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Accounting for income taxes

A quarterly perspective

21 March 2017
Today’s moderator

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Polling question

What position do you hold?

A. Accounting or finance
B. Tax
C. Member of an accounting, auditing or law firm
D. Other
Today’s agenda

► FASB projects update
► Legislative and other developments
► US tax reform considerations
► EAETR and interim reporting reminders
### Selected FASB projects

**Current status**

<table>
<thead>
<tr>
<th>Project</th>
<th>Status</th>
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</thead>
<tbody>
<tr>
<td>Revenue – technical corrections and improvements</td>
<td>ASU 2016-20</td>
</tr>
<tr>
<td>Definition of a business</td>
<td>ASU 2017-01</td>
</tr>
<tr>
<td>Goodwill impairment</td>
<td>ASU 2017-04</td>
</tr>
<tr>
<td>Sale of nonfinancial assets</td>
<td>ASU 2017-05</td>
</tr>
<tr>
<td>Presentation of pension costs</td>
<td>ASU 2017-07</td>
</tr>
<tr>
<td>Disclosure framework</td>
<td>Redeliberations¹</td>
</tr>
<tr>
<td>Disclosures about government assistance</td>
<td>Redeliberations</td>
</tr>
<tr>
<td>Hedging</td>
<td>Redeliberations</td>
</tr>
</tbody>
</table>

¹ The disclosure framework project is being executed across several topics, which are in various stages of completion, but most are generally in the Redeliberations phase.
FASB projects – effective dates

Several standards can be adopted as early as Q1’17:

- ASU 2016-09, Improvements to employee share-based payment accounting
- ASU 2016-16, Intra-entity transfers of assets other than inventory
- ASU 2014-09 (codified in ASC 606), Revenue from contracts with customers
- ASU 2016-01, Recognition & measurement of financial assets and financial liabilities
- ASU 2016-02 (codified in ASC 842), Leases

<table>
<thead>
<tr>
<th></th>
<th>ASU 2016-09</th>
<th>ASU 2016-16</th>
<th>ASC 606</th>
<th>ASU 2016-01</th>
<th>ASC 842</th>
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<tr>
<td>Early adoption</td>
<td>1/1/2016</td>
<td>1/1/2017*</td>
<td>1/1/2017</td>
<td>1/1/2016**</td>
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<td>Public company</td>
<td>1/1/2017</td>
<td>1/1/2018</td>
<td>1/1/2018</td>
<td>1/1/2018</td>
<td>1/1/2019</td>
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<tr>
<td>Private company</td>
<td>1/1/2018</td>
<td>1/1/2019</td>
<td>1/1/2019</td>
<td>1/1/2019</td>
<td>1/1/2020</td>
</tr>
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</table>

* Early adoption only permitted in the first interim period if an entity issues interim financial statements.
** Applies to certain provisions only.

For public companies which have not yet adopted the new standards, disclose the effect of adoption on future periods.
FASB projects – effective dates
Additional considerations

► Certain standards will have a direct impact to the guidance in ASC 740.

► Other standards indirectly impact income taxes, due to a change in the timing of book income or expenses, or the existence of new assets and liabilities on the balance sheet.
  ► Recognition and measurement of deferred tax assets (DTAs) and deferred tax liabilities (DTLs)
  ► Assessment of the recoverability of DTAs (i.e., the need for and measurement of a valuation allowance)

► Consider whether the company has appropriate processes and controls in place to account for taxes under the new standards.
Today’s agenda

► FASB projects update
► Legislative and other developments
► US tax reform considerations
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Legislative and other developments

Significant legislation enacted in the current quarter – International

- **Gabon** – enacted legislation that imposes a 5% withholding tax on income from immovable property. The legislation also incorporates the latest OECD recommendations against base erosion and profit shifting (BEPS). Changes are generally effective 1 January 2017.

- **Malaysia** – enacted legislation that imposes a 10% withholding tax on payments made to nonresidents for services, even if those services are performed outside Malaysia. The legislation also imposes the 10% domestic royalty withholding tax on payments for the use of or the right to use software. The changes are effective 17 January 2017.

- **Oman** – enacted legislation increasing its standard corporate income tax rate to 15% from 12%. The legislation also limits income tax exemptions to the manufacturing sector for five years, provided certain conditions are met, and imposes a 10% withholding tax on payments to nonresidents for interest, dividends and services. The changes, among others, are effective for tax years beginning 1 January 2017.

- **Uruguay** – enacted legislation that imposes taxes on income from transactions involving derivative financial instruments. The legislation also allows corporate income taxpayers to deduct losses from derivative financial instruments, if certain conditions are met. The changes are effective for derivative financial instruments liquidated from 31 January 2017.
Legislative and other developments

Other considerations – US Federal

► Under temporary and proposed regulations, a US company’s transfer of appreciated property to a partnership with related foreign partners is taxable, unless certain conditions are satisfied. The regulations are generally retroactively effective to August 2015 and were not affected by the regulatory freeze issued by the Trump administration on 20 January 2017.

► In final regulations, the Government shortened to five years from 10 years the period Real Estate Investment Trusts (REITs) must hold contributions of appreciated property to avoid taxation on the appreciated value.
Other considerations – US State

► **Massachusetts** – the state Supreme Judicial Court held that a biotechnology company must use the statutorily prescribed single sales factor apportionment formula to calculate Massachusetts taxable income because the company qualified as a "manufacturing corporation" for the tax years at issue.

► **Michigan** – the Government announced that it will retroactively apply to all open tax years a decision by the Michigan Court of Appeal holding that two corporations and a limited partnership were not a “unitary group” for combined filing purposes. The announcement followed a refusal by the Michigan Supreme Court to consider the Government’s appeal of the decision.

► **New Jersey** – the state Tax Court held that a pharmaceutical company could include unsourced receipts in the denominator for the apportionment of income that is subject to tax in New Jersey.

► **Tennessee** – the Government outlined how certain telecommunications companies should source their receipts from sales of non-tangible personal property under the franchise and excise tax in effect for tax years beginning 1 July 2016.

► **Texas** – a Texas Court of Appeals held that a heavy machinery rental company could not include delivery and pick-up fees charged to its customers in its cost of goods sold deduction because they did not qualify as “costs of goods sold” under the franchise tax statute.
Legislative and other developments

Other considerations – International

► **India** – in a circular, the Government clarified how its general anti-avoidance rules will apply when they become effective on 1 April 2017.

The Government also finalized guidance on determining whether a foreign company is resident in India based on its “place of effective management.”

► **Mauritius** – The Supreme Court held that a financial services company must apportion its expenses between taxable dividend income and tax-exempt capital gains, even though it did not incur the expenses in the production of its capital gains.

► **Spain** – the Tax Administrative Court held that interest payments on net equity (i.e., Juros) received by a Spanish company before 1 January 2015 from its Brazilian subsidiaries were not subject to tax because they qualified as dividends for Spanish domestic tax purposes.

► **Vietnam** – in a decree, the Government outlined the requirements companies must meet to deduct related party service and interest expenses. The Government also provided guidance on applying various transfer pricing methods.
Legislative and other developments

Other considerations – International

▶ **Singapore** – revised transfer pricing guidelines, the Government provided additional guidance on the arm’s-length principle.

▶ **United Kingdom** – the Government issued guidance on the transfer pricing issues created by “cash pooling” arrangements.
Legislative and other developments

Things we have our eyes on – Domestic

- **Hawaii** – the Government proposed repealing the dividends paid deduction for REITs for 15 years for tax years beginning after 31 December 2017. An exception would apply for dividends generated from affordable housing properties.
Legislative and other developments

Things we have our eyes on – International

- **Australia** – the Government introduced legislation that would impose a 40% tax on profits generated by large multinational companies (i.e., those with over AU$1 billion in annual global revenues) in Australia and artificially shifted out of the country. The legislation would also implement expanded transfer pricing rules in line with the October 2015 OECD Transfer Pricing Guidelines.

- **Cyprus** – the Government announced that it will replace the current rules governing the pricing of certain related party loans (i.e., the minimum margin scheme) with detailed transfer pricing requirements based on the OECD’s Transfer Pricing Guidelines.
Legislative and other developments

Things we have our eyes on – International

► **European Union** – the Economic and Financial Affairs Council of the European Union amended rules in its anti-tax avoidance directive that are designed to eliminate tax advantages from certain hybrid instruments and hybrid entities (i.e., eliminate “hybrid mismatches” between EU and non-EU Member States). The amended rules would apply to additional types of hybrid mismatches, such as hybrid permanent establishment mismatches, hybrid transfers, imported mismatches, reverse hybrid mismatches and certain dual resident mismatches.

► **Norway** – in a letter to the European Free Trade Association Surveillance Authority, the Government maintained that its rules limiting interest deductions do not violate the European Economic Area Agreement, but noted that it is considering modifying the rules to align them with the OECD’s BEPS initiative.
Legislative and other developments

Things we have our eyes on – International

- **India** – proposed reducing the corporate tax rate for small businesses (revenues less than INR500 million (US$7.5 million)) to 25% (plus surcharges) from 30% (plus surcharges). In line with OECD recommendations, it also proposed limiting the deductibility of related party interest expenses to 30% of earnings before interest, taxes, depreciation and amortization. Disallowed interest expenses could be carried forward up to eight years, subject to the 30% cap. Other proposals, effective 1 April 2017 include:
  - Making general anti-avoidance rules effective 1 April 2017
  - Imposing a 5% withholding tax (plus surcharges) on certain interest earned by nonresidents
  - Revising the standards for computing minimum alternative tax (MAT) and extending the carry-forward period for MAT credits to 15 years from 10 years
  - Retroactively reducing from 1 April 2012 the long-term capital gains rate on sales of shares of an Indian private company to 10% (plus surcharges) from 20%
  - Reducing the withholding tax rate on payments made to call centers to 2% from 10%
  - Excluding transactions between two related parties from Indian transfer pricing requirements unless either party claims related deductions
Legislative and other developments

Things we have our eyes on – International

► **Singapore** – the Government proposed replacing existing tax benefits for income from intellectual property with new tax benefits that would comply with the OECD’s BEPS initiative. The new tax benefits would take effect beginning 1 July 2017, but recipients of the existing tax benefits would retain them until 30 June 2021. Other changes include:
  ► Extending the reduced income tax rates under the Global Trader Programme to certain income from supplying fuel to aircraft or vessels within Singapore
  ► Extending the reduced income tax rates under the Global Trader Programme to certain income from storing commodities in Singapore
  ► Extending the expiration dates of certain tax incentives (e.g., allowance for capital expenditures) to 31 December 2022
  ► Extending the corporate income tax rebate another year to financial years ending in 2017 but reducing the rebate rate to 20% from 50% and capping the rebate amount at S$10,000 (US$7,000)
  ► Introducing a safe harbor under which companies may deduct 75% of payments made under a cost-sharing agreement for eligible research and development projects

► **United Kingdom** – the UK Parliament conferred on UK Prime Minister Theresa May the power to notify the other EU Member States of the UK’s intention to withdraw from the EU.
Today’s agenda

► FASB projects update

► Legislative and other developments

► US tax reform considerations

► EAETR and interim reporting reminders
## Trump/Republican priorities for 2017

<table>
<thead>
<tr>
<th>Topic</th>
<th>Details</th>
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<tbody>
<tr>
<td><strong>ACA repeal</strong></td>
<td>- Reconciliation instructions provided for Senate passage</td>
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<td></td>
<td>- Multiple proposed “replace” plans retain some Affordable Care Act (ACA) elements</td>
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<tr>
<td></td>
<td>- Trump signed ACA executive order on 20 January 2017</td>
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<tr>
<td><strong>Tax reform</strong></td>
<td>- Trump, House GOP have similar proposals on rates</td>
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<td></td>
<td>- Different approaches to international taxation</td>
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<td></td>
<td>- Controversy over House GOP’s border adjustments</td>
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<td><strong>Infrastructure</strong></td>
<td>- Trump wants public-private partnerships, private investments</td>
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<td></td>
<td>- Focus off of repatriation as funding?</td>
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<td></td>
<td>- Senate Democrats unveiled their own infrastructure proposal</td>
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<tr>
<td><strong>Regulatory reform</strong></td>
<td>- Trump signed executive order on 30 January 2017</td>
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<td></td>
<td>- Trump issued “Regulatory Freeze Pending Review” memo</td>
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<td></td>
<td>- House GOP Better Way effort also targeted regulatory reform</td>
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<tr>
<td><strong>Immigration</strong></td>
<td>- Trump signed executive orders - immigration/border security</td>
</tr>
<tr>
<td></td>
<td>- Budget bills could include funds for border enforcement</td>
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<td></td>
<td>- Trump: “work out something” for immigrant children</td>
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<tr>
<td><strong>Trade</strong></td>
<td>- Instructing Treasury to label China a currency manipulator</td>
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<td></td>
<td>- Removed United States from Trans-Pacific Partnership</td>
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<td></td>
<td>- Renegotiating existing US trade deals</td>
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</table>
Major elements of the House Blueprint impacting business income tax system

► The Blueprint would:
  ► Allow immediate expensing of all capital expenditures (other than land)
  ► Eliminate deductibility of net interest expense
  ► Repeal most business tax preferences, except for the R&E credit and LIFO
  ► Repeal the corporate alternative minimum tax (AMT)
  ► Move to a territorial international tax system with a 100% exemption for dividends from foreign subsidiaries (with a one-time tax on accumulated foreign earnings as a transition mechanism)
  ► Implement a border adjustment mechanism

► Business tax rates also lowered:
  ► 20% statutory corporate tax rate
  ► 25% top tax rate for business income passed-through to individuals
Overview – transition tax

► It is likely that a mandatory tax on unremitted earnings provision will be effective for 2017 or 2018 (the “transition toll-charge”) and that the computation will be based on earnings & profits (E&P), a US tax concept, as the measurement of earnings.

► Both Congress and President Trump have said or have inferred they would tax undistributed foreign earnings in controlled foreign corporations (CFCs).
  ► President Trump’s plan proposes a 10% rate.
  ► House Blueprint proposes 8.75% rate to the extent earnings are attributable to cash and 3.5% for other earnings.

► “Former” indefinitely reinvested E&P of foreign subsidiaries will be “deemed repatriated” under both plans.

► A shift to a low-rate environment and a territorial tax regime generates the need to identify current attributes and quantify the value of accelerating/utilizing them in the pre-reform period.

► Consider the impact of planning undertaken in preparation of reform on indefinite reinvestment assertion.
Example – transition tax

<table>
<thead>
<tr>
<th>USP</th>
<th>Deferred foreign earnings</th>
<th>Pro-Rata Share</th>
<th>Allocation of E&amp;P Deficit</th>
<th>Actual Inclusion</th>
<th>Gross Deemed Paid Foreign Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC1</td>
<td>40</td>
<td>40</td>
<td>(20)</td>
<td>20</td>
<td>7.5</td>
</tr>
<tr>
<td>CFC2</td>
<td>60</td>
<td>60</td>
<td>(30)</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>CFC3</td>
<td>(50)</td>
<td>(50)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
<td>-</td>
<td><strong>50</strong></td>
<td><strong>17.5</strong></td>
<td></td>
</tr>
</tbody>
</table>

E&P: Earnings and Profits, Taxes: Tax Payments

- CFC1: E&P: 40, Taxes: 15
- CFC2: E&P: 60, Taxes: 20
- CFC3: E&P: (50), Taxes: 25
Addressing the effects of proposed legislation is complex and rapidly changing

- Preparing for US tax reform involves understanding the impact of proposals and communicating the effects with your C-suite and board.

- It is important to understand the timing of accounting for changes in tax law and model out the impact of proposals on current and deferred taxes and existing tax attributes.

- Consideration should be given to existing tax processes and internal controls to evaluate readiness.

- Don’t wait for the proposals to be enacted to react – review accounting framework and potential impact of proposals now.
Today’s agenda

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► EAETR and interim reporting reminders
Estimated annual effective tax rate (EAETR) Overview

► Make best estimate of the annual effective tax rate for full fiscal year at end of each interim period

► Use EAETR to record tax on current year-to-date basis
  ► Project year-end temporary differences and valuation allowance
Estimated annual effective tax rate (EAETR)  
Reminders related to new standards

► Excess tax benefits and tax deficiencies from share based payment awards are accounted for as discrete items in the interim period in which they occur (ASU 2016-09).

► Evaluate whether the tax effects of an intercompany transaction should be treated as a discrete item or included in the computation of the estimated annual effective tax rate using existing guidance (i.e., transaction is both significant and either unusual or infrequently occurring) (ASU 2016-16).
Change in tax law

- Recognized in income tax expense from continuing operations in the period of enactment

- Enactment date
  - When all steps in the legislative process are complete

- Cumulative effect of the change is recognized in the interim period of enactment
  - Spreading is prohibited
  - Cannot include in the EAETR prior to enactment

- Disclose the effects of:
  - Adjustments to deferred tax amounts for enacted changes
  - Change in EAETR in interim periods
Change in tax law – retroactive

- Recognized consistently with other changes in tax law
  - In period of enactment
  - Included in tax expense from continuing operations
- Two principal factors to determine the tax effect of a retroactive change
  - Estimated taxable income (includes retroactive period)
    - Cannot allocate the tax effects of a retroactive tax law change to prior interim periods
  - Deferred tax balances existing at enactment date
Change in indefinite reinvestment assertion

- A significant event may represent change in facts and circumstances related to ability and intent to indefinitely reinvest

- Recognize deferred taxes on unrepatriated earnings in period assertion changes
  - Generally not the same period as repatriation
  - Income tax expense (continuing operations)
  - Discrete event
One-minute recap
Upcoming Thought Center webcasts
www.ey.com/ustaxwebcasts

► **Wednesday, 22 March:** Navigating in a post-BEPS world: multilateral instrument impact on implementation of treaty-related BEPS measures (part 3 of 6)

► **Thursday, 23 March:** Tax and regulatory reform: hedge fund industry

► **Tuesday, 28 March:** New and notable in tax controversy…LB&I Campaigns – a conversation with IRS LB&I executives

► **Friday, 31 March:** BorderCrossings with EY’s transfer pricing and tax professionals – An update on reducing transfer pricing uncertainty through the IRS Advance Pricing and Mutual Agreement (APMA) Program
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  ► Click on the link that will be provided in the post-webcast message.
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