A NOTE ON THE NEW FASB RULE ON "STRANDED INCOME TAX EFFECTS"

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The Tax Cuts and Jobs Act (P.L. 115-97, 12/22/17), a complex piece of legislation, was quickly put together and passed by Congress in 2017. This is the most significant tax law revision since 1986. Intended to enhance economic growth, the new law contains several changes for businesses and individuals alike. While there are still many questions about its specific provisions, there are a number of significant changes to consider for income tax compliance and planning. Among the prominent changes for businesses is the reduction in the maximum corporate income tax rate from 35% to 21%. The alternative minimum income tax provision has been eliminated for businesses. Also, the two-year net operating loss (NOL) carryback was eliminated. Now only carryforwards will be allowed for NOLs, restricted to 80% of taxable income in any carryforward year. However, the future number of carryforward years is not limited, contrary to the 20-year provision in the previous tax law. There is a 20% reduction in pass-through business income subject to taxation, albeit constrained by various caveats. Additionally, the law calls for a more liberal bonus depreciation allowance. Limitations on the business interest deduction and business entertainment expenses are also included in the law. On the other hand, there is a new, considerably higher estate tax exemption of $11 million. At this point, the overall effects of the law, both short and long term, are unknown.

Lower tax rates affecting financial accounting

This note deals with one narrow facet of the law: specifically, it discusses the manner in which the tax rate reduction affects income tax accounts reported on the accounting income statement, balance sheet, and comprehensive income statement. The purpose of the note is to focus on the deferred income tax effects on items in the comprehensive income statement. Some companies in the banking and insurance industries, in particular, have sought clarification on the impact of the tax rate changes on their shareholders' equity accounts since they are required to adhere to strict rules for maintaining regulatory capital. The argument has been made that the former higher tax rates could distort those accounts.

Comprehensive accounting income

The comprehensive income statement includes the bottom-line net income from the income statement and all the other comprehensive income (OCI) items net of income tax effects. While the income statement includes the revenues, expenses, gains, and losses pertaining primarily to the firm's operating performance, the comprehensive income statement encompasses all of those items in the net income plus the unrealized fair value gains and losses from a set of arbitrary items that the Financial Accounting Standards Board (FASB), which issues accounting principles, has decided to exclude from the income statement because those fair value changes could be volatile. The arbitrary items include the following assets or liabilities: available-for-sale debt securities; the effective portion of cash flow hedging derivatives; defined benefit pension and other post retirement assets and liabilities; and foreign currency translation rate adjustments.

Deferred tax accounts

Each OCI fair value change tends to have deferred tax consequences. Although those unrealized gains and losses appear on neither the accounting income statement nor the income tax return, they produce temporary differences in the asset or liability bases in financial reporting and income taxation. Those differences are either expected future taxable or deductible amounts. Multiplying those amounts by the tax rates in effect in the specific future periods in which those amounts are anticipated generates deferred tax balances. The balances stemming from future taxable amounts are deferred tax accounting liabilities while the balances from future deductibles are deferred tax assets.

In such circumstances when the accounting basis exceeds the tax basis for an asset, future taxable amounts are expected. If the converse holds, future deductible amounts are expected. In those circumstances when the accounting liability basis exceeds the tax liability basis, future deductible amounts are expected. If the converse holds, future taxable amounts are expected. It should be noted that all deferred tax accounts are considered long term in nature given the uncertainty about when the asset or liability basis differences between accounting and taxation will reverse.

Accordingly, the OCI items reported in the comprehensive income statement and cumulatively on the accounting balance sheet in the stockholders equity section—within an account named "accumulated other comprehensive income" (AOCI)—reflect the deferred tax effects of the differences between the accounting and tax bases. However, those effects are a function of the earlier tax rates rather than those under the new law. In generally accepted accounting principles (GAAP)—(ASC 740 on Income Taxes)—the latest tax rates on enactment should be used to compute the income tax expense within the income from continuing operations found in the income statement along with the income tax liability as well as the deferred tax liability and asset accounts. Nevertheless, there has not been a GAAP procedure to allow for changes in tax rates to be made in deferred tax amounts embedded in AOCI. Therefore, the new tax effects going from the 35% to 21% rates have come to be called "stranded tax amounts." Prior to the new tax law, stranded amounts remained that way unless the AOCI underlying assets or liabilities were sold or liquidated.

Reclassifying stranded tax effects

In light of the new tax law, after deliberating on this topic and issuing an exposure draft of a proposed standard, the FASB has decided to allow companies the option of reclassifying the stranded amounts from AOCI to retained earnings to more appropriately reflect the specific shareholders equity accounts—see FASB Accounting Standards Codification Update No. 2018-02 Topic 220—"Income Statement—Reporting Comprehensive Income: Reclassification of Certain Tax Effects from AOCI." This rule, which permits retrospective or just current treatment in the year of adoption, goes into effect for companies whose fiscal year begins after 12/15/18 and for interim periods as well. It should be noted that if companies are using provisional figures to assess the tax effects from the new law, they may have additional reclassifications to make. [See SEC Staff Accounting Bulletin (SAP) 118, 12/22/17.] Whatever policy on reclassification a company selects, it is required to disclose that policy in accordance with the FASB standard update.

Illustration

As an illustration of an application of the reclassification option, assume a company has a deferred tax liability balance due to a difference between the higher accounting basis relative to the tax basis for an AOCI asset such as available-for-sale debt securities. Unrealized holding gains from changes in the fair value of this security are included in the accounting but not the tax basis of this asset. The deferred tax liability on this book-tax difference, which is expected to reverse in the future, was recognized previously at 35%. In view of the 21% newly-enacted tax rate, a reclassification adjustment out of AOCI to income from continuing operations within the income statement would reduce both the deferred tax liability and the income tax expense. As a result, the net income and retained earnings would increase.

Conclusion

The TCJA contains several new features for income tax compliance and planning. In response, a few major companies have already announced their intentions to pay bonuses based on the tax rate reductions. Given the current low unemployment rate, perhaps the law will stimulate wage growth. The effect on repatriation of foreign earnings is a big question mark at this juncture even though that could occur at significantly reduced tax rates. The extent to which major companies will invest in American-based business projects as opposed to those abroad also remains to be seen. Even before the law was passed, many U.S. firms were disinclined to invest in this country despite huge cash reserves. Will companies continue to pursue the financial strategy of buying back their own shares to raise the market price per share instead of investing in capital expenditures on plant and equipment? Another factor is that the government is raising interest rates, which tends to discourage capital investment. Additionally, whether foreign governments decide to change their tax laws to follow suit is an issue to consider. Finally, there is the possible effect of steep tariffs on steel and aluminum and other trade restrictions, including a major tax on Chinese imports, that the federal administration has announced.

One clear-cut negative associated with this law is that its provisions will increase the federal deficit substantially. As one attempts to analyze, understand, and apply its provisions, it will be a while before the long-term effects of the law are clear and whether it will enhance economic growth. Regardless of its long-term consequences, this law has reduced corporate tax rates considerably, and therefore financial reporting requires reclassification adjustments to better align income statement and balance sheet accounts with the appropriate new figures. This note has focused on that ramification of the law.