ASC 740 requires the effects of changes in tax rates and laws on deferred tax balances to be recognized in the period in which the legislation is enacted.

**Highlights**

- The Tax Cuts and Jobs Act significantly changes US income tax law, and companies need to account for the effects of these changes in the period that includes the 22 December 2017 enactment date.

- The SEC staff issued Staff Accounting Bulletin 118 to provide guidance for companies that are not able to complete their accounting for the income tax effects of the Act in the period of enactment.

- The Act reduces the corporate income tax rate to 21%, creates a territorial tax system (with a one-time mandatory tax on previously deferred foreign earnings), broadens the tax base and allows for immediate capital expensing of certain qualified property. It also requires companies to pay minimum taxes on foreign earnings and subjects certain payments from US corporations to foreign related parties to additional taxes.

- Companies with fiscal years that end on a date other than 31 December will need to use a blended tax rate because the new rate is administratively effective at the beginning of their fiscal year.

- The financial reporting effects of the Act may be complex, especially for multinationals. Companies also will need to make appropriate disclosures.

**Overview**

The Tax Cuts and Jobs Act (the Act), which President Donald Trump signed into law on 22 December 2017, aims to encourage economic growth and bring back jobs and profits from overseas by reducing US corporate income tax rates, creating a territorial tax system,
allowing for immediate expensing of certain qualified property and providing other incentives. The Act also includes various base-broadening provisions (e.g., the elimination of existing deductions) and anti-base erosion provisions.

On 22 December 2017 the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin (SAB) 118\(^1\) to provide guidance for companies that are not able to complete their accounting for the income tax effects of the Act in the period of enactment. In doing so, the SEC staff acknowledged the challenges companies may face in accounting for the effects of the Act by their financial reporting deadlines and said the guidance is intended to help companies provide investors with timely, decision-useful information.

The SEC staff noted that Accounting Standards Codification (ASC) 740, *Income Taxes*, does not address these challenges and said a clarification was needed to address uncertainty or diversity in views about the application of ASC 740 in the period of enactment. If a company does not have the necessary information to determine a reasonable estimate to include as a provisional amount, the SEC staff said that it would not expect a company to record provisional amounts in its financial statements for the income tax effects for which a reasonable estimate cannot be determined. In these cases, the SEC staff said a company should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. Ernst & Young LLP believes SAB 118 may be applied to non-SEC US GAAP financial statements when accounting for the effects of the Act.

The Financial Accounting Standards Board (FASB) staff has expressed preliminary views on implementation issues related to the accounting for the effects of the Act and plan to finalize Staff question and answer (Q&A) documents on these matters in near future. Companies should monitor developments.

This publication incorporates Ernst & Young LLP’s views on the accounting implications of the Act and the SAB and provides additional discussion on other accounting effects from the Act. It also addresses the accounting implications for companies that use fiscal years that end on a date other than 31 December, among other things.

\(^1\) SAB 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act*. 
## Contents

Summary of key provisions of the Tax Cuts and Jobs Act .................................................... 5

Timing of accounting for enacted tax law changes ............................................................... 6
  Subsequent events ......................................................................................................... 6

Effects of a lower corporate income tax rate........................................................................ 6
  Accounting considerations related to deferred tax assets and liabilities ....................... 6
  Prohibition on backward tracing .................................................................................. 7
  Changes in tax rates and adoption of new accounting standards (updated 16 January 2018) .............................................................. 8
  Accounting for the year of enactment ......................................................................... 8
  Accounting in the year of adoption .............................................................................. 8

One-time transition tax .................................................................................................... 9
  Cash versus other specified asset rate ........................................................................... 9
  Accounting considerations related to the one-time transition tax .................................. 10

The new territorial system ............................................................................................... 11
  Accounting considerations related to the territorial system ........................................... 11

Anti-deferral and anti-base erosion provisions .................................................................. 13
  Global intangible low-taxed income .............................................................................. 13
  Accounting considerations for GILTI provisions .......................................................... 13
  SAB 118 considerations for GILTI provisions (updated 16 January 2018) .................... 13
  Export incentive on foreign-derived intangible income ................................................. 14
  Accounting considerations for the export incentive for foreign-derived intangible income .................................................................................. 14
  Tax on otherwise deductible payments to related foreign corporations ....................... 14
  Accounting considerations for BEAT provisions .......................................................... 15

Effects of certain other key provisions ............................................................................ 15
  Changes to NOL carryback and carryforward rules (updated 16 January 2018) ............. 15
  Accounting implications on NOLs ................................................................................ 15
  Repeal of the corporate alternative minimum tax ............................................................ 16
  Accounting implications of AMT repeal (updated 16 January 2018) ......................... 16
  Interest expense deduction limits .................................................................................. 17
  Accounting implications of interest expense deduction limits ..................................... 17
  Immediate expensing ................................................................................................. 17
  Accounting implications of immediate expensing ........................................................ 17
  Limit on employee remuneration ................................................................................. 17
  Accounting implications of limits on employee remuneration ..................................... 18
  Tax method changes ................................................................................................. 18
  Restriction or elimination of exclusions, deductions and credits .................................... 18
Special considerations for non-calendar year-end companies ................................................................. 19
  Effects of a lower corporate income tax rate for non-calendar year-end companies – blended rate (updated 16 January 2018) ................................................................................................................................. 19
  Accounting considerations related to deferred tax assets and liabilities for non-calendar year-end companies ................................................................................................................................. 20
  Non-calendar year-end interim reporting considerations ........................................................................ 20
  Accounting for the effects of rate change on EATR .............................................................................. 21
  Accounting for changes in provisional amounts ................................................................................ 21
  Non-calendar year-end transition tax considerations .............................................................................. 21
  Non-calendar year-end entities’ interim disclosures ............................................................................... 22

SEC guidance on accounting for US tax reform (updated 16 January 2018) ............................................... 22
  SAB 118 and subsequent event considerations (updated 16 January 2018) ............................................. 25
  Measurement period ................................................................................................................................. 25
  Initial and subsequent reporting of provisional amounts ......................................................................... 26
  Investment companies affected by the Act .............................................................................................. 29

Other effects ............................................................................................................................................. 29
  Investments in qualified affordable housing projects accounted for using the proportional amortization method ................................................................................................................................. 29
  Tax effects of intercompany asset transfers prior to the enactment of the Act ........................................ 30
  Leveraged leases ...................................................................................................................................... 30
  Business combinations (updated 16 January 2018) ............................................................................... 31
  Goodwill impairment testing .................................................................................................................. 31
  After-tax hedging of foreign currency risk ............................................................................................. 31
  Annual pension and other postretirement benefit plans ......................................................................... 32
  Share-based payments (updated 16 January 2018) ............................................................................... 32
  Accounting considerations for withholding taxes ................................................................................. 32
  Accounting considerations for performance conditions based on after-tax metrics ........................................ 33
  Non pro-rata profit and loss allocations among investors (updated 16 January 2018) ............................. 33
  Fair value measurements (updated 16 January 2018) ......................................................................... 34
  Other considerations ............................................................................................................................... 34

Disclosures .................................................................................................................................................. 34
  Additional SEC disclosure considerations .............................................................................................. 36
  Form 8-K reporting considerations ...................................................................................................... 37

Internal control considerations .................................................................................................................. 37

What companies need to do now ............................................................................................................... 38

Preparing for reporting after the effective date ........................................................................................... 39

For additional information, please contact: ............................................................................................. 40

Appendix A: FASB staff Q&A: Whether private companies and not-for-profit entities can apply SAB 118 (updated 16 January 2018) .................................................................................................................... 41

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Summary of key provisions of the Tax Cuts and Jobs Act

The Act makes the following key changes to US tax law:

- Establishes a flat corporate income tax rate of 21% to replace current rates that range from 15% to 35% and eliminates the corporate alternative minimum tax (AMT)

- Creates a territorial tax system rather than a worldwide system, which will generally allow companies to repatriate future foreign source earnings without incurring additional US taxes by providing a 100% exemption for the foreign source portion of dividends from certain foreign subsidiaries

- Subjects certain foreign earnings on which US income tax is currently deferred to a one-time transition tax

- Creates a “minimum tax” on certain foreign earnings and a new base erosion anti-abuse tax (BEAT) that subjects certain payments made by a US company to a related foreign company to additional taxes

- Creates an incentive for US companies to sell, lease or license goods and services abroad by effectively taxing them at a reduced rate

- Reduces the maximum deduction for net operating loss (NOL) carryforwards arising in tax years beginning after 2017 to a percentage of the taxpayer’s taxable income, allows any NOLs generated in tax years beginning after 31 December 2017 to be carried forward indefinitely and generally repeals carrybacks

- Eliminates foreign tax credits or deductions for taxes (including withholding taxes) paid or accrued with respect to any dividend to which the new exemption (i.e., the 100% exemption for the foreign source portion of dividends from certain foreign subsidiaries) applies, but foreign tax credits will continue to be allowed to offset tax on foreign income taxed to the US shareholder subject to limitations

- Limits the deduction for net interest expense incurred by US corporations

- Allows businesses to immediately write off (or expense) the cost of new investments in certain qualified depreciable assets made after 27 September 2017 (but would be phased down starting in 2023)

- May require certain changes in tax accounting methods for revenue recognition

- Repeals the Section 199 domestic production deductions beginning in 2018

- Eliminates or reduces certain deductions (including deductions for certain compensation arrangements, certain payments made to governments for violations of law and certain legal settlements), exclusions and credits and adds other provisions that broaden the tax base

Many of the provisions could have state and local tax implications. Most state income tax laws use federal taxable income as a starting point for determining state income tax. While some states automatically adopt federal tax law changes, other states conform their laws with federal law on specific dates. States also may choose to decouple from new federal tax provisions and continue to apply current law. A company may need to follow one set of rules when determining taxable income for US income tax purposes and multiple sets of rules when determining state and local taxable income.
Because states generally do not conform their income tax rates with changes in the federal tax rate but generally conform to the federal definition of taxable income, state income taxes could rise as the federal tax base expands. Companies should understand the conformity rules in the states in which they operate so they can appropriately account for the effects on their state income taxes.

**How Ernst & Young LLP sees it**

The law could have significant income tax accounting implications for companies, beginning in the period of enactment. As a result, companies should not underestimate the time needed to focus on their accounting and disclosure for the financial reporting effects of the new law.

**Timing of accounting for enacted tax law changes**

ASC 740, *Income Taxes*, requires the effects of changes in tax rates and laws on deferred tax balances (including the effects of the one-time transition tax discussed below) to be recognized in the period in which the legislation is enacted. See section 8.1 *Changes in tax laws and rates*, of Ernst & Young LLP Financial reporting developments (the FRD) publication, *Income Taxes*. US income tax laws are considered enacted on the date that the president signs the legislation.

While the effective date of the new corporate tax rates is 1 January 2018, a company is required to calculate the effect on its deferred tax balances as of the enactment date. For companies with fiscal years that do not end on 31 December, the new lower corporate rate is applied by determining a blended tax rate for the fiscal year that includes the enactment date. Therefore, the effect of the rate change on a non-calendar year-end company’s current and deferred income taxes is considered in the first interim period that includes the enactment date (refer to the *Special considerations for non-calendar year-end companies* section below).

**Subsequent events**

If a company’s fiscal year ended before the enactment date but it hadn’t yet issued its financial statements on that date, the company should make appropriate disclosures about the change in tax law as a subsequent event. ASC 740 states that a company should not include the effect of a new tax law in its financial statements earlier than the period that contains the enactment date.

**Effects of a lower corporate income tax rate**

**Accounting considerations related to deferred tax assets and liabilities**

The Act established a flat corporate income tax rate of 21% to replace previous rates that ranged from 15% to 35%. Companies need to apply the new corporate tax rate when calculating the effects of the tax law change on their deferred tax balances as of the enactment date.

Calendar year-end companies may determine the effects of the rate change using year-end temporary differences if the temporary differences are expected to approximate the companies’ deferred tax balances as of the enactment date. However, these companies may need to make adjustments for material unusual or infrequent transactions that occurred between the enactment date and year end. Further, any assets or liabilities that are measured at fair value on a recurring basis (e.g., available-for-sale-securities) should be adjusted to fair value at the enactment date. Companies that use a fiscal year ending on a date other than 31 December are also required to account for the effects of the change in the tax law on its deferred tax balances as of the enactment date. Estimating temporary differences as of the enactment date may present additional challenges for these companies (see the *Special considerations for non-calendar year-end companies* section below).
Under the guidance in SAB 118, companies that have not completed their accounting for the effects of the lower corporate tax rate but can determine a reasonable estimate of those effects should include a provisional amount based on their reasonable estimate in their financial statements. If they cannot make a reasonable estimate of the effects of the Act, companies should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. See the SEC guidance on accounting for US tax reform section below.

The lower corporate income tax rate reduces the future tax benefits of existing deductible temporary differences, such as accruals for pension liabilities and net operating loss carryforwards. It also reduces the expected future taxes payable from the reversal of existing taxable temporary differences, such as those related to accelerated depreciation on property and equipment.

Companies need to remeasure existing deferred tax assets (including loss carryforwards) and liabilities and record an offset for the net amount as a component of income tax expense from continuing operations in the period of enactment. If a company changes the amount of a previously recorded valuation allowance as a result of remeasuring existing temporary differences and loss carryforwards, the amount of the change in the valuation allowance is also reflected in continuing operations.

**Illustration 1 – How changing the tax rate affects taxable temporary differences**

Assume that at the end of 2017, a calendar year-end company’s only temporary difference is a $1 million taxable temporary difference that arose in the prior year and is expected to reverse in 2018 and 2019. The deferred tax liability at the beginning of 2017 is $350,000, reflecting the 35% corporate tax rate in effect at that date. On 22 December 2017, legislation was enacted that reduced the tax rate to 21%, effective 1 January 2018.

The company’s deferred tax liability at 22 December 2017 would be $210,000 ($1 million x 21%). As a result of applying the new 21% tax rate, the deferred tax liability would be reduced by $140,000 ($350,000 − $210,000) as of 31 December 2017. The $140,000 adjustment would be recorded as an income tax benefit in continuing operations in 2017.

Note: If a portion of the temporary difference was expected to reverse in 2017, the company would first be required to estimate its temporary differences as of the enactment date rather than using the beginning of the year balance.

**Prohibition on backward tracing**

In some situations, deferred tax assets and deferred tax liabilities relate to transactions that initially were accounted for as direct adjustments to shareholders’ equity or other comprehensive income, and the offsetting tax effects also were accounted for as equity or other comprehensive income adjustments. Examples include the deferred tax effects on foreign currency translation adjustments, unrealized holding gains and losses for available-for-sale securities, and cash flow hedges and pensions and other postretirement benefits that are reported in other comprehensive income.

The effect of income tax law changes on deferred taxes initially recorded as shareholder equity or in other comprehensive income is recorded as a component of tax expense related to continuing operations in the period in which the law is enacted. Similarly, the effects of tax law changes on deferred tax assets and liabilities related to prior-year items reported in discontinued operations or initially recorded in connection with a prior business combination are reflected in continuing operations in the period the tax law is enacted. This is consistent with ASC 740’s general prohibition on backward tracing (i.e., an entity would not consider where the previous tax effects were allocated in the financial statements). See section 8.6, Change in tax law or rates related to items not recognized in continuing operations, of the FRD on income taxes.
Because of the prohibition against backward tracing, debits or credits related to income taxes will be stranded in accumulated other comprehensive income. Companies should continue to follow their existing accounting policies to clear out the remaining stranded debits and credits in other comprehensive income balances related to income taxes.

FASB meeting – 10 January 2018

The FASB decided to add a narrow-scope project on the reclassification of certain tax effects stranded in accumulated other comprehensive income OCI and instructed the FASB staff to draft an exposure draft that would require the amounts to be reclassified to retained earnings. The narrow-scope project will address only the reclassification from OCI to retained earnings of stranded amounts resulting from the new corporate tax rate. However, the Board decided to add a project to its research agenda on the broader issue of backward tracing. Companies should continue to monitor the status of this project for further developments.

The following illustration shows the effect of the change in law when a deferred tax asset has been recognized for operating loss carryforwards.

<table>
<thead>
<tr>
<th>Illustration 2 – Effect of income tax law change on items not originally recognized in continuing operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assume that a calendar-year company has only one deferred tax item, an NOL carryforward related to losses of $100 million from discontinued operations recognized in the prior year. The carryforward is expected to reduce taxes payable in 2018 and beyond and cannot be carried back. The effect of a decrease in the tax rate to 21% from 35% ($14 million) enacted in December 2017 would be reflected in continuing operations in 2017, despite the fact that the deferred tax asset was originally recorded in discontinued operations.</td>
</tr>
</tbody>
</table>

Changes in tax rates and adoption of new accounting standards (updated 16 January 2018)

Many public business entities adopted new accounting standards (most notably, ASC 606, Revenue from Contracts with Customers) on 1 January 2018 (or shortly thereafter, depending on their fiscal year end). The following discussion focuses on ASC 606, but the concepts apply to any new accounting standard or accounting change that revises amounts previously reported for periods prior to the enactment date of the new tax law. For a broader discussion of the interaction of changes in tax law and the adoption of new accounting standards, see section 8.5, Changes in tax rates following adoption of new accounting standards, of the FRD on income taxes.

Accounting for the year of enactment

Companies that have not adopted a new accounting standard prior to the enactment date need to first calculate the tax accounting effects of the new tax law (e.g., remeasure deferred taxes for the tax rate change and record an offset to tax expense) without considering the change in accounting that will occur in the future. For example, if a calendar year-end company is adopting ASC 606 on 1 January 2018, its 2017 annual financial statements included in the 2017 10-K will show the effects of the enactment of the new tax law but not the effects of ASC 606.

Accounting in the year of adoption

Companies that account for the adoption of a new accounting standard after accounting for the effects of changes in the tax law will likely need to calculate the enactment date effects of the Act for a second time if the new accounting standard changes the financial results for transactions that occurred prior to the enactment date. The first calculation would be for the
reporting period that included the enactment date (e.g., the period ended 31 December 2017). The company will then need to account for the income tax effects of adopting the new standard, which will change the previously reported financial results (i.e., a change to the previously issued financial statements that included the period of enactment or a change reflected in the cumulative catch-up effect of adoption).

For example, if a company adopts the new revenue standard on 1 January 2018 and elects to use the full retrospective method, it will first recast its 2016 financial results and its 2017 financial results for the period prior to enactment based on the tax law in effect during those periods. The effects of tax reform on the enactment date will then be recalculated based on the revised ASC 606 results. This means that the enactment date effects of the Act in a company's recast financial results will generally differ from the amounts reported in the 2017 financial statements that a company issues.

Under the modified retrospective method, a company will first need to elect either to apply the new revenue guidance to all contracts as of the date of initial application or only to contracts that are not completed as of that date. Based on that election, a company will recognize a cumulative catch-up adjustment to the opening balance of retained earnings on the date of initial application. Like companies that use the full retrospective approach, companies will need to consider the tax laws in effect during the contract period to calculate the income tax effects of the cumulative catch-up adjustment. Therefore, for companies electing to use the modified retrospective approach, the change in the enactment date effects of the Act as a result of applying ASC 606 will be embedded in the tax effect of the cumulative catch-up adjustment.

### One-time transition tax

Foreign earnings on which US income taxes were previously deferred are subject to a one-time tax when the company transitions to the new dividend-exemption system. Generally, US corporations need to include in income for each specified foreign subsidiary’s last tax year beginning before 2018 their pro rata share of the net post-1986 historical earnings and profits (E&P) of the foreign subsidiary if E&P has not been previously subject to US tax. The foreign earnings subject to the transition tax need to be measured on 2 November 2017 and on 31 December 2017, and the transition tax is based on the greater amount.

The portion of the E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate. A company can elect to pay its tax liability over a period of up to eight years based on the payment schedule included in the law.

### Cash versus other specified asset rate

The portion of the E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate. To determine the aggregate foreign cash position of the US shareholder, cash is measured on the following three dates:

- **Date 1** – The close of the last taxable year beginning before 1 January 2018
  (31 December 2017 for a calendar year-end company)

- **Date 2** – The close of the last taxable year that ends before 2 November 2017
  (31 December 2016 for a calendar year-end company)

- **Date 3** – The close of the taxable year preceding Date 2 (31 December 2015 for a calendar year-end company)

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2 That is, the difference between (1) what was originally reported (and will continue to be reported in the 2017 financials) as the effects of enactment prior to the adoption of ASC 606 and (2) the recomputed effects of enactment after factoring in the adoption of ASC 606.
The aggregate foreign cash position for a US taxpayer is the greater of the foreign cash position determined as of Date 1 or the average of the foreign cash positions determined as of Date 2 and Date 3.

A company with non-calendar year-end foreign subsidiaries may not be able to determine its aggregate foreign cash position until the end of its 2018 fiscal year. As a result, such a company would need to consider whether the amount it recognized for its one-time transition tax payable can be completed earlier than that date (see the Special considerations for non-calendar year-end companies section below).

Existing net operating loss and foreign tax credit carryforwards can be used to offset the transition tax. However, the Act sets certain limits that may restrict a company’s use of any foreign tax credits generated from the one-time transition tax.

Accounting considerations related to the one-time transition tax

A company needs to recognize the income tax accounting consequences of the one-time transition tax as a component of income tax expense from continuing operations in the period of enactment. Companies that recognized deferred taxes for prior foreign earnings may need to adjust previously recognized deferred tax liabilities and consider the classification of the transition income tax payable.

Companies applying the guidance in SAB 118 when their accounting for the one-time transition tax is incomplete should include a provisional amount in their financial statements if they can determine a reasonable estimate. If they cannot make a reasonable estimate of the effects, companies should continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to enactment. For example, if a company previously asserted indefinite reinvestment for a particular entity, Ernst & Young LLP believes the company could continue to follow its existing accounting until it has the necessary information to determine a reasonable estimate for the transition tax for that entity. See the SEC guidance on accounting for US tax reform section below.

While the transition tax is intended to apply to all post-1986 taxable E&P of a company’s non-US investees that were previously tax deferred, it does not necessarily eliminate book and tax basis differences. Companies still need to determine the outside basis differences for each of their foreign subsidiaries after taking into consideration payment of the transition tax. For example, there still may be a book and tax basis difference related to the investment that requires the company to evaluate whether any of the exceptions for recording deferred taxes under ASC 740-30 apply (e.g., indefinite reinvestment assertion or the prohibition on recognizing deferred tax assets related to an investment in a subsidiary unless it will reverse in the foreseeable future). Also, there may be withholding taxes in foreign jurisdictions that are only triggered on distribution of earnings to shareholders and taxes that apply upon disposition of the investments.

Additionally, companies need to consider the effect on the balance sheet classification between current and noncurrent if they elect to pay the transition tax over the allowed period of time. Companies can elect to pay the transition tax without incurring interest over a period of up to eight years.

It is understandable that questions exist about whether the guidance in ASC 835-30, Interest – Imputation of Interest, applies to long-term income taxes payable. Further, if discounting applies, a question would arise about how to classify the periodic interest expense (e.g., consistent with the classification of interest on tax uncertainties).
The FASB staff said the one-time transition tax liability should not be discounted. ASC 740 prohibits the discounting of deferred taxes, and the staff said that guidance should be applied to this liability. Additionally, the FASB staff said the one-time transition tax is not in the scope of ASC 835. The staff explained that this liability did not result from a bargained transaction. Instead, the staff said, it represents an amount imposed on a company by the government, and the amount is subject to estimation and the resolution of uncertain tax positions and therefore is not fixed. Board members said they agreed with this interpretation of ASC 740 and support the staff’s recommendation. Companies should monitor developments.

The new territorial system

Under the worldwide taxation system previously in effect, US corporate income tax applied to all of a company’s income, regardless of whether it was earned in the US or overseas. However, foreign income earned by a foreign subsidiary of a US corporation was generally not taxed until the foreign earnings were repatriated to the US.

The Act created a territorial tax system that allows companies to repatriate certain foreign source earnings without incurring additional US tax by providing for a 100% dividend exemption. Under the dividend-exemption provision, 100% of the foreign source portion of dividends paid by certain foreign corporations to a US corporate shareholder are exempt from US taxation. The dividend exemption does not apply to foreign income earned by a domestic corporation through foreign branches (including foreign corporations for which the company made check-the-box elections) or to gain on sales attributable to the appreciation of stock. However, the dividend exemption applies to the gain on the sale of foreign stock up to the amount of the foreign subsidiary’s E&P.

This provision applies to distributions made after 31 December 2017 of E&P that were not subject to the one-time transition tax.

Accounting considerations related to the territorial system

Outside basis differences represent the difference between the financial reporting basis and the tax basis of an investment. Under ASC 740, a company may have historically applied certain exceptions for recording deferred tax amounts related to the outside basis differences of its foreign subsidiaries or foreign corporate joint ventures (i.e., asserted indefinite reinvestment). In other instances, a company may have not met the criteria to apply those exceptions or may have been required to record the related deferred tax amounts, as would have been the case with an investee accounted for using the equity method (that did not meet the definition of a corporate joint venture).

Under the new territorial tax system, a company still needs to apply the guidance in ASC 740-30 to account for the tax consequences of outside basis differences from investments in foreign investees. Companies need to carefully evaluate the provisions of the law for each individual foreign investee to determine whether they can assert indefinite reinvestment or otherwise are required to recognize deferred tax liabilities related to outside basis differences (even after considering the one-time transition tax discussed in the One-time transition tax section below) and the appropriate tax effects of the outside basis differences.
The following are some of the considerations related to outside basis differences that companies will need to consider in evaluating taxes that may need to be provided on outside basis differences and whether the exceptions in ASC 740-30 apply:

- **Outside basis differences** – The one-time transition tax applies to post-1986 tax E&P. That basis difference will not equate to the entire outside basis difference of some entities’ international subsidiaries. The remaining outside basis difference will need to be examined to understand any federal, foreign or state taxes that could arise and whether the exceptions in ASC 740-30 related to indefinite reinvestment apply. In addition, companies will need to evaluate their intention for the reinvestment or continued reinvestment of E&P subject to the transition tax. There may be additional taxes (e.g., state and local, foreign withholding taxes) that would be due on these earnings, if remitted. While future earnings will be subject to 100% dividend exemption, companies will need to continue to evaluate their reinvestment intentions in order to determine if they can continue to assert indefinite reinvestment or if they will be required to provide for additional taxes that would be due on those earnings if remitted.

- **Foreign withholding taxes** – Companies will still need to assess whether they can assert indefinite reinvestment of foreign earnings (including E&P subject to the one-time transition tax). Although a company will need to provide taxes on E&P due to the one-time transition tax, it will need to evaluate whether it can continue to assert indefinite reinvestment of those earnings with respect to withholding taxes.

- **Gains on sale** – Because gains from the sales of shares in a foreign investee are not eligible for the dividend exemption, companies need to separately track basis differences related to their investment balances and consider any intentions for disposal of a foreign investee.

- **State and local taxes** – Many states may have existing statutes, or will choose to enact legislation, to decouple from federal treatment of foreign sourced dividends. These differences could apply to both post-1986 E&P taxed under the federal one-time transition tax as well as pre-1986 E&P. As a result, companies will need to continue to assess their outside basis differences created by all book to tax differences and the state taxes that might apply. Individual state and local tax law changes should be accounted for when enacted in accordance with ASC 740.

- **Foreign-to-foreign investments** – The guidance in ASC 740-30 on accounting for outside basis differences still applies to the local country taxes applicable to foreign-to-foreign structures despite ultimate US ownership.

Companies may not have the necessary information to complete their analysis of the reversal of outside basis differences in their investments in foreign subsidiaries, after considering the one-time transition tax, by their financial reporting deadline. Companies applying the guidance in SAB 118 should include provisional amounts in their financial statements if they can determine reasonable estimates of the future tax effects of their outside basis differences and the tax cost of any transition taxes (see the SEC guidance on accounting for US tax reform section below). If they cannot make a reasonable estimate, companies should continue to apply ASC 740 based on the provisions of the tax law that was in effect immediately prior to the enactment of the new law, including their historical accounting for outside basis differences for which they asserted indefinite reinvestment.
Anti-deferral and anti-base erosion provisions

The Act includes anti-deferral and anti-base erosion provisions targeting both US-based and foreign-based multinational companies, including:

- A new minimum tax on global intangible low-taxed income
- A lower effective tax rate (after deduction) on a US company’s sales, leases or license of goods and services abroad that provides an incentive for these activities
- A new tax on certain payments from a corporation subject to US tax to a related foreign corporation that are otherwise deductible (e.g., royalty payments)

Global intangible low-taxed income

The Act subjects a US parent shareholder to current tax on its “global intangible low-taxed income” (GILTI). GILTI is calculated based on the following formula: the excess of the aggregate of a US shareholder’s pro rata share of net income of its controlled foreign corporations (CFCs) over a calculated return on specified tangible assets of the CFCs. The income inclusion under GILTI is eligible for a deduction that is intended to lower the effective tax rate to 10.5% for taxable years beginning after 31 December 2017 and ending in 2025. The effective rate will rise to 13.125% for taxable years beginning after 31 December 2025.

Further, the Act limits foreign tax credits (FTCs) to 80% of the foreign tax paid and properly attributable to GILTI income. It also limits a company’s ability to use these FTCs against other foreign source income or to carry these FTCs back or forward to other years.

Accounting considerations for GILTI provisions

The income subject to tax under the GILTI provisions will be treated in a manner similar to a Subpart F income inclusion (i.e., it should be included in the US shareholder’s taxable income in the current year) and included in its US income tax provision. However, questions exist about whether companies should include the effects of the Act in income tax in the future period the tax arises or as part of deferred taxes on the related investments.

FASB meeting – 10 January 2018

The FASB staff presented these alternatives to the Board, noting that both received support from different stakeholders. The FASB staff and the Board acknowledged that it is not clear how current guidance under ASC 740 applies to GILTI, leading to reasonable arguments to support both interpretations. Board members said they agreed with the staff’s recommendation that companies should make a policy election to account for the effects of GILTI either as a component of income tax expense in the future period the tax arises or as a component of deferred taxes on the related investments, and include appropriate disclosures in their financial statements. The Board also asked the FASB staff to evaluate this accounting as practice develops so it can consider whether future standard setting is necessary. Companies should monitor developments.

SAB 118 considerations for GILTI provisions (updated 16 January 2018)

As noted in the SEC guidance on accounting for US tax reform section, the FASB staff preliminarily concluded that a company can elect an accounting policy to account for GILTI in either of the following ways:

- As a period charge in the future period the tax arises
- As part of deferred taxes related to the investment or subsidiary
Questions have arisen about whether companies can “provisionally” elect a GILTI accounting policy under the guidance in SAB 118 and change their election during the SAB 118 measurement period. SAB 118 does not contemplate changes to an elected accounting policy. Instead, it recognizes that companies may need time to analyze and assess the effects of the Act and allows them to record provisional amounts until they complete their accounting.

Ernst & Young LLP believes a company that has not progressed far enough along in its analysis, and in turn its accounting, such that an evaluation of GILTI and the related accounting policy has not been made, should disclose that its accounting for the effects of the GILTI tax law provisions is incomplete and that an accounting policy has not yet been elected. However, Ernst & Young LLP believes that a company that has recorded either a provisional or final amount that reflects GILTI as a component of its deferred taxes has elected an accounting policy and that any change in that policy would be considered an accounting change that would be subject to ASC 250-10-45-2. Similarly, Ernst & Young LLP believes that a company that has finalized its accounting or recorded provisional amounts and has concluded it will not account for GILTI as part of deferred taxes has elected an accounting policy to account for GILTI as a period expense, and any subsequent change in the policy would be subject to ASC 250-10-45-2.

Refer to ASC 250-10-45-1 for a discussion of the initial election of an accounting policy and ASC 250-10-45-2 for a discussion of voluntary changes in accounting policy.

**Export incentive on foreign-derived intangible income**

The law provides tax incentives to US companies to earn income from the sale, lease or license of goods and services abroad in the form of a deduction for foreign-derived intangible income. Foreign-derived intangible income is taxed at an effective rate of 13.125% for taxable years beginning after 31 December 2017 and 16.406% for taxable years beginning after 31 December 2025.

**Accounting considerations for the export incentive for foreign-derived intangible income**

Ernst & Young LLP believes the accounting for the deduction for foreign-derived intangible income is similar to a special deduction and should be accounted for based on the guidance in ASC 740-10-25-37. The tax benefits for special deductions ordinarily are recognized no earlier than the year in which they are deductible on the tax return. See section 5.7, Special deductions, of the FRD on income taxes.

**Tax on otherwise deductible payments to related foreign corporations**

The Act establishes a tax on certain payments from corporations subject to US tax to related foreign persons, also referred to as base erosion and anti-abuse tax. Base erosion payments generally include payments from a US corporation to foreign related entities for any amounts that are deductible, including royalty payments or payments to acquire depreciable or amortizable property. Base erosion payments do not include payments for costs of goods sold, payments for certain qualified services and qualified derivative payments, if certain requirements are met.

Companies that meet certain thresholds are required to pay the new minimum base erosion and anti-abuse tax. The minimum base erosion and anti-abuse tax (BEAT) is based on the excess of a percentage of the corporation’s modified taxable income over its regular tax liability for the year reduced by certain credits, but the amount cannot be less than zero. The modified income is taxed at 5% in 2018, 10% in 2019 through 2025 and 12.5% for years beginning after 31 December 2025.

This provision generally applies to corporations that are subject to US net income tax with average annual gross receipts of at least $500 million and that have made related-party
Companies need to reevaluate the realizability of any remaining NOL carryforwards after considering NOLs used to offset their transition tax.

Deductible payments totaling 3% or more of the corporation’s total deductions for the year. The BEAT is effective for base erosion payments paid or accrued in taxable years beginning after 31 December 2017.

**Accounting considerations for BEAT provisions**

For companies that meet certain thresholds, the base erosion provision of the Act creates additional tax on net income by effectively excluding deductions on certain payments to foreign related entities.

Questions exist about whether this tax should be considered part of the regular US tax system, which would require the effects of the BEAT to be included in income tax in the period the tax arises, or a separate parallel tax regime. If the tax is determined to be part of a separate parallel tax regime, a question would arise about the appropriate tax rate to be applied in measuring certain US deferred taxes, including temporary differences existing on the enactment date, by entities subject to the BEAT regime (i.e., the new US corporate tax rate of 21% or the BEAT rate).

**FASB meeting – 10 January 2018**

The FASB staff discussed the questions raised by some stakeholders about whether deferred tax assets and liabilities should be measured at the regular tax rate or the lower BEAT rate if the taxpayer expects to owe BEAT in future years. ASC 740 currently provides guidance on what rate to use to measure deferred tax assets and liabilities when an entity owes an AMT. The Board agreed that the framework for accounting for AMT is an appropriate analogy for the new BEAT system, because both represent an incremental tax. The staff recommended that a company should analogize to the AMT guidance and use the regular tax rate (i.e., the new 21% rate) to measure its temporary differences. Board members said they agreed with this interpretation of ASC 740 and support the staff’s recommendation. Companies should monitor developments.

**Effects of certain other key provisions**

**Changes to NOL carryback and carryforward rules (updated 16 January 2018)**

The Act limits the amount taxpayers are able to deduct for NOL carryforwards generated in taxable years beginning after 31 December 2017 to 80% of the taxpayer’s taxable income. The law also generally repeals all carrybacks for losses generated in taxable years ending after 31 December 2017. However, any NOLs generated in taxable years ending after 31 December 2017 can be carried forward indefinitely.

| NOLs generated in taxable years ending after 31 December 2017 | • Not eligible for carryback  
| • Eligible for indefinite carryforward |
| NOLs generated in taxable years beginning after 31 December 2017 | • Limited usage (80% of taxable income) |

**Accounting implications on NOLs**

Companies need to reevaluate the realizability of any remaining NOL carryforwards (after appropriate remeasurement for the change in tax rates) after considering NOLs used to offset
their transition tax, as discussed above. Further, a company that relies on projections of future taxable income when evaluating NOLs’ realizability needs to consider whether other provisions of the Act will affect its ability to use NOLs in the future (e.g., GILTI).

Companies applying the guidance in SAB 118 that have not completed the accounting for the effects of the Act but can determine a reasonable estimate of those effects on their NOL carryforwards should include a provisional amount based on their reasonable estimate in the financial statements. If they cannot make a reasonable estimate of the effects, companies should continue to apply ASC 740 and continue to account for their NOL carryforwards based on the provisions of the tax laws that were in effect immediately prior to enactment. See the SEC guidance on accounting for US tax reform section below.

Companies need to consider other provisions in the law and how they may affect projections of future taxable income (e.g., interest limitations and expense deductibility discussed below) on valuation allowance conclusions.

It is not appropriate to assume, for NOLs originating in taxable years beginning after 31 December 2017, that the carryforward will ultimately be realized simply because it does not expire. A valuation allowance for NOLs that do not expire may still be necessary if, based on the weight of available evidence, it is more likely than not (likelihood of more than 50%) that the deferred tax asset will not be realized. See chapter 6, Valuation allowances, of the FRD on income taxes.

Repeal of the corporate alternative minimum tax

The corporate alternative minimum tax (AMT) was repealed. Taxpayers with AMT credit carryovers can use the credits to offset regular tax liability for any taxable year. In addition, the AMT credit is refundable in any taxable year beginning after 2017 and before 2022 in an amount equal to 50% (100% in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, a taxpayers’ entire AMT credit carryforward amounts are fully refundable by 2022.

Accounting implications of AMT repeal (update 16 January 2018)

How Ernst & Young LLP sees it

We believe it would be appropriate for a company to either continue to classify AMT credits along with its other deferred tax balance or reclassify credits that are expected to be refundable in future periods to an income tax receivable. If AMT credits are significant, a company should disclose in the notes to its financial statements how it classified the AMT credits.

It is understandable that questions exist about whether it is appropriate to discount a receivable for amounts refundable and how to classify the related accretion.

FASB meeting – 10 January 2018

The FASB staff said AMT credits that become refundable should not be discounted, regardless of whether the credits are classified as receivables or deferred tax assets. The FASB staff explained that these credits represent unique amounts that will be used and should be accounted for under ASC 740, which prohibits the discounting of deferred taxes. The FASB staff said that, similar to the one-time transition tax liability, these credits are not in the scope of ASC 835. Additionally, AMT credits may be recognized on the financial statements but not on the tax return due to the uncertainty of the tax position and these amounts would not be discounted. The FASB staff said its recommendation is that it is
inappropriate to discount the related receivable or deferred tax asset. Board members said they agreed with this interpretation of ASC 740 and support the staff’s recommendation. Companies should monitor developments.

Interest expense deduction limits
The law limits the deduction for net interest expense that exceeds 30% of the taxpayer’s adjusted taxable income (ATI) for that year. ATI is computed initially excluding depreciation, amortization or depletion (approximating earnings before interest, taxes, depreciation and amortization) and includes these items beginning in 2022 (approximating earnings before interest and taxes).

The Act permits an indefinite carryforward of any disallowed business interest. This provision applies to taxable years beginning after 31 December 2017 and provides exceptions to the interest limitation for companies with gross receipts not exceeding $25 million.

Accounting implications of interest expense deduction limits
Going forward, companies with interest limited under the new law will have to assess the realizability on any resulting deferred tax assets for interest carried forward. A company whose interest deduction is already limited may not be able to realize the benefits of amounts carried forward.

Immediate expensing
Companies are able to claim bonus depreciation to accelerate the expensing of the cost of certain qualified property acquired and placed in service after 27 September 2017 and before 1 January 2024. For the first five-year period (through 2022), companies can deduct 100% of the cost of qualified property. During the period starting in 2023, the additional bonus depreciation is gradually phased out by 20% each year through 2027.

Companies need to implement processes to identify eligible capital expenditures and revise tax depreciation to properly measure deferred tax liabilities related to qualified property.

Accounting implications of immediate expensing
Companies need to carefully determine the appropriate rate to apply when calculating their deferred taxes and current taxes at the enactment date when claiming the bonus depreciation. Given the retroactive nature of this provision, a calendar year-end company should record deductions in the 2017 current tax provision calculation at 35%, while measuring the related deferred tax liability at the newly enacted rate.

Limit on employee remuneration
The Act expanded the number of individuals whose compensation is subject to a $1 million cap on deductibility under Section 162(m) and includes performance-based compensation such as stock options and stock appreciation rights in the calculation.

Until now, a public company has been able to deduct up to $1 million of compensation paid to covered employees consisting of the chief executive officer and the next three highest compensated officers (but not the chief financial officer (CFO)). However, the limit didn’t apply to performance-based compensation.

The new law expands the definition of covered employees to include the CFO and any individual who has been considered a covered employee, even if that individual is no longer a covered employee. Thus, once an individual is a covered employee, the deduction limitation applies to compensation paid to that individual at any point in the future, including after a separation from service. Any individual who is a covered employee for a tax year after 31 December 2016
will remain a covered employee for all future years. The law also eliminates the exception for performance-based compensation.

The provision generally applies to taxable years beginning after 31 December 2017 and provides a transition for compensation paid pursuant to a written binding contract that is in effect on 2 November 2017. Companies will need to carefully review the terms of their compensation plans and agreements to assess whether they are considered to be written binding contracts in effect on 2 November 2017.

**Accounting implications of limits on employee remuneration**

Companies need to evaluate the effect of these changes on their deferred tax assets in the period of enactment as well as the effect on their effective tax rate.

**Tax method changes**

In certain cases, the Act requires companies to change their tax accounting methods for revenue recognition to conform with their financial reporting methods. The law generally requires a taxpayer to recognize revenue no later than the taxable year in which it is recognized in the taxpayer’s financial statements. As a result, a company will automatically conform its tax method with its book method for all revenue items recognized sooner under the book method. This provision is effective for years beginning after 31 December 2017. See section 8.7, *Changes in tax accounting method*, of the FRD on income taxes.

**Restriction or elimination of exclusions, deductions and credits**

The Act repeals or limits deductions for amounts previously deductible (beginning in 2018 unless otherwise noted), including:

- Repeals the Section 199 domestic production deduction (see section 5.7.1, *Domestic production activities deduction*, of the FRD on income taxes)
- Creates additional restrictions on deductions for meals and entertainment
- Reduces the allowable deduction against the dividends received from a domestic corporation other than certain small businesses or those treated as “qualifying dividends” from 70% to 50%, and from 80% to 65% for dividends received from 20% owned corporations
- Extends the amortization period of research and experimental expenses incurred in the US to five years and for expenses incurred outside the US to 15 years, beginning in years after 2021
- Eliminates the deductibility of payments made or incurred to a government after 22 December 2017 in connection with the violation of a law, except for restitution payments to come into compliance with the law and amounts subject to a binding agreement as of the enactment date, meaning deferred tax assets related to the accrual of such settlements may need to be adjusted at the enactment date
- Eliminates the deductibility of payments made for settlements of certain harassment suits, meaning any deferred tax amounts related to accruals for potential settlements before the enactment date will need to be adjusted

Companies applying SAB 118 should include a provisional amount based on a reasonable estimate of the effects of these provisions in their financial statements. If they cannot make a reasonable estimate of the effects they should continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to enactment. See the SEC guidance on accounting for US tax reform section below.
Special considerations for non-calendar year-end companies
Effects of a lower corporate income tax rate for non-calendar year-end companies – blended rate (updated 16 January 2018)

Based on language in the Act, non-calendar year-end companies might conclude that the 21% corporate tax rate would be effective in the first taxable year beginning on or after 1 January 2018. However, existing tax law, which was not amended by the Act, governs when a change in tax rate is effective. The tax law provides that if the taxable year includes the effective date of any rate changes (unless the effective date is the first day of the taxable year), taxes should be calculated by applying a blended rate to the taxable income for the year. To compute the blended rate, a company calculates the weighted average tax rate based on the ratio of days in the fiscal year prior to and after enactment.

Illustration 3 – Blended rate

Assume Company A has a fiscal year ending 30 June 2018. To determine its blended rate, Company A calculates an average tax rate weighted based on the ratio of days in the fiscal year prior to and after the enactment date, as follows:

| Days prior to enactment | 184 |
| Days after enactment    | 181 |
| Total days              | 365 |

| Tax based on 35% tax rate | 50.41% | 17.65% |
| Tax based on 21% tax rate | 49.59% | 10.41% |
| Blended rate for the year ended 30 June 2018 | 28.06% |

Company A's blended tax rate for its year ended 30 June 2018 is 28.06%.

As explained above, the blended rate does not depend on a company’s taxable income for the period and therefore can be calculated using only its fiscal year end. The following table lists the blended rates based on certain fiscal 2018 year-end dates. Companies with periods ending on dates other than the end of the month will need to determine their blended tax rate based on their specific fiscal year end.

<table>
<thead>
<tr>
<th>Fiscal year ending on</th>
<th>Blended rate</th>
<th>Fiscal year ending on</th>
<th>Blended rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 January 2018</td>
<td>33.81%</td>
<td>31 July 2018</td>
<td>26.87%</td>
</tr>
<tr>
<td>28 February 2018</td>
<td>32.74%</td>
<td>31 August 2018</td>
<td>25.68%</td>
</tr>
<tr>
<td>31 March 2018</td>
<td>31.55%</td>
<td>30 September 2018</td>
<td>24.53%</td>
</tr>
<tr>
<td>30 April 2018</td>
<td>30.40%</td>
<td>31 October 2018</td>
<td>23.34%</td>
</tr>
<tr>
<td>31 May 2018</td>
<td>29.21%</td>
<td>30 November 2018</td>
<td>22.19%</td>
</tr>
<tr>
<td>30 June 2018</td>
<td>28.06%</td>
<td>31 December 2018</td>
<td>21.00%</td>
</tr>
</tbody>
</table>

ASC 740-10-50-12 requires a public company to disclose a reconciliation of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying the domestic federal statutory tax rate to pretax income from continuing operations.

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4 Internal Revenue Code, Section 15 Effect of changes.
How Ernst & Young LLP sees it

We believe the blended rate calculated as described in this section is the appropriate domestic federal statutory tax rate for non-calendar year-end companies to use in their rate reconciliation.

Accounting considerations related to deferred tax assets and liabilities for non-calendar year-end companies

Companies with a non-calendar year end may face additional complexities in calculating their deferred tax assets and liabilities at the enactment date and determining the appropriate rate to use. These companies need to schedule when temporary differences are expected to reverse to apply the appropriate rate. Temporary differences reversing during the fiscal year that includes the enactment date should be remeasured using the blended rate described in the Effects of a lower corporate income tax rate for non-calendar year-end companies – blended rate section above. Temporary differences reversing after that fiscal year should be remeasured at the new 21% rate.

Estimating temporary differences as of the most recent quarter end (e.g., 31 December) for purposes of remeasuring deferred tax amounts at the enactment date is often adequate with appropriate consideration of significant adjustments between the enactment date and the quarter end. However, if the enactment date is not near the beginning or end of a reporting period, companies need to estimate temporary differences as of the enactment date (i.e., estimate temporary differences (to the extent significant) using a short-period tax return or estimate that temporary differences will be generated and reverse ratably or will be generated in the same period as the financial reporting income occurs during the year). Since non-calendar year-end companies do not typically estimate the reversal of temporary differences during interim periods, they may require additional effort to determine the effect on their temporary differences at the enactment date.

The effects of a change in tax laws or rates on deferred tax assets or liabilities should be recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate.

For a company that is applying the guidance in SAB 118, the remeasurement of deferred tax balances should be recorded in the period of enactment if it can complete its accounting or a reasonable estimate can be made. If a company cannot complete its accounting or make a reasonable estimate, it should continue to account for its deferred taxes based on the provisions of the tax laws that were in effect immediately prior to enactment. See the SEC guidance on accounting for US tax reform section below.

Non-calendar year-end interim reporting considerations

Non-calendar year-end companies also need to consider the effects of the tax rate change on interim reporting if the enactment date is in an interim period. Under ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year must be recorded after the effective dates prescribed in the statutes and reflected in the estimated annual effective tax rate (EAETR) beginning no earlier than the first interim period that includes the enactment date of the new legislation. In addition, the implementation guidance in ASC 740-270-55-49 and 50 indicates that the effect of new legislation would not be reflected until it is effective or administratively effective.
ASC 740 indicates that tax legislation may prescribe changes that become effective during an entity’s fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. Existing tax law provides that if the taxable year includes the effective date of any rate changes (unless the effective date is the first day of the taxable year), taxes should be calculated by applying a blended rate to the taxable income for the entire year. The tax rate changes thus are administratively effective on the enactment date.

**Accounting for the effects of rate change on EAETR**

The effects of new tax law legislation on taxes currently payable must be recognized in the period of enactment with allocation to earlier or later interim periods prohibited. See sections 8.1 Changes in tax laws and rates, and 15.1.2, Changes in tax laws, rates or tax status, of the FRD on income taxes.

**Illustration 4 – Effects of rate change on EAETR**

Assume that for the full fiscal year, an entity with a 30 June year end anticipates ordinary taxable income of $100,000. All income is taxable in one jurisdiction at a 35% rate. All anticipated transactions will have tax consequences.

New legislation enacted in the second quarter of the entity’s fiscal year reduces the tax rate to 21%. The new tax rate is administratively effective as of the beginning of the company’s fiscal year. The new legislation is administratively implemented by applying a portion of the change to the full fiscal year. As a result, the entity revises its EAETR computation using the appropriate blended rate as described above.

<table>
<thead>
<tr>
<th>Reporting period</th>
<th>Ordinary income</th>
<th>EAETR</th>
<th>Reporting period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarter</td>
<td>Year to date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q1</td>
<td>$20,000</td>
<td>35.00%</td>
<td>$7,000</td>
</tr>
<tr>
<td>Q2</td>
<td>20,000</td>
<td>28.06%</td>
<td>11,224</td>
</tr>
<tr>
<td>Q3</td>
<td>20,000</td>
<td>28.06%</td>
<td>16,836</td>
</tr>
<tr>
<td>Q4</td>
<td>40,000</td>
<td>28.06%</td>
<td>28,060</td>
</tr>
<tr>
<td><strong>$100,000</strong></td>
<td></td>
<td></td>
<td><strong>$28,060</strong></td>
</tr>
</tbody>
</table>

**Accounting for changes in provisional amounts**

For companies that are applying the guidance in SAB 118 during an interim period of enactment, the accounting for the effects of certain aspect of the Act may be incomplete. Until a company can complete its analysis, it may not be able to determine the effects certain aspects of the Act may have on its tax provision. See the SEC guidance on accounting for US tax reform section below.

**Non-calendar year-end transition tax considerations**

The portion of E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate, as discussed in the One-time transition tax section above. To determine the aggregate foreign cash position of the US shareholder, cash is measured on the following three dates:

- Date 1 – The close of the last taxable year beginning before 1 January 2018
- Date 2 – The close of the last taxable year that ends before 2 November 2017
- Date 3 – The close of the taxable year preceding Date 2
The aggregate foreign cash position for a US taxpayer is the greater of the foreign cash position determined as of Date 1 or the average of the foreign cash position determined as of Date 2 and Date 3. For example, a company with a 30 September fiscal year end, Dates 1, 2 and 3 would fall on 30 September 2018, 2017 and 2016 respectively.

Because a company with non-calendar year-end CFCs may not be able to determine the aggregate foreign cash position until it completes its 2018 fiscal year, a company needs to consider whether the amounts recognized for its one-time transition tax payable can be completed earlier than that date. Companies applying SAB 118 may need to consider the disclosure requirements until they can complete their analysis of the one-time transition tax payable.

**Non-calendar year-end entities’ interim disclosures**

For financial reporting purposes, ASC 740 requires disclosure of the effect of adjustments to deferred tax amounts for enacted changes in tax laws or rates as well as, for interim periods, the effect of the change in the estimated annual effective rate. See section 18.4, *Disclosure of changes in tax laws or rates*, of the FRD on income taxes.

**Illustration 5 – Disclosure example for a 30 June year-end company**

In the second quarter, the Company revised its estimated annual effective rate to reflect a change in the federal statutory rate from 35% to 21%, resulting from legislation that was enacted on 22 December 2017. The rate change is administratively effective at the beginning of our fiscal year, using a blended rate for the annual period. As a result, the blended statutory tax rate for the year is 28.06%.

In addition, we recognized a tax benefit in our tax provision for the period related to adjusting our deferred tax balance to reflect the new corporate tax rate. As a result, income tax expense reported for the first six months was adjusted to reflect the effects of the change in the tax law and resulted in a decrease in income tax expense of $400,000 during the second quarter. This amount comprises a reduction of $100,000 in income tax expense for the six-month period ended 31 December 2017 related to the lower corporate rate and $300,000 from the application of the newly enacted rates to existing deferred balances.

The accounting for the effects of the rate change on deferred tax balances is complete and no provisional amounts were recorded for this item.

Note: If the company also recorded provisional amounts, additional disclosure would be required by SAB 118. See the *Disclosures* section below for an example disclosure for the period of enactment.

**SEC guidance on accounting for US tax reform (updated 16 January 2018)**

The SEC staff issued SAB 118 to provide guidance for companies that have not completed their accounting for the income tax effects of the Act in the period of enactment. The SEC staff noted that ASC 740 does not address these challenges and said a clarification was needed to address uncertainty or diversity in views about the application of ASC 740 in the period of enactment.

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FASB staff question and answer on whether private companies and not-for-profit entities can apply SAB 118

Question

Given the longstanding practice of private companies electing to apply SABs, would the FASB staff object to private companies and not-for-profit entities applying SAB 118?

Response

Based upon the longstanding practice of private companies electing to apply SABs, the FASB staff would not object to private companies and not-for-profit entities applying SAB 118. If a private company or not-for-profit entity applies SAB 118, they would be in compliance with GAAP.

The FASB staff believes, however, that if a private company or a not-for-profit entity applies SAB 118, it should apply all relevant aspects of the SAB in its entirety. This would include the disclosures listed in SAB 118. The FASB staff also believes that a private company or a not-for-profit entity that applies SAB 118 should disclose its accounting policy of applying SAB 118 in accordance with paragraphs 235-10-50-1 through 50-3 of the Accounting Standards Codification.

See Appendix A for the full contents of the FASB staff Q&A.

Excerpt from SAB 118

Applicability

This staff guidance is only applicable to the application of ASC Topic 740 in connection with the Act and should not be relied upon for purposes of applying ASC Topic 740 to other changes in tax laws.

SAB 118 provides the following guidance:

- **Accounting for income tax effects is completed** – When reporting the effects of the Act on the enactment date, a company must first reflect in its financial statements the income tax effects of the Act for which the accounting under ASC 740 is complete. These completed amounts will not be provisional amounts.

- **Accounting for income tax effects is incomplete but the company has a reasonable estimate** – If a company’s accounting for certain income tax effects of the Act is incomplete but it can determine a reasonable estimate of those effects, the SEC staff said that it will not object to a company including the reasonable estimate in its financial statements. The staff said it would not be appropriate for a company to exclude a reasonable estimate from its financial statements if one had been determined. The reasonable estimate should be included in a company’s financial statements in the first reporting period in which a company is able to determine the estimate. The estimate would be reported as a provisional amount in the financial statements during a “measurement period.”

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6 The SEC staff also said it would not object to a foreign private issuer reporting under International Financial Reporting Standards applying a measurement period solely for purposes of completing the accounting requirements for the income tax effects of the Act under International Accounting Standard 12, Income Taxes.

7 SAB 118 says, “The staff was informed, in part, by the measurement period guidance applied in certain situations when accounting for business combinations under ASC Topic 805, Business Combinations. The measurement period guidance in ASC paragraph 805-10-25-13 addresses situations where the initial accounting for a business combination is incomplete upon issuance of the financial statements that include the reporting period the business combination occurred.”
could include, for example, reasonable estimates that give rise to new current or deferred
taxes based on certain provisions of the Act, as well as adjustments to current or deferred
taxes that existed prior to the Act’s enactment date.

- **Accounting for income tax effects is incomplete and the company does not have a reasonable estimate** – If a company does not have the necessary information to determine a reasonable estimate to include as a provisional amount, the SEC staff said that it would not expect a company to record provisional amounts in its financial statements for the income tax effects for which a reasonable estimate cannot be determined. In these cases, the SEC staff said a company should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to enactment. That is, the staff does not believe a company should adjust its current or deferred taxes to account for the income tax effects of the Act until the first reporting period in which a reasonable estimate can be determined.

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**How Ernst & Young LLP sees it**

The Act’s one-time transition tax requires companies that have deferred recognizing income taxes on certain foreign earnings and profits earned in prior periods (i.e., asserted indefinite reinvestment) to now pay income taxes on those earnings. If a company previously asserted indefinite reinvestment, we believe the company could continue to follow its existing accounting until it has the necessary information to determine a reasonable estimate for the transition tax.

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**Excerpt from SAB 118**

**Question 1:** If the accounting for certain income tax effects of the Act is not completed by the time Company A issues its financial statements that include the reporting period in which the Act was enacted, what amounts should Company A include in its financial statements for those income tax effects for which the accounting under ASC Topic 740 is incomplete?

**Interpretive Response:** To the extent that Company A’s accounting for certain income tax effects of the Act is incomplete, but Company A can determine a reasonable estimate for those effects, the staff would not object to Company A including in its financial statements the reasonable estimate that it had determined. Conversely, the staff does not believe it would be appropriate for Company A to exclude a reasonable estimate from its financial statements to the extent a reasonable estimate had been determined. The reasonable estimate should be included in Company A’s financial statements in the first reporting period in which Company A was able to determine the reasonable estimate. The reasonable estimate would be reported as a provisional amount in Company A’s financial statements during a “measurement period”. The measurement period is described in further detail below.

The staff believes reporting provisional amounts for certain income tax effects of the Act will address circumstances in which an entity does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting under ASC Topic 740.

An entity may not have the necessary information available, prepared, or analyzed (including computations) for certain income tax effects of the Act in order to determine a reasonable estimate to be included as provisional amounts. The staff would expect no related provisional amounts would be included in an entity’s financial statements for those specific income tax effects for which a reasonable estimate cannot be determined. In circumstances in which provisional amounts cannot be prepared, the staff believes an entity should continue to apply ASC Topic 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. That is, the staff does not believe an entity should adjust its current or deferred taxes for those tax effects of the Act until a reasonable estimate can be determined.
Therefore, to summarize the above and for the avoidance of doubt, in Company A’s financial statements that include the reporting period in which the Act was enacted, Company A must first reflect the income tax effects of the Act in which the accounting under ASC Topic 740 is complete. These completed amounts would not be provisional amounts. Company A would then also report provisional amounts for those specific income tax effects of the Act for which the accounting under ASC Topic 740 will be incomplete but a reasonable estimate can be determined. For any specific income tax effects of the Act for which a reasonable estimate cannot be determined, Company A would not report provisional amounts and would continue to apply ASC Topic 740 based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. For those income tax effects for which Company A was not able to determine a reasonable estimate (such that no related provisional amount was reported for the reporting period in which the Act was enacted), Company A would report provisional amounts in the first reporting period in which a reasonable estimate can be determined.

SAB 118 and subsequent event considerations (updated 16 January 2018)

Ernst & Young LLP has received questions about whether companies need to update provisional amounts through the date the financial statements are issued or are available to be issued.

**How Ernst & Young LLP sees it**

While SAB 118 does not address this question, we believe it is appropriate for a company to record provisional amounts based on the information available through the date it closes its books, unless it identifies a significant error. We believe that significant errors need to be corrected in the current period.

Under this approach, any changes to provisional amounts that would result from a company obtaining additional information or analyzing information after it closes its books but before it issues its financial statements or makes them available to be issued would be recorded in the next reporting period. Ernst & Young LLP believes a company that has identified significant unrecorded adjustments between the date it closes its books and the date it issues its financial statements should consider disclosing the pending adjustments.

**Measurement period**

The measurement period begins in the reporting period that includes the Act’s enactment date and ends when a company has obtained, prepared and analyzed the information needed to complete the accounting requirements under ASC 740. The measurement period should not extend beyond one year from the enactment date (i.e., the measurement period must be completed by 22 December 2018). During the measurement period, the staff said it expects companies to act in good faith to complete the accounting under ASC 740.

**Excerpt from SAB 118**

The measurement period begins in the reporting period that includes the Act’s enactment date and ends when an entity has obtained, prepared, and analyzed the information that was needed in order to complete the accounting requirements under ASC Topic 740. During the measurement period, the staff expects that entities will be acting in good faith to complete the accounting under ASC Topic 740. The staff believes that in no circumstances should the measurement period extend beyond one year from the enactment date.
Initial and subsequent reporting of provisional amounts

Any provisional amounts or adjustments to provisional amounts included in a company’s financial statements during the measurement period (including the period of enactment) should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined.

During the measurement period, a company may need to reflect adjustments to its provisional amounts if it obtains, prepares or analyzes additional information about facts and circumstances that existed as of the enactment date that, if known, would have affected the income tax effects initially reported as provisional amounts. A company may also need to report additional tax effects during the measurement period that were not initially reported as provisional amounts, if it obtains, prepares or analyzes additional information about facts and circumstances that existed as of the enactment date.

Any income tax effects of events unrelated to the Act should not be reported as measurement period adjustments. Hence, companies will need to make sure they have procedures in place to distinguish between changes to provisional amounts that are related to the Act and transactions entered into after the enactment date. For example, a company may enter into a business combination after the enactment date. The tax accounting consequences of the business combination, including the effects on a company’s pre-business combination tax attributes (e.g., realizability of deferred tax assets) will need to be considered separately from any changes in provisional amounts related to the accounting for the tax consequences of the Act.

SAB 118 does not address the accounting effects of the Act in interim periods.

How Ernst & Young LLP sees it

• Ernst & Young LLP believes that, if a company is unable to estimate the effects of certain aspects of the Act on its estimated annual effective rate, the company should make disclosures describing what part of the Act the company did not consider in calculating its estimated annual effective tax rate. Because companies can make reasonable estimates or adjust those estimates, the effect of those changes should be included in the first interim period that those estimates can be made (or can be adjusted) as an adjustment to the estimated annual effective tax rate.

• Ernst & Young LLP also believes the effects of initially recording provisional amounts related to the enactment date of the Act and making adjustments to those amounts, if significant, should be recognized as a discrete event similar to the accounting for tax law changes in the period of enactment. Accordingly, companies should not allocate the effect of changes in the enactment date provisional amounts to subsequent interim periods by adjusting the EAETR.

Excerpt from SAB 118

Changes in subsequent reporting periods

During the measurement period, an entity may need to reflect adjustments to its provisional amounts upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that, if known, would have affected the income tax effects initially reported as provisional amounts. Further, an entity may also need to report additional tax effects during the measurement period, based on obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that was not initially reported as provisional amounts. Any income tax effects of events unrelated to the Act should not be reported as measurement period adjustments.
Reported

Any provisional amounts or adjustments to provisional amounts included in an entity’s financial statements during the measurement period should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined.

SAB 118 does not specify how a company should determine whether it can make a reasonable estimate. A company will need to determine whether a reasonable estimate can be made based on its facts and circumstances. This includes the availability of records to complete the necessary calculations, technical analysis of the new tax law and finalization of its accounting analysis, including its assessment of how certain provisions of the Act may affect its outside basis differences related to foreign subsidiaries.

To help companies with their accounting during the measurement period, SAB 118 provides the following examples. Each example assumes the company has only one foreign subsidiary. A company that has more than one foreign subsidiary may reach different conclusions for each subsidiary, depending on the facts and circumstances, including the availability of information necessary to complete the analysis.

### Excerpt from SAB 118

**Example 1 – Analysis is incomplete and company cannot reasonably estimate provisional amounts**

Prior to the reporting period in which the Act was enacted, Company X did not recognize a deferred tax liability related to unremitted foreign earnings because it overcame the presumption of the repatriation of foreign earnings.\(^8\)

Upon enactment, the Act imposes a tax on certain foreign earnings and profits at various tax rates. Based on Company X’s facts and circumstances, it was not able to determine a reasonable estimate of the tax liability for this item for the reporting period in which the Act was enacted by the time that it issues its financial statements for that reporting period; that is, Company X did not have the necessary information available, prepared, or analyzed to develop a reasonable estimate of the tax liability for this item (or evaluate how the Act will impact Company X’s existing accounting position to indefinitely reinvest unremitted foreign earnings).

As a result, Company X would not include a provisional amount for this item in its financial statements that include the reporting period in which the Act was enacted, but would do so in its financial statements issued for subsequent reporting periods that fall within the measurement period, beginning with the first reporting period falling within the measurement period by which the necessary information became available, prepared, or analyzed in order to develop the reasonable estimate, and ending with the first reporting period within the measurement period in which Company X was able to obtain, prepare, and analyze the necessary information to complete the accounting under ASC 740.

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\(^8\) ASC 740-30-25-17.
Excerpt from SAB 118

Example 1a – Analysis is incomplete and company can reasonably estimate provisional amounts

Assume a similar fact pattern as Example 1; however, Company Y was able to determine a reasonable estimate of the income tax effects of the Act on its unremitted foreign earnings for the reporting period in which the Act was enacted.

Company Y, therefore, reported a provisional amount for the income tax effects related to its unremitted foreign earnings in its financial statements that included the reporting period the Act was enacted. In a subsequent reporting period within the measurement period, Company Y was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740, which resulted in an adjustment to Company Y’s initial provisional amount to recognize its tax liability.

Excerpt from SAB 118

Example 2 – Analysis is incomplete and company may need to recognize a valuation allowance

Company Z has deferred tax assets (assume Company Z was able to comply with ASC Topic 740 and re-measure its deferred tax assets based on the Act’s new tax rates) for which a valuation allowance may need to be recognized (or released) based on application of certain provisions in the Act.

If Company Z determines that a reasonable estimate cannot be made for the reporting period [in which] the Act was enacted, no amount for the recognition (or release) of a valuation allowance would be reported.

In the next reporting period (following the reporting period in which the Act was enacted), Company Z was able to obtain, prepare and analyze the necessary information in order to determine that no valuation allowance needed to be recognized (or released) in order to complete the accounting under ASC 740.

Ernst & Young LLP developed the following example of another situation that might arise.

Illustration 6 – Analysis is incomplete and company can reasonably estimate provisional amounts related to the one-time transition tax but cannot reasonably estimate tax effects of remaining outside basis difference

Facts

Assume a similar fact pattern to Example 1, but assume that Company W was able to determine a reasonable estimate of the income tax effects of the Act on its unremitted foreign earnings for the reporting period in which the Act was enacted as it relates to the one-time transition tax (i.e., the tax due based on accumulated earnings and after 1986).

Company W did not have the necessary information available, prepared or analyzed to develop a reasonable estimate of the tax liability, if any, for its remaining outside basis difference as well as any other current or deferred tax accounting that may be required for foreign earnings subject to the transition tax. In addition, remaining outside basis differences may have deferred tax consequences due to other provisions in the Act.
## Analysis

Company W reported a provisional amount for the income tax effects of the one-time transition tax in its financial statements that included the reporting period the Act was enacted. In a subsequent reporting period within the measurement period, Company W was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740 for the one-time transition tax, and Company W adjusted the provisional amount it had previously reported to recognize its tax liability.

Company W was not able to determine a reasonable estimate of the tax liability, if any, under the Act for its remaining outside basis difference (or evaluate how the Act will affect Company W’s existing accounting position to indefinitely reinvest unremitting foreign earnings) by the time it issued its financial statements for the reporting period in which the Act was enacted. As a result, Company W would not include a provisional amount for this item in its financial statements for the reporting period in which the Act was enacted, but Company W would do so in its financial statements issued for subsequent reporting periods that fall within the measurement period, beginning with the first reporting period in the measurement period in which the necessary information became available, prepared or analyzed so Company W could develop the reasonable estimate, and ending with the first reporting period in the measurement period in which Company W was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740.

## Investment companies affected by the Act

The SEC’s Division of Investment Management issued guidance in IM Information Update 2017-07 in which the SEC staff confirmed that investment companies can rely on SAB 118 for purposes of calculating their net asset value (NAV) and reporting measurement period adjustments. The SEC staff also reminded investment companies to make disclosures, where applicable, about any material effects of the Act on their NAV calculations and information about material provisions for which the accounting is incomplete. Such disclosures could be made in a press release, on a website or in another reasonable manner.

## Other effects

### Investments in qualified affordable housing projects accounted for using the proportional amortization method

Investors in qualified affordable housing projects that meet certain conditions can elect to use the proportional amortization method to account for their investment. In applying the proportional amortization method, an investor amortizes the cost of its investment in proportion to the tax credits and other tax benefits it receives and presents the amortization as a component of income tax expense. Investors in these projects receive tax benefits in the form of tax deductions from operating losses and low-income housing tax credits over a 10-year period.

Under the proportional amortization method, an investment shall be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss is measured as the amount by which the carrying amount of the investment exceeds its fair value. While ASC 323-740 does not address how an impairment loss should be presented, Ernst & Young LLP believes that it should be included as a component of income tax expense from continuing operations. Previously recognized impairment losses cannot be reversed.

Although the Act does not change existing tax law for low-income housing tax credits, investors in these projects will need to consider the effects of the reduction in the corporate tax rate to 21% from 35% when applying the proportional amortization method. Companies should first consider whether it is more likely than not that the carrying amount of the investment will not be realized. If events or changes in circumstances indicate that it is more
likely than not that the carrying amount of the investment will not be realized, an impairment would be recorded. If a company concludes that the investment is not impaired, it should revise its proportional amortization schedule to reflect the revised expected future tax benefits from the remaining tax credits and the lower corporate tax rate. The reduction in the corporate rate will likely reduce the expected tax benefits during the remaining investment period.

How Ernst & Young LLP sees it

ASC 323-740-35 does not provide guidance on how to account for the effects of a change in a tax rate during the investment period when the investment is not impaired. We believe one acceptable approach is to record a “cumulative catch-up” adjustment to the proportional amortization balance so that it reflects the remaining tax benefits at the new rate. Consistent with the guidance in ASC 323-740-45-2, the catch-up charge should be recognized in the income statement as a component of income tax expense from continuing operations. There may be other acceptable ways to account for the effects of a tax rate change.

Tax effects of intercompany asset transfers prior to the enactment of the Act

Transactions may occur among entities that are part of a consolidated reporting entity. In accordance with ASC 810-10-45-1, intercompany balances and transactions are eliminated in the preparation of the consolidated financial statements. However, income tax consequences may result from intra-entity transactions. Companies may have entered into intra-entity transfers of assets prior to the Act’s enactment date and deferred the taxes paid or accrued on the intra-entity profit that is eliminated in consolidation in accordance with ASC 810-10-45-8. Prepaid (accrued) taxes arising from intercompany transactions are different from deferred taxes under ASC 740. Because prepaid (accrued) taxes on intercompany transactions are attributable to taxes paid (incurred) on prior transactions, the reversal of those amounts will generally not be subject to the new tax laws or rates and, therefore, are generally not subject to remeasurement due to a change in tax rate or law.

A company with a non-calendar year end will need to consider the Act’s new corporate tax rates by applying a blended tax rate retroactively to the beginning of its 2018 fiscal year (see the Special considerations for non-calendar year-end companies section). These companies will need to consider the effects of using a blended tax rate and adjust the related prepaid or accrued income taxes from intercompany transfers arising in fiscal 2018 in the reporting period that includes the enactment date.

In 2016, the FASB issued Accounting Standard Update (ASU) 2016-16, Intra-Entity Transfers of Assets Other Than Inventory. ASU 2016-16 requires companies to recognize the income tax effects of intra-entity transfers of assets, other than inventory, in the period the sale or transfer occurs. Unless a company early adopted the ASU, the ASU is effective for annual periods beginning after 15 December 2017 for public business entities and one year later for all other entities. Companies that have not yet adopted the ASU prior to the Act’s enactment date first need to account for the tax effects of the Act prior to considering the tax consequences of ASU 2016-16 on their deferred tax balances.

Leveraged leases

For companies with existing leveraged leases, the Act may require the recognition of an additional adjustment in the reporting period that includes 22 December 2017. Income tax rates are an important assumption in determining the rate of return on a leveraged lease. If tax rates change, all components of a leveraged lease must be recalculated from inception of the lease. That is, lessors must recalculate the allocation of income on the leveraged lease based on after-tax cash flows as revised for the change in tax rates.
If a lessor considered the effects of the AMT in its assumptions, it must also consider the effects of AMT being repealed. The difference between the amounts originally recorded and the recalculated amount would be included as a cumulative catch-up in pretax income. Additionally, if the effect of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the reason for that variation should be disclosed.

**Business combinations (updated 16 January 2018)**

New information about the facts and circumstances that existed at the acquisition date for tax positions acquired in or that arose from a business combination may result in an adjustment to goodwill during the measurement period. However, a change in tax rate after the business combination would not result in a business combination measurement period adjustment. That is, any change in income tax position, including the remeasurement of deferred tax balances or the assessment of the realizability of acquired deferred tax assets attributable to a change in tax law, should be recognized within income tax expense attributable to continuing operations.

If a business combination occurs after the enactment date, the acquirer may recognize provisional amounts associated with income tax assets and liabilities in accordance with ASC 805-740. These amounts may include an estimate for the effects of the new tax law. Ernst & Young LLP believes that subsequent changes to provisional amounts resulting from new information about the facts and circumstances that existed at the acquisition date, including additional information about estimates related to the new tax law, should be recognized as a measurement period adjustment under ASC 805 rather than under SAB 118.

**Goodwill impairment testing**

Many companies perform their annual goodwill impairment testing on a date prior to the enactment date that falls within the reporting period that includes the enactment date (e.g., a 1 October 2017 annual goodwill impairment assessment date for a calendar year-end company). Questions exist about whether the effect of US tax reform should be considered in performing annual goodwill impairment testing during the quarter that includes the enactment date when the annual goodwill assessment date precedes the enactment date.

The annual goodwill impairment test, including the determination of fair value should be based on the facts and circumstances that existed as of the annual assessment date and should consider market participant assumptions at that date. If the annual goodwill assessment date occurred prior to the 22 December 2017 date of enactment, the fair value analysis would include market participant assumptions related to income taxes that existed as of that date. The valuation would consider the uncertainty that existed on the annual testing date about whether tax reform would be enacted and should not factor in the hindsight of ultimate enactment.

**After-tax hedging of foreign currency risk**

Companies that designate hedges of foreign currency risk on an after-tax basis will need to consider whether the Act affects the hedging arrangement. For example, for companies that assert indefinite reinvestment of a net investment in a foreign subsidiary under ASC 740 and enter into net investment hedges, it is common to designate the hedging instrument on an after-tax basis in order to compensate for the nontaxable nature of the translation gain or loss that results from the net investment.
In these situations, companies will need to consider how the change in tax rates will affect the hedging relationship, including whether the hedge remains highly effective or whether any ineffectiveness after the enactment date needs to be recorded in earnings if the company has not yet adopted ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. The shift to a territorial tax system may also affect a company’s ongoing use of after-tax hedging strategies.

Given that the provisions in the Act can affect both the amount of a foreign net investment eligible to be hedged and the tax-effected gains and losses on the hedging instrument, companies should assess their original hedging relationships to determine whether to desiginate and redesignate new hedging relationships in the first assessment period after the enactment date. Companies need to consider not only the reduction in US corporate income tax rates but how the BEAT and GILTI provisions of the Act may affect their effective tax rates when redesignating or entering into new net investment hedges.

**Annual pension and other postretirement benefit plans**

Companies that have defined pension and other postretirement benefit plans need to consider the effects of the new corporate tax rates on deferred tax balances related to these plans. Companies that are performing their annual measurement of pension and other postretirement benefits as of 31 December 2017 should first calculate the tax effect of enactment on their pension and postretirement benefit deferred tax balances on the enactment date. The tax effect of a remeasurement of existing deferred taxes should be recorded in income tax expense.

The tax effect of a change in the benefit obligation resulting from a company’s annual remeasurement or any remeasurement performed after the enactment date that is recorded in other comprehensive income would also be recorded in other comprehensive income (using the new 21% rate). If the change in benefit obligation resulting from a remeasurement is recorded in income, the tax effect would also be recorded in income.

**Share-based payments (updated 16 January 2018)**

*Accounting considerations for withholding taxes*

The Internal Revenue Service (IRS) requires employers to withhold and remit tax on income generated when an employee exercises a nonqualified stock option or when stock awards vest. Companies often repurchase shares equal in value to the tax owed and remit the cash on behalf of the employee to satisfy the tax withholding requirements. ASU 2016-09, which was effective for public business entities for fiscal years beginning after 15 December 2016, amended ASC 718 to allow entities to withhold up to the maximum statutory tax rate in the employee’s jurisdiction, instead of the minimum tax rate required by the IRS, without causing liability classification of the award.

Because the Act reduces the maximum federal statutory tax rate to 37% from 39.6% and the minimum federal statutory rate to 22% from 25%, companies should reduce the applicable tax withholding rates to continue to avoid liability classification for the related awards. Companies should verify that they are withholding amounts in accordance with the 2018 IRS income tax withholding tables that were issued on 11 January 2018, regardless of whether they outsource their payroll and related tax responsibilities to third-party service providers or perform these processes in-house.

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9 ASU 2016-09, Improvements to Employee Share-Based Payment Accounting.
**Accounting considerations for performance conditions based on after-tax metrics**

Companies that have issued awards with performance conditions based on after-tax metrics (e.g., earnings per share, net income) should consider the effect of the Act on the probability that the performance condition will be met. For example, vesting in an award with a performance condition may have been assessed as improbable prior to the enactment of the Act. However, as a result of the reduced corporate income tax rate, the vesting may be probable. The effect of the change in estimate of an award’s probability of vesting should be accounted for in the period of change by recording a cumulative catch-up adjustment to compensation cost to retroactively apply the new estimate.

Companies may modify the terms and conditions of awards with performance conditions based on after-tax metrics to remove the effects of the Act, as they often do for unanticipated events. Companies that make this type of change will apply the modification accounting guidance in ASC 718-20 for adjustments to awards resulting from the application of the Act.

See section 5.2.6, *Broker-assisted cashless exercises and statutory withholding requirements*, section 4.4.2.3, *Changes in estimate of the probability of achievement of the performance condition*, and section 8.4, *Modifications of vesting conditions*, in our FRD publication, *Share-based payment*, for more guidance on these topics.

**Non pro-rata profit and loss allocations among investors (updated 16 January 2018)**

Investees or subsidiaries may have contractual profit-sharing arrangements that allocate earnings or losses among the investors (e.g., an equity method investor) in amounts that differ from the investors’ pro-rata ownership interests. When these arrangements are substantive, the profit-sharing provisions should be used to allocate earnings and losses to investors.

One approach applied in practice to account for substantive profit-sharing arrangements is the hypothetical-liquidation-at-book-value (HLBV) method. The use of this approach is appropriate when the terms of the substantive profit-sharing arrangement are consistent with the HLBV calculation. See section 6.7 of the FRD publication, *Equity method investments and joint ventures*, and section 16.1.1 of the FRD, *Consolidation*, for more guidance on assessing whether a profit-sharing arrangement is substantive and the HLBV method.

The substantive profit-sharing arrangement may refer to a target internal rate of return (IRR) or preferential return to allocate earnings or losses. If the IRR or preferential return is stated on an after-tax basis, generally the terms of the arrangement will specify the tax rate to be applied. When determining equity method income or losses, or allocating income or losses to the non-controlling interest, it is important to obtain an understanding of the terms and conditions of the specific arrangement.

When the terms of the arrangement refer to the tax rate in effect when the benefits are delivered, Ernst & Young LLP believes the tax rate in effect at the date HLBV is applied should be used. For example, an investor that applies HLBV to a calendar year-end investee to determine its share of the investee’s earnings or losses for the period ending 31 December 2017 would use the tax rate in effect on that date because the investor would assume the investee was liquidated on that date (rather than the rate in effect as of 1 January 2018). If the terms of the arrangement require a fixed tax rate to be used (e.g., 35%), the fixed tax rate would be used in an investor’s application of HLBV to determine its share of an investee’s earnings or losses.
**Fair value measurements (updated 16 January 2018)**

The Act may have immediate and long-term implications for valuations of businesses, equity interests and other assets and liabilities (e.g., intangible assets). Companies should review their fair value estimates and consider whether and, if so, how the Act has affected a market participant’s view of fair value.

The implications may go beyond the change in the assumed tax rate. Changes in the calculation of taxable income, which may be affected by the industry and location of a company’s operations, should also be considered. For this reason, companies that use an income approach will need to carefully model and appropriately support the changes in taxable income due to the Act. It might also be appropriate for a company to use a market approach, such as using a market multiple based on public company stock prices for comparable companies (e.g., a price to earnings ratio), because these prices should reflect a market participant view of fair value as of the measurement date. While the tax rate for most companies is expected to drop, how a company is affected will depend on its facts and circumstances.

Companies should make a good faith effort to estimate fair value based on the market participant view using available information that is known or knowable to a market participant as of the measurement date. The overall objective of a fair value measurement is to reflect the price a market participant would pay for the asset or receive to assume the liability on the measurement date, assuming customary and normal due diligence. As such, it is possible that the market participant assumptions will evolve in subsequent periods when the market has had more time to fully assess the effects of the Act.

**Other considerations**

Companies also need to consider:

- The effect of the tax law change on previously recorded federal, state and foreign unrecognized tax benefits and assessment of uncertain tax positions as well as related recognition, measurement and disclosure requirements
- Any effects related to existing deferred state tax amounts
- Assessment of any deferred tax assets for realizability
- The potential effect on other accounting assumptions that incorporate a company’s US tax rate

**Disclosures**

ASC 740 requires companies to disclose the effect of adjustments to deferred tax amounts for enacted changes in tax laws or rates. Companies also need to carefully consider how other aspects of the Act, such as the one-time transition tax, may affect each of the income tax disclosures required under ASC 740.

In addition to the disclosures required by ASC 740, SAB 118 requires companies to disclose information about the material financial reporting effects of the Act for which the accounting under ASC 740 is incomplete, including:

- Qualitative information about the income tax effects of the Act for which the accounting is incomplete
- The items reported as provisional amounts
- Existing current or deferred tax amounts for which the income tax effects of the Act have not been completed
The reason the initial accounting is incomplete

The additional information that needs to be obtained, prepared or analyzed to complete the accounting requirements under ASC 740

The nature and amount of any measurement period adjustments recognized during the reporting period

SAB 118 also requires companies to disclose the following information about material financial reporting effects of the Act, which companies will likely disclose in financial reporting periods after the period in which the Act was enacted:

- The effect of measurement period adjustments on the effective tax rate
- Disclosures of when the accounting for the income tax effects of the Act has been completed

**Illustration 8 – Disclosures a calendar year-end company might make in the period of enactment about incomplete accounting**

A calendar year-end company that has not yet completed its accounting might make the following disclosures in the notes to its financial statements for the period ended 31 December 2017.

This is a simple example that addresses only federal income tax effects and does not reflect other disclosures required by ASC 740. Depending on its facts and circumstances, a company will need to provide more information. Disclosures should be sufficiently detailed for a reader to understand the status of a company’s accounting for the tax effects of the Act (i.e., effects for which the accounting is complete, effects for which the accounting is incomplete but a reasonable estimate can be made, and effects for which the accounting is incomplete and no provisional amounts have been recorded) and the additional information needed to complete the accounting under ASC 740.

**Example disclosure:**

The Tax Cuts and Jobs Act was enacted on 22 December 2017. The Act reduces the US federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. At 31 December 2017, we have not completed our accounting for the tax effects of enactment of the Act; however, in certain cases, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances and the one-time transition tax. In other cases, we have not been able to make a reasonable estimate and continue to account for those items based on our existing accounting under ASC 740, Income Taxes, and the provisions of the tax laws that were in effect immediately prior to enactment. For the items for which we were able to determine a reasonable estimate, we recognized a provisional amount of $XXXX, which is included as a component of income tax expense from continuing operations.

**Provisional amounts**

Deferred tax assets and liabilities: We remeasured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. However, we are still analyzing certain aspects of the Act and refining our calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of our deferred tax balance was $XXXXX.
Foreign tax effects: The one-time transition tax is based on our total post-1986 earnings and profits (E&P) that we previously deferred from US income taxes. We recorded a provisional amount for our one-time transition tax liability for XX of our foreign subsidiaries, resulting in an increase in income tax expense of $XXX. We have not yet completed our calculation of the total post-1986 E&P for these foreign subsidiaries. Further, the transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when we finalize the calculation of post-1986 foreign E&P previously deferred from US federal taxation and finalize the amounts held in cash or other specified assets. No additional income taxes have been provided for any remaining undistributed foreign earnings not subject to the transition tax, or any additional outside basis difference inherent in these entities, as these amounts continue to be indefinitely reinvested in foreign operations. Determining the amount of unrecognized deferred tax liability related to any remaining undistributed foreign earnings not subject to the transition tax and additional outside basis difference in these entities (i.e., basis difference in excess of that subject to the one-time transition tax) is not practicable, but the related cumulative temporary difference as of 31 December 2017 was $XX.

We have not made sufficient progress on the E&P analysis for the remaining XX of our foreign subsidiaries to reasonably estimate the effects of the one-time transition tax and, therefore, have not recorded provisional amounts. We continued to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. Because we had previously determined these amounts were indefinitely reinvested, no deferred taxes have been recorded. It is impracticable to determine unrecognized deferred tax liabilities related to these entities, but the cumulative temporary difference as of 31 December 2017 was $XX.

Additional SEC disclosure considerations

When the effects of the tax law changes are or will be material to a registrant, the registrant should consider the disclosure implications in preparing its management’s discussion and analysis (MD&A) under Item 303 of Regulation S-K, including its discussion of results of operations and liquidity and capital resources.

The remeasurement of deferred tax assets and liabilities, recording the one-time transition tax and any reassessment of the realizability of deferred tax assets may have a material effect on many registrants’ tax provisions.

In addition, the Act will likely result in changes to a registrant’s effective tax rates in future periods. When disclosing results of operations, registrants should disclose and explain the effect of the new tax law on the 2017 tax provision as well as the expected effects on the effective tax rate in future years.

Registrants’ MD&A must consider any material liquidity implications of paying the required one-time transition tax. Registrants should also include their one-time transition tax liability in the table of contractual obligations based on the estimated installments and describe any related uncertainties.

The SEC staff has historically requested that registrants disclose the amount of cash held overseas that is unavailable for use domestically if the registrant has asserted it will indefinitely reinvest foreign earnings. Registrants may revisit their permanently reinvested assertions about foreign earnings in light of the tax law changes and should update liquidity and capital resources disclosures in MD&A, taking into account the additional funds that would be available to meet the needs of domestic operations net of transition tax payments.
Form 8-K reporting considerations
The SEC staff issued Compliance and Disclosure Interpretation (C&DI) 110.02 in response to questions it has received from companies regarding whether the remeasurement of a deferred tax asset (DTA) to reflect the new tax rates or other provisions of the Act would trigger an obligation to file a Form 8-K under Item 2.06, Material Impairments. The C&DI states that the remeasurement of a DTA to reflect the effect of a change in tax rate or tax laws is not an impairment under ASC 740 and would not trigger the reporting requirement. However, the enactment of new tax rates or tax laws could have financial reporting implications, including whether it is more likely than not that the DTA will be realized.

In the C&DI, the SEC staff also noted that registrants employing the measurement period approach described in SAB 118 and concluding that an impairment has occurred (e.g., a valuation allowance) for the period that includes the enactment date due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06, which exempts registrants from filing a Form 8-K if the conclusion is made in connection with the preparation, review or audit of financial statements to be included in the next periodic report to be filed. In those situations, registrants must disclose the impairment, or a provisional amount with respect to that possible impairment, in that next timely filed report.

Excerpt from C&DI

<table>
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<th>Question 110.02</th>
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<td><strong>Question:</strong> Does the re-measurement of a deferred tax asset (“DTA”) to incorporate the effects of newly enacted tax rates or other provisions of the Tax Cuts and Jobs Act (“Act”) trigger an obligation to file under Item 2.06 of Form 8-K?</td>
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<tr>
<td><strong>Answer:</strong> No, the re-measurement of a DTA to reflect the impact of a change in tax rate or tax laws is not an impairment under ASC Topic 740. However, the enactment of new tax rates or tax laws could have implications for a registrant’s financial statements, including whether it is more likely than not that the DTA will be realized. As discussed in Staff Accounting Bulletin No. 118 (Dec. 22, 2017), a registrant that has not yet completed its accounting for certain income tax effects of the Act by the time the registrant issues its financial statements for the period that includes December 22, 2017 (the date of the Act’s enactment) may apply a “measurement period” approach to complying with ASC Topic 740. Registrants employing the “measurement period” approach as contemplated by SAB 118 that conclude that an impairment has occurred due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report. [December 22, 2017]</td>
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</table>

How Ernst & Young sees it
While the C&DI clarifies Item 2.06 of Form 8-K, companies should continue to discuss with their securities counsel whether they are required to report any effects of the Act on Form 8-K.

Internal control considerations
Companies need to evaluate whether changes to their existing processes and controls are necessary to address the financial reporting effects of implementing both the Act and SAB 118. That is, companies need effective internal controls to make sure that the accounting implications of the transition and future tax provision calculations are accurately recorded in their financial statements.
In addition to the overall effect of the Act on the income tax accounts, key areas also requiring controls include the processes for estimating and finalizing provisional amounts, calculating the one-time transition tax, tracking outside basis differences after enactment, determining the timing of the reversal of temporary differences, assessing the realizability of deferred tax assets and carryforwards, calculating any minimum taxes and making disclosures.

Additionally, companies need to evaluate whether they need any new information to account for the effects of the tax law changes and whether they will use any new information in internal control over financial reporting. If they will use new information, companies also need to consider the effectiveness of their controls over the completeness and accuracy of that new information.

What companies need to do now

Personnel in a company’s finance, treasury and tax departments need to work together to execute a plan to respond to items such as the new corporate tax rate, the one-time transition tax, an immediate write-off of certain assets, any changes to existing tax attributes and any changes to internal controls that might be required.

Steps companies should take include:

- **Calculate changes to federal deferred tax balances** – Companies need to measure their deferred tax balances using the new tax rates in the period the tax law was enacted. Companies with fiscal years that do not end on 31 December need to estimate and schedule their temporary differences in the interim period that includes enactment to account for the effects of the tax law change.

- **Calculate the one-time transition tax on previously deferred foreign earnings and its accounting implications** – Companies should validate US tax attributes such as current and accumulated E&P, previously taxed income and foreign tax credit pools. Further, companies need to identify the amount of accumulated E&P that is held in cash and other specified assets or in illiquid assets for purposes of measuring the transition tax. Companies should consider whether earnings subject to the transition tax are expected to be remitted and any additional tax consequences.

- **Evaluate whether NOL and foreign tax credits are available to offset the transition tax and whether any remaining carryforwards are realizable** – Companies should determine whether there are excess carryforwards and credits that will remain and whether these carryforwards and credits are more likely than not to be realized.

- **Estimate which outside basis differences related to foreign subsidiaries exist after considering any one-time transition tax** – Companies should evaluate whether any of the exceptions to recording deferred taxes are available for those basis differences. For any remaining outside basis differences that do not meet any of the exceptions in ASC 740, companies need to determine the appropriate tax rate to measure related deferred tax amounts. Companies should keep in mind that capital gains are not exempted.

- **Evaluate whether AMT credit carryforwards are realizable** – Companies need to evaluate whether a deferred tax asset is currently recognized in connection with an AMT credit carryforward, the realizability of AMT credit carryforwards and whether amounts should be reclassified to a current or long-term receivable at the enactment date.

- **Evaluate which assets qualify for immediate expensing** – Companies need to finalize their inventory of qualified depreciable assets purchased since 27 September 2017.

- **Evaluate compensation plans** – Companies should determine whether their existing plans are subject to the grandfather provisions and whether any adjustments are needed to recorded deferred tax assets in the period of enactment.
Preparing for reporting after the effective date
Steps companies should take to prepare for the ongoing effects of the new tax law include:

- **Evaluate the effect of the GILTI inclusion and BEAT provisions** – Companies should evaluate what effect these provisions may have on their existing systems and processes to comply with these potential new tax laws.

- **Evaluate the effect on the estimated annual effective tax rates** – Companies should evaluate the Act’s effects on their effective tax rate, including the effects of the new tax rates, GILTI and BEAT provisions.

- **Evaluate compensation plans** – Companies should determine whether additional employees are considered covered persons who are subject to existing deductibility limits.

- **Evaluate the effects of limiting deductions related to other expenses (e.g., meals and entertainment expenses)** – Companies need to consider the effect on their estimated effective tax rates if this change is significant.
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Appendix A: FASB staff Q&A: Whether private companies and not-for-profit entities can apply SAB 118 (updated 16 January 2018)

Background

The staff of the Division of Corporation Finance and the Office of the Chief Accountant of the Securities and Exchange Commission (SEC staff), from time to time, issue statements in staff accounting bulletins (SABs) that express a view on the application of the Financial Accounting Standards Board (FASB) Accounting Standards Codification® and/or other disclosure requirements. The statements in SABs are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the SEC Staff in administering the disclosure requirements of the federal securities laws.

The views and interpretations of the SEC staff are not directly applicable to private companies and not-for-profit entities (as defined in the FASB Codification Master Glossary). However, in the past some private companies and not-for-profit entities have voluntarily applied the guidance in SABs.

The SEC staff recently issued SAB 118 on the application of Topic 740 on income taxes in the reporting period that includes the date on which the 2017 Tax Cuts and Jobs Act (Act) was signed into law.

Question

Given the longstanding practice of private companies electing to apply SABs, would the FASB staff object to private companies and not-for-profit entities applying SAB 118?

Response

Based upon the longstanding practice of private companies electing to apply SABs, the FASB staff would not object to private companies and not-for-profit entities applying SAB 118. If a private company or not-for-profit entity applies SAB 118, they would be in compliance with GAAP.

The FASB staff believes, however, that if a private company or a not-for-profit entity applies SAB 118, it should apply all relevant aspects of the SAB in its entirety. This would include the disclosures listed in SAB 118. The FASB staff also believes that a private company or a not-for-profit entity that applies SAB 118 should disclose its accounting policy of applying SAB 118 in accordance with paragraphs 235-10-50-1 through 50-3 of the Accounting Standards Codification.