td>
<td>$0</td>
<td>($56)</td>
</tr>
<tr>
<td>Total income tax expense – State</td>
<td>$56</td>
<td>$4</td>
<td>$60    [b]</td>
</tr>
</tbody>
</table>

ETR = [b] ÷ [a] 6%

ATR to measure temps 7%
## ETR vs. ATR

### Example continued

**Additional facts and solution**

- Corp X and New Co have $2,000 of consolidated pretax income in Year 2 when temporary difference reverses, as follows

<table>
<thead>
<tr>
<th>Description</th>
<th>Corp X</th>
<th>New Co</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book income</td>
<td>$1,800</td>
<td>$200</td>
<td>$2,000</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>(800)</td>
<td>0</td>
<td>(800)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,000</td>
<td>$200</td>
<td>$1,200</td>
</tr>
<tr>
<td>State tax rate</td>
<td>7%</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Current tax expense – State</td>
<td>$ 70</td>
<td>$ 4</td>
<td>$ 74</td>
</tr>
<tr>
<td>Deferred tax expense – State*</td>
<td>$ 56</td>
<td>$ 0</td>
<td>$ 56</td>
</tr>
<tr>
<td>Income tax expense – State</td>
<td>$ 126</td>
<td>$ 4</td>
<td>$ 130</td>
</tr>
<tr>
<td>State ETR</td>
<td>7%</td>
<td>2%</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

*Temporary difference results in a tax savings at the rate of 7% in Year 2. If the DTA had been incorrectly recorded at the ETR of 6% in Year 1, the ETR in Year 2 would have been 6.1%.*
Facts

• A single entity company files tax returns in Jurisdiction A that has an enacted statutory tax rate of 9%

• In 20X0, the company apportioned 100% of its income to Jurisdiction A

• At the end of 20X0, the company had net taxable temporary differences of $500 expected to reverse at various times over the next 5 years

• During 20X0, Jurisdiction A enacts a phased-in triple weighted apportionment sales factor that will decrease the company’s total apportionment factor in Jurisdiction A to 60% over the next 5 years
### Scheduling of ATR

#### Example (cont’d)

#### Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Total balance sheet amount</th>
<th>Scheduled to reverse in</th>
<th>Total as scheduled</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>20X1</td>
<td>20X2</td>
</tr>
<tr>
<td>Deductible temporary differences</td>
<td>$4,500</td>
<td>$4,250</td>
<td>$ 250</td>
</tr>
<tr>
<td>Taxable temporary differences</td>
<td>(5,000)</td>
<td>(250)</td>
<td>(250)</td>
</tr>
<tr>
<td>Net temporary differences</td>
<td>($ 500)</td>
<td>$4,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Apportionment</td>
<td>100%</td>
<td>90%</td>
<td>80%</td>
</tr>
<tr>
<td>Tax rate</td>
<td>9%</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>State tax effect – correct</td>
<td>$ 324</td>
<td>$ 0</td>
<td>($ 27)</td>
</tr>
</tbody>
</table>

### Other Components

- **Net Temporary Differences**: ($500)
- **State tax effect of temps at current applicable rate - Incorrect**: ($45)
- **Fully phased in future apportionment**: 60%
- **Tax Rate**: 9%
- **“Expected” deferred without scheduling – Incorrect**: ($27)
Uncertain tax positions
State Income Tax Considerations of *Wayfair*

**Uncertainty in the income tax arena**

- In 1993, South Carolina Supreme Court held that physical presence was not required for the imposition of income tax, and that *Quill*'s physical presence standard was limited to only sales and use tax.
- To date, the U.S. Supreme Court has not granted certiorari in any case pertaining to economic nexus and income taxes.
- Number of states have enacted so-called “factor-based” economic nexus presence standards for income or gross-receipts type taxes.
- Taxpayers will need to revisit positions that they may have taken regarding the need for physical presence in order to establish substantial nexus.
- Potential retroactive application and enforcement to the effective date of a state’s applicable income tax nexus statute or rule is possible.
- *Wayfair* will also receive careful consideration by other states, which may seek to enforce or adopt economic factor-based presence nexus provisions.
- P.L. 86-272 remains in force and prohibits states from levying a net income tax upon an out-of-state company if the company’s activities in a state are limited to the solicitation of orders *for the sale of tangible personal property* and the orders are approved and filled from outside the state. Any sales of services can void this protection.
- Financial reporting considerations.
Unrecognized Tax Benefits Considerations

• Were positions taken on previous financial statements that could be affected by the Wayfair decision?

• Is the tax position “more likely to be sustained than not” on the basis of its technical merits? If “no”, record UTB for the full amount

  – Need to understand tax law in local jurisdictions

  – Nexus issues/considerations are intensively fact sensitive

    o PL 86-272

    o Consider the limitations of PL 86-272

    o Factor-based nexus standards – under a bright-line “factor-based” standard, nexus is created with a state when a minimum amount of payroll, property or sales in the state is met.

    o What are the reserve requirements if not filing in a state with a bright-line nexus statute based on a specified amount of in-state revenue that is lower than a company’s sales into that state?

    o What are the reserve requirements if not filing in a state with a broad nexus statute, but no specific threshold based on a defined amount if sales into the state?

    o Economic nexus – Will the Wayfair decision influence the number of states asserting economic nexus from an income tax perspective?

• Calculate interest and penalties
Administrative Practice and Precedent and Remediation

- Focal point in determining the number of years for which UTBs are recognized when returns have not been filed but are MLTN required

- Unless an administrative practice or precedent limits the look-back periods, UTBs are recorded for all “nexus” years when the recognition standard is not satisfied

- Deferred taxes must also be recognized if nexus is ongoing

- Administrative practices and precedents need to be widely understood

- Opportunity may exist to remediate nexus issues through voluntary disclosure agreements (VDAs) or state amnesty programs

- The lack of a statute of limitations period means that nexus exposures may continue to build year-over-year

- As nexus exposures can relate to periods many times the typical three-year statute of limitations periods, they may be more likely to be material to a financial statement audit.
Consider Impact of Nexus on Combined/Consolidated Filings

• “Joyce” states include the apportionment factor information of entities that individually have nexus with the state

• As a result of Wayfair, some affiliated groups may no longer have support for a position that in-state sales of an affiliate may be excluded from the combined group’s sales factor
Unrecognized tax benefits—deferred tax consequences example 1

Recording a liability for a UTB may result in a corresponding temporary difference and DTA

Assumptions

- Company A has taken a UTP in State B that reduces taxes payable by $10,000
- A determines that is it not MLTN that the position will be sustained upon examination
- A records a $10,000 UTB liability for the UTB
- Income taxes paid to State B are deductible for federal income tax purposes for A
- The federal tax rate is 20%

Question

How should A account for the UTB liability attributable to State B and any related indirect deferred tax assets?
Unrecognized tax benefits—deferred tax consequences example 1 (cont’d)

**Answer**

- Company A will receive an additional federal tax deduction if it is ultimately required to make an additional tax payment to the state.

- A should record a DTA for the indirect benefit from the potential disallowance of the UTP taken on its tax return in State B.

- A would record the following journal entries to account for the UTP and the indirect tax benefit:

| Journal entries |
|-----------------|-----------------|
| **DR** | **Current income tax expense** | $10,000 |
| **CR** | **Liability for state UTBs** | $10,000 |

To record the UTB liability in connection with the UTP for State B

| Journal entries |
|-----------------|-----------------|
| **DR** | **DTA for indirect tax benefit*** | $2,000 |
| **CR** | **Deferred income tax expense** | $2,000 |

To record the indirect tax benefit for the additional federal tax deduction

*Like other DTAs, the DTA created as a result of recording the liability for the UTB should be evaluated for realizability*
Unrecognized tax benefits—deferred tax consequences example 2

Recording a liability for a UTB may result in a corresponding temporary difference and DTA

Assumptions

- Company A has operations in State B but has never filed a tax return in that state
- A determines it may have nexus in State B and it is not MLTN that the position will be sustained upon examination
- A records a $10,000 liability for the taxes payable to State B for the current and prior years
- If A were to file a return in State B, it would also have a large deductible temporary difference that would result in a $8,000 DTA in State B.

Question

How should A account for the UTP and the related deductible temporary difference if A were to file a return in State B?
Unrecognized tax benefits—deferred tax consequences example 2 (cont.)

Answer

- A should record a DTA as a result of potential nexus in State B and evaluate for realizability
- Company A would record the following journal entries to account for the UTP and the related temporary difference:

<table>
<thead>
<tr>
<th>Journal entries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>To record the UTB liability in connection with the UTP for State B</strong></td>
</tr>
<tr>
<td>DR</td>
</tr>
<tr>
<td>CR</td>
</tr>
</tbody>
</table>

| **To record the DTA as a result of potential nexus in State B** |
| DR | DTA for indirect temporary differences | $8,000 |
| CR | Deferred income tax expense | $8,000 |

NOTE: In this scenario, A may have other tax consequences to consider as a result of recording a liability for taxes payable in State B (e.g. an additional federal deduction, as referred to in Example 1)
ASC 842, Leases
Accounting for Income Tax
Implications
Effective Date and Transition

Effective date

- Public business entities—effective for periods beginning after December 15, 2018, and interim periods therein (calendar 2019)
- All other entities—effective for periods beginning after December 15, 2019, and interim periods thereafter (calendar 2020)
- Early adoption is permitted

Transition

- Lessees and lessors are required to use a modified retrospective transition method for all existing leases
- Application of method linked to current lease classification and new lease classification
- Guidance in ASU 2016-02 requires that the new model be applied and reflected as of the earliest year presented in the financial statements
Where Are Your Leases?

Common Leases within an Organization

| Real estate | • Property leases generally represent one of the more significant areas of leasing within a healthcare services organization  
**Examples:** Third party manufacturing arrangements, storage facilities, corporate offices, shared office space, land |
| Manufacturing and transportation equipment | • Equipment within a manufacturing or storage facility could meet the definition of a lease regardless of whether the arrangement is described as a lease  
**Examples:** Manufacturing equipment, forklifts, cherry pickers, pallet jacks, yard dog truck, tractor, trailers, storage containers, and railcars |
| Internet, cable, and other technology-related services | • Internet, cable and other technology-related service agreements may include embedded leases of the equipment used to deliver the service  
**Examples:** Routers, modems, set-top boxes, cloud-based hosting arrangements that rely on dedicated assets |
| Other service agreements | • Service-based agreements that rely on the use of a dedicated asset should be evaluated as they may include an embedded lease  
**Examples:** Various services including mailroom and print management, food and beverage, cafeteria, document storage, storage units, laundry |
| Corporate office, vehicles, and other equipment | • Equipment used to support business operations at the corporate level should be evaluated to see if they contain or are a lease  
**Examples:** Printers, copiers, computer hardware, vehicles, aviation, other office equipment |

Note: for illustrative purposes only
Overview of Income Tax Implications

Lease characterization for federal income tax purposes has not changed (e.g., true lease vs. sale) as a result of ASC 842. For tax, the focus remains on which party bears the benefits and burdens of ownership.

ASC 842 **does not contain tax accounting guidance** and only includes minor, conforming amendments to ASC 740, *Accounting for Income Taxes*, that do not change the basic requirements of current accounting.

ASC 842 will create book/tax differences consistent with current GAAP. However, since the new standard may result in the recognition of more assets and liabilities, ASC 842 **may require entities to record new or adjust existing DTAs and DTLs**.

ASC 842 **may also impact the computation of state and local income-based taxes** as a result of changes to the apportionment formula.
State income taxes and federal tax reform. . .
Transition tax on deemed repatriation/actual repatriation

What you may hear

"States don’t tax subpart F income or foreign dividends” OR
"Those states that provide a partial exemption apply the exclusion to an amount net of the 965(c) deduction” OR
"Actual foreign cash dividends aren’t subject to state tax”

Why state tax impact may be different

• 18 states provide <100% DRD or exclusion for dividends paid by foreign corporations > 80% owned (many states with a full or partial exclusion also disallow related expenses)

• §965(c) deduction varies depending on conformity with many disallowing deduction

• Non-conforming states (e.g., California) may not tax repatriation amount but may tax a portion of actual dividends (e.g., California allows 75% DRD for dividends not from previously-taxed income and has an expense disallowance requirement for excluded amount)

What to analyze?

• Understand starting point based on ownership of CFC’s (i.e., population of applicable states)

• Model impact of repatriation amount (by legal entity): conformity, §965(c) deduction, income exclusion/DRD based on ownership percentage of CFC’s, disallowance of expenses, and inclusion in apportionment factor

• Track “untaxed” E&P in states that do not conform to §965(a)

ASC 740 Considerations

• Error v. change in estimate

• Indefinite reinvestment assertions (ASC 740-30)

• Analyze impact on valuation allowance and deferred taxes

• State applicable tax rate (e.g., worldwide, 80/20 rule)
### Assumptions
- §965 repatriation amount = $3B
- Blended (aggregate) state tax rate = 5%
- No cash dividends paid
- All deemed dividend is apportionable income
- §965 deemed inclusion in Subpart F income
- Single factor apportionment

### Potential conclusions
- If assume all DRD eligible, state tax = $0
- If assume all taxable, state tax = $150 million (5% x $3B)
- Based on specific state analysis below, state tax = $15.3M (before federal benefit)

### State Tax Considerations Example

<table>
<thead>
<tr>
<th></th>
<th>State A</th>
<th>State B</th>
<th>State C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conformity to 12/31/2017 IRC</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Deemed Dividend</td>
<td>-</td>
<td>$3B</td>
<td>$3B</td>
</tr>
<tr>
<td>DRD%</td>
<td>100%</td>
<td>80%</td>
<td>80%</td>
</tr>
<tr>
<td>Dividend amount incl. in state tax base</td>
<td>-</td>
<td>$600M</td>
<td>$600M</td>
</tr>
<tr>
<td>Dividends Statutorily Included In Sales Factor</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Sales Factor Numerator</td>
<td>$20M</td>
<td>$50M</td>
<td>$30M</td>
</tr>
<tr>
<td>Sales Factor Denominator</td>
<td>$100M</td>
<td>$100M</td>
<td>$3.1B</td>
</tr>
<tr>
<td>Sales %</td>
<td>20%</td>
<td>50%</td>
<td>1%</td>
</tr>
<tr>
<td>State tax rate (before federal benefit)</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Actual state tax (before federal benefit)</td>
<td>-</td>
<td>$15M</td>
<td>$300K</td>
</tr>
</tbody>
</table>
Global intangible low-taxed income ("GILTI")

What you may hear from a taxpayer

"GILTI isn’t taxable in states“ or “GILTI doesn’t impact my state tax apportionment“

Why state tax impact may be different

• In many states, GILTI is included in taxable income if the state does not decouple or provide a state-specific subtraction (many states with an exclusion disallow related expenses)

• To the extent GILTI is included in state tax base, consideration should be given to include GILTI income or CFC’s underlying attributional factors in Parent’s apportionment computation

• Identify state positions, elections and other adjustments, including worldwide filing options, previously-taxed income/state E&P considerations, and 80/20 analysis/tax haven rules

What to analyze?

• Understand starting point – applicable states (based on Company’s ownership of CFC’s) and taxability of Company’s GILTI; model state tax liabilities by legal entity

• Consider impact of GILTI inclusion and impact on underlying apportionment factors

• Based on materiality, model benefit of worldwide v. water’s edge options, consider qualification for 80/20 company rules for exclusion from select combined returns

ASC 740 Considerations

• Determine impact of GILTI on state AETR and state ATR

• Analyze impact on valuation allowance
Tax Reform and ASC 740 — state tax considerations

Value of performing a GILTI-specific state analysis — illustrative example

Federal context

• GILTI Inclusion Amount = $1B
• GILTI Deduction Amount = ($500M)
• FDII Deduction Amount = ($100M)

State tax assumptions

• Blended State Tax Rate: 6%

• All GILTI is apportionable income but is not included in the receipts apportionment factor

• Entity recognizing GILTI income is considered an 80/20 company that may be excludable from certain combined groups, as applicable

• States would not allow a “double benefit” for GILTI deduction, if GILTI income is not included in state taxable income
**Value of performing a GILTI-specific state analysis — illustrative example**

**Potential conclusions**

- If we assume all GILTI income is DRD eligible, state tax = $0
- If, however, we assume all GILTI is taxable, state tax = $24M ($400M * 6%)
- Based on specific state analysis shown below, however, state tax = $13.6M (before federal tax benefit)

<table>
<thead>
<tr>
<th>Conformity to 2018 IRC</th>
<th>State A</th>
<th>State B</th>
<th>State C</th>
<th>State D</th>
</tr>
</thead>
<tbody>
<tr>
<td>§ 951A GILTI Income</td>
<td>$0</td>
<td>$1B</td>
<td>$1B</td>
<td>$1B</td>
</tr>
<tr>
<td>DRD Applicable</td>
<td>N/A</td>
<td>No</td>
<td>No</td>
<td>100%</td>
</tr>
<tr>
<td>US Shareholder Files as part of Worldwide group?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Includable Income</td>
<td>$0?</td>
<td>$1B</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>§250 Deduction Allowed?</td>
<td>N/A</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Allowable Deduction</td>
<td>N/A</td>
<td>$0</td>
<td>$0</td>
<td>($100M)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$0</td>
<td>$1B</td>
<td>$0</td>
<td>($100M)</td>
</tr>
<tr>
<td>Group Apportionment %</td>
<td>10%</td>
<td>20%</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Actual State Tax</td>
<td>$0</td>
<td>$16M</td>
<td>$0</td>
<td>($2.4M)</td>
</tr>
</tbody>
</table>
Interest expense limitation (IRC §163(j))

**What you may hear from a taxpayer**

"We don’t have an interest limitation”

**Why state tax impact may be different**

- State interest limitation may exist even if there is no federal limitation
- State may not conform
- Existing state limitations on related party debt may impact the Entity’s limitation and/or ability to deduct interest in future years

**What to analyze**

- Compute interest limitation in context of separate company filing states and states with filing groups that differ from federal consolidated group

**ASC 740 Considerations**

- Consider impact on company’s state AETR
- Analyze impact on valuation allowance analysis (e.g., NOLs may be available to offset limited interest)
- DTA to record state limitation (federal limitation is a deferral, not disallowance)
- Consider state related party addback rules when considering state deferreds
Immediate federal expensing (IRC §168(k))

What you may hear from a taxpayer

“We don’t record a state specific DTA for state disallowance of bonus depreciation”

Why state tax impact may be different

• Many states do not conform to immediate expensing under §168(k) potentially resulting in significant federal and state basis differences. These differences may create a state DTA where a DTA does not exist for federal tax purposes

• Some state tax credits reference federal tax basis. Immediate expensing may impact an Entity’s ability to claim these credits

What to analyze?

• Calculate the difference between federal and state basis in depreciable assets

ASC 740 Considerations

• Consider state deferreds

• Analyze impact on valuation allowances

• Consider impact on any existing or expected state tax credits
10 Questions to Consider

1. Has the Company considered potential state interest expense limitations (even if no federal limitation) or has the Company considered whether there could be different limitations for separate company states or where consolidated group members differ from the federal group?

2. Has the Company considered consequences of changing ASC 740-30 assertions and/or cash distributions in non-conforming states (e.g., California)?

3. If there is significant GILTI, has the Company modeled specific state consequences on both a consolidated and separate entity basis, including CFC tested income netting/allocation? What is the state PTR related to repatriation tax?

4. Has the Company considered the impact of GILTI on the Company’s state applicable tax rate?

5. Has the Company considered a state DTA related to federal and state basis differences created by state non-conformity to §168(k)?
10 Questions to Consider (cont’d)

6. Has the Company undertaken cross-border restructurings and/or transactions? If so, has the Company considered state non-conformity to certain IRC sections, such as §1248 (e.g., California)? Has the company considered whether restructuring has an impact on existing state filing footprint or treatment on worldwide state filings, if any?

7. Has the Company considered state tax planning, including 80/20 positions, Subpart F treatment, state implications of deemed and actual repatriation, apportionment, elective filing options, etc.?

8. How does the Company monitor/address enacted and proposed state legislation, promulgated administrative guidance, and notices related to state taxing authorities?

9. Is the Company planning to increase investment through capital spending or expanded workforce?

10. Does the Wayfair decision impact the Company’s state filing footprint; and if so, how do any new state filings impact the Company’s analysis of tax reform?
Next steps... issues for immediate consideration

• If not yet done, analyze impact of the various TCJA provisions under current state law
  - Evaluate scenario planning for potential state legislation
• Update analysis of state temporary differences and related deferred taxes
• Consider how interest expense limitations could restrict state deductibility of interest expense and impact a company’s effective tax rate
• Analyze valuation allowances (if any)
• Consider possibly overlooked attributes (e.g., NOLs, credits, etc.)
Other considerations
State tax law changes
Impact to current and deferred income taxes

Current income taxes

• Local tax jurisdiction legislative changes and updates are reflected in the estimated annual effective tax rate calculation beginning no earlier than the first interim period that includes the enactment date of the new legislation

• Effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be recorded after the effective dates

Deferred income taxes

• Effects of tax law changes are recorded or taken into account in the period that includes the enactment date
  
  − Deferred tax balances are adjusted accordingly
Tax law changes

Enactment dates

Enactment date

• Often more difficult to determine for state and foreign jurisdictions than for federal (federal generally when President signs bill into law), for example:

  − Oregon tax law change – some legislative changes considered enacted upon voters approval and some when signed by Governor

State tax observations

• Federal tax reform creates many state considerations from an ASC740 perspective

• Recently, tax law changes have been related to sourcing of the sales factor and other apportionment factor changes

• In prior years, tax law changes focused more on tax base changes (MI, TX, OH)
Contingent state tax law changes

Example — Measurement

Question

• If a phased-in change in tax rates is enacted and the applicable future tax rate is contingent on an event outside the control of the entity, what are the acceptable methods under ASC 740 to determine the applicable tax rate to be used in measuring the tax consequences of existing temporary differences and carryforwards?

Considerations

• ASC 740 does not specifically address this matter; entities will need to establish a policy regarding the determination of the rate to be used in measuring DTAs and DTLs

• An entity should be consistent in applying whatever policy it ultimately chooses and ensure that it provides proper documentation regarding scheduling of DTAs and DTLs, the basis for judgments applied, and the conclusions reached
Considerations (cont’d)

• Approach 1 – determine if the difference in measurement between the two rates is material by scheduling future reversals and if material, make an assessment regarding whether the contingency will be met in order to determine the future rate by period

  – Similar to the application of graduated tax rates

  – Entities using this approach should have sufficient documentation regarding its assessment of whether the contingency will be met

• Approach 2 – establish an accounting policy to always use the highest of the enacted rates until the contingency is resolved and confirmation of the period being eligible for a lower rate is available

  – The lower rate would only be applied to those DTAs and DTLs for which the associated liability is expected to be settled or asset recovered in that one period for which the contingency is resolved
Contingent tax rate change

Example

Facts

• Company A has 50% apportionment in State 1 and 50% in State 2
• Company A has several DTAs and several DTLs that are expected to reverse over the next 10 years
• State 1 enacts a tax law that includes modification to the income tax rates to be phased-in over the next 5 years subject to certain contingencies, as follows

<table>
<thead>
<tr>
<th>Tax rate before change</th>
<th>5.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>5.5%</td>
</tr>
<tr>
<td>Year 2</td>
<td>6.0%</td>
</tr>
<tr>
<td>Year 3</td>
<td>6.5%</td>
</tr>
<tr>
<td>Year 4</td>
<td>7.0%</td>
</tr>
<tr>
<td>Year 5 and subsequent</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

- Rate increases in years 2 through 5 may be suspended if state spending limits are exceeded and the Governor approves the suspension

• Company A determines that it must remeasure its DTA and DTL pursuant to ASC 740 for the enacted law change
Contingent tax rate change
Example (cont’d)

Question

• What tax rate should Company A apply when measuring its DTAs and DTLs that are scheduled to reverse in years 2 and beyond?

Considerations

• ASC 740 does not provide specific guidance in determining what rate to apply when contingent on events that are outside the control of the entity. Two Alternative approaches for State 1:

  − Determine if the use of the higher rate would cause a significant difference compared to the use of the lower rate. If not applying the higher rate, Company A should have adequate documentation supporting its position. Must consider how objectively verifiable the contingency is and the likelihood of occurrence.

  − Company could adopt a policy to always apply the highest enacted rate until the event causing the contingency is resolved. If the contingency is resolved and the lower rate is applicable, measurement for the single year affected is appropriate.
State apportionment changes
ASC 740 implications

Deferred tax provision

• May cause remeasurement of recorded DTAs and DTLs, which should be included as a discrete item in the period the law change is enacted as prescribed by ASC 740-270-25-5

• The effect of remeasuring DTAs and DTLs should be presented as an item of income from continuing operations even if the DTA or DTL was originally established through an item other than continuing operations, e.g., OCI, discontinued operations, pursuant to ASC 740-20-45-8

Current tax provision

• The effect of the law change in the current year should be recorded after the effective date and reflected in the entity’s annualized ETR pursuant to ASC 740-270-25-5
Questions?
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