Accounting for Income Taxes Panel Discussion

2022 TEI-SJSU High Tech Tax Institute

TAX EXECUTIVES INSTITUTE, INC.
Silicon Valley Chapter

SJSU | LUCAS COLLEGE AND GRADUATE SCHOOL OF BUSINESS
MST Program

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US tax law – CHIPS and IRA

- Refundable Credits
- Transferable Credits
- Grant Accounting
- Corporate AMT
- Stock Buybacks (see next slide)

Stock Buybacks / Repurchases

Excise Tax

- The Inflation Reduction Act adds a new 1-percent excise tax on stock repurchases by publicly traded companies that occur after December 31, 2022.
- A covered corporation would be subject to a tax equal to 1 percent of:
  1) the fair market value of any stock of the corporation that is repurchased by such corporation (or certain affiliates) during any taxable year, with limited exceptions, less
  2) the fair market value of any stock issued by the covered corporation (or certain affiliates) during the taxable year (including compensatory stock issuances).
- As the tax is not based on an element of taxable income it is not within the scope of ASC 740.
- It is generally acceptable to account for an excise tax obligation that results from the repurchase of common stock classified within permanent equity as a cost of the treasury stock transaction.

Valuation Allowance

- Cumulative losses in recent years
- Cumulative income in recent years
- Time horizon for forecasted income
- Scheduling of DTAs against DTLs
- Interim Accounting

Valuation Allowance Scheduling

General overview

- Consider deferred tax liabilities that represent a source of taxable income when they reverse
- While total deferred tax liabilities may exceed deferred tax assets, it is important to evaluate existing deferred tax liabilities to determine when such reversals will occur
- Must evaluate when a taxable temporary difference will reverse and determine if it reverses within the “reach” of items giving rise to deferred tax assets
- If taxable temporary difference reverses after the deferred tax asset expires, a valuation allowance may be required

Example – Scheduling Reversal of Temporary Differences (IRC Section 174 to be discussed later)

Facts:

- Company ABC is a calendar year end company
- On 12/31/2022, the Company has a deductible temporary difference for capitalized R&D and a taxable temporary difference for intangible assets
- The capitalized R&D will reverse over the next 5 years while the intangible assets will reverse over the next two years

Question: How much valuation allowance is required?

		Reversal Pattern		
	12/31/22	12/31/23	12/31/24	Later Years
Capitalized R&D	450	(100)	(100)	(250)
Intangible Assets	(500)	250	250	0
Valuation allowance	(250)			
Gross temp difference	-300			
Tax rate	21%			
Net DTA / (DTL)	(63)			

Cryptocurrency & Other Digital Assets

- US Federal Income Tax Treatment
- Impacts to Timing and Character of income/loss recognition
- Some of the IRS guidance thus far
  - IRS Notice 2014-21
  - Rev. Rul. 2019-24 – Hard Forks and Airdrops

"Digital assets are any digital representation of value that may function as a medium of exchange, a unit of account, and/or a store of value."

https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets

Cryptocurrency & Other Digital Assets

On Oct. 12, FASB tentatively decided to require an entity to:

- Measure crypto assets at fair value, using the guidance in Topic 820, Fair Value Measurement.
- Recognize increases and decreases in fair value in comprehensive income each reporting period.
- Recognize certain costs incurred to acquire crypto assets, such as commissions, as an expense (unless the entity follows specialized industry measurement guidance that requires otherwise).

We expect FASB to continue its project deliberations around the recognition (and derecognition), presentation and disclosure of in-scope crypto assets

Cryptocurrency & Other Digital Assets

Application of US GAAP, Additional Concepts

- Valuation allowance considerations
- Timing or permanent differences?
- Interim for year-to-date gains (AETR vs. Discrete)

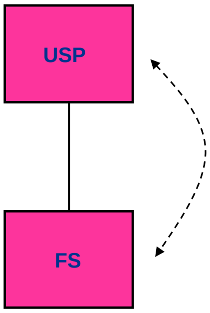
Section 174 – Capitalization Requirement

For tax years beginning after December 31, 2021, Section 174 is modified as a result of the TCJA.

- Requires taxpayers to capitalize and amortize R&D over five tax years, beginning with the midpoint of the tax year.
- For foreign research, the amortization period is extended to 15 tax years.
- Requires the extended amortization even in cases of a retired, abandoned, or disposed property.
- Eliminates taxpayers' ability to rely on Rev. Proc. 2000-50 to immediately deduct software development expenditures.

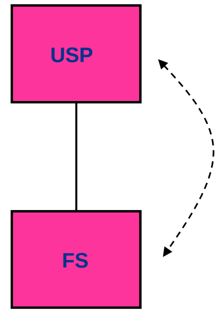
Section 174 Deduction (cont.)

Contract R&D



Intercompany R&D services – cost-plus compensation (assume USP pays $110 to compensate FS for $100 of expenses)

R&D Cost-Sharing



R&D cost-sharing between US and non-US cost-sharing participants (assume USP and FS “share” in $100 of expenses)

Which entity(ies) has 174 deduction deferral, including for GILTI purposes?

IRC Section 174 Costs – GILTI Period Cost

Assumptions

- USP and a CFC both have R&D expenses of $100M each
- US tax rate 21%; CFC US GILTI inclusion taxed at a net 10.5%
- Group has total profits of $200M
- The company has elected the period cost method for reporting GILTI

Effects of IRC section 174 costs only	2021	2022
Current income tax expense benefit	$31.5M (1)	$2.5M (2)
Deferred income tax expense benefit	N/A	$18.9M (3)
Total income tax expense benefit for the $200M of R&D	$31.5M	$21.4M
Effective tax rate increase in 2022		5%

2021 **(1)**	US	Foreign	Total
R&D Expense	$100M	$100M	$200M
Tax Rate	21%	10.5%	
Current income tax benefit	$21M	$10.5M	$31.5M

2022 **(2)**	US	Foreign	Total
R&D Expense	$100M	$100M	$200M
Plus: Sec. 174 Cap	$90M*	$97M**	
Current Tax Deduction	$10M	$3M	$13M
Tax Rate	21%	10.5%	
Current income tax benefit	$2.1M	$.4M	$2.5M

2022 **(3)**	US	Foreign	Total
R&D Expense	$100M	$100M	$200M
Less: 2022 Deduction	$10M*	$3M*	
Deductible Temporary Diff	$90M	$97M	$187M
Tax Rate	21%	0%	
Deferred income tax benefit	$18.9M	$0M	$18.9M

*US R&D of $100M x 20% (5-year amortization) x 50% (half-year convention) x 21%
**CFC R&D of $100M x 6.7% (15-year amortization) x 50% (half-year convention) x 10.5%

IRC Section 174 Costs – GILTI Deferred Accounting

Assumptions

- USP and a CFC both have R&D expenses of $100M each
- US tax rate 21%; CFC US GILTI inclusion taxed at a net 10.5%
- Group has total profits of $200M
- The company has elected GILTI deferred accounting

Effects of IRC section 174 costs only	2021	2022
Current income tax expense benefit	$31.5M (1)	$2.5M (2)
Deferred income tax expense benefit	N/A	$29M (3)
Total income tax expense benefit for the $200M of R&D	$31.5M	$31.5M
Effective tax rate increase in 2022		0%

2021 **(1)**	US	Foreign	Total
R&D Expense	$100M	$100M	$200M
Tax Rate	21%	10.5%	
Current income tax benefit	$21M	$10.5M	$31.5M

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Tax Rate	21%	10.5%	
Deferred income tax benefit	$18.9M	$10.1M	$29M

*US R&D of $100M x 20% (5-year amortization) x 50% (half-year convention) x 21%
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GILTI Policy Choice

Can I change my accounting policy election?

- Preferability Letter
- No policy elected previously – Immaterial difference

Base Erosion and Anti-Abuse Tax (BEAT)

Once a company's average annual gross receipts exceeds $500 million, the Company must account for outbound payments to affiliates and may be subject to BEAT tax even if there is net operating loss carryforward (i.e. no regular tax due). See the example below

Examples of outbound payments are:

- Payments for R&D services
- Payments for sales/marketing services
- Other similar outbound cost-plus payments for services

This is a very common fact pattern with high growth US companies

Regular Tax Computation (with NOL Utilization)	
Taxable Income	**300,000**
Net Operating Loss	**(300,000)**
Taxable Income after NOL	**-**
U.S. Tax Rate	21%
Regular Tax Liability	**-**
BEAT Modified Taxable Income	
Regular Taxable Income	-
Add Base Erosion Payments	150,000
Add BEAT % of NOLs	15,000
Modified Taxable Income	165,000
	10%
Modified Tax Amount	**16,500**
BEAT	
Modfied Tax Amount	16,500
in excess of Regular tax	-
Permanent BEAT tax cost	**16,500**

Miscellaneous topics

- Goodwill Impairments
- Indefinite reinvestment

Notice

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

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