2023 YEAR-END TAX PLANNING GUIDE

INCOME TAX - ASC 740

Lumsden McCormick LLP

CERTIFIED PUBLIC ACCOUNTANTS

CONTENT

This guide identifies tax strategies and considers how they may be influenced by recent administrative guidance and potential legislative changes that remain under consideration. Unless otherwise noted, the information contained in this article is based on enacted tax laws and policies as of the publication date and is subject to change based on future legislative or tax policy changes.

What Lessons Can Corporate Tax Departments Take Into 2024?

In 2022, corporate tax departments that were already facing a persistent lack of resources had to adapt tax provision work and control frameworks to account for policy-related changes enacted over the last few years. With 2023 drawing to a close, now is a good time to revisit planning considerations – no matter when your tax year ends.

That is especially true, given the various important changes that are affecting, will affect, and will continue to affect tax functions. For instance, many Inflation Reduction Act rules took effect this year, and other changes, including some under OECD Pillar Two, are set to begin in 2024. Those policies, coupled with staffing and resource challenges, will make it even more important for tax departments to maintain and follow internal controls in the 2023 tax provision season.

Tax practices should therefore be prepared to continue handling complex issues in the year ahead. Addressing topics such as internal controls and tax technology can prepare you for the myriad changes 2024 could bring.

Managing Internal Controls

A tax office is only as strong as its accountability structure, and a strong control environment allows the tax function to operate more thoroughly, accurately, and efficiently. As companies adapt to policy changes and face new requirements and tighter deadlines, building and maintaining reliable control frameworks can help address issues like base erosion and profit shifting. While strong control frameworks are required for public companies under the Sarbanes-Oxley Act, private companies can benefit from implementing similar internal controls. Taking a more rigorous approach to internal controls can enhance organizational accountability, reduce fraud risk, and improve reporting. Private companies can also enlist third-party service providers for support in establishing a control framework.

A business is ultimately responsible for managing whatever tax framework it chooses to build. Even if an internal tax department outsources provision and tax return preparation work to a third-party service provider, it should ask its vendors the right questions and flag items that could result in control issues, such as significant transactions like mergers and acquisitions. Involving the tax department in transactional decision-making will help leadership stay informed and avoid potential tax liabilities and penalties. Further, quarterly controller meetings between internal tax departments and external service providers to discuss recent and ongoing transactions, lessons learned from past activities, and relevant tax issues, as well as each party's responsibility in addressing them, can help companies develop and maintain effective control frameworks.

Maintaining Successful Tax Processes

As companies grow, management inevitably becomes more decentralized as local teams are established to handle region-specific operations. Those smaller teams might not have the tax expertise to manage local obligations, such as timely filing returns and statutory audits and remaining compliant with transfer pricing. That leads to financial statement risk and cash tax exposure, complicating calculations of tax provision and taxes owed. Decentralized teams also create concerns for the corporate tax department, which must ensure that local offices are meeting their tax obligations.

Companies can combat those challenges by adding more oversight to local finance teams. Although it would be ideal to employ regional tax professionals to oversee and report into the overall tax function, ongoing shortages of experienced employees makes staffing those positions difficult. For departments unable to hire in-house regional tax professionals, outsourcing specific tax functions like global tax compliance and requirements to third-party tax service teams allows the internal workforce to focus on regional oversight.

Addressing Challenges Faced by Technical Functions

As technical tax functions have become more complex, strong control frameworks have become more important for tax departments. Because of continual changes in national and international tax policy and shifting financial responsibilities resulting from economic uncertainty, tax departments faced their fair share of obstacles in 2023.

Changing Tax Legislation

Between the implications of federal legislation like the Tax Cuts and Jobs Act (TCJA) and changes to corporate income taxation in numerous states, tax functions have had to adapt to many new tax laws. The TCJA eliminated the graduated corporate rate schedule and reduced the top U.S. corporate rate to 21% from 35%, and changes in state law have resulted in corporate rate reductions. While some of those legislative changes ultimately reduce tax liabilities, they impose on tax departments the added responsibility of monitoring and maintaining compliance as evolving laws continue to affect companies' total tax liability and tax provision computations.

Looking ahead to 2023 and 2024 tax reporting, businesses must navigate how new minimum taxes introduced in the Inflation Reduction Act and the OECD's Pillar Two framework might affect their tax positions. The U.S. corporate alternative minimum tax applies to companies with U.S. presence that have book income greater than $1 billion for three consecutive years. Once subject to that tax, a company must make adjustments based on current-year income to calculate if there is an additional tax. The global minimum tax introduced in Pillar Two also has a revenue threshold, but it applies only if individual countries have enacted laws to conform to the Pillar Two framework.

Companies that are close to those thresholds should have plans in place for what could happen if they grow beyond them and become subject to the tax requirements.

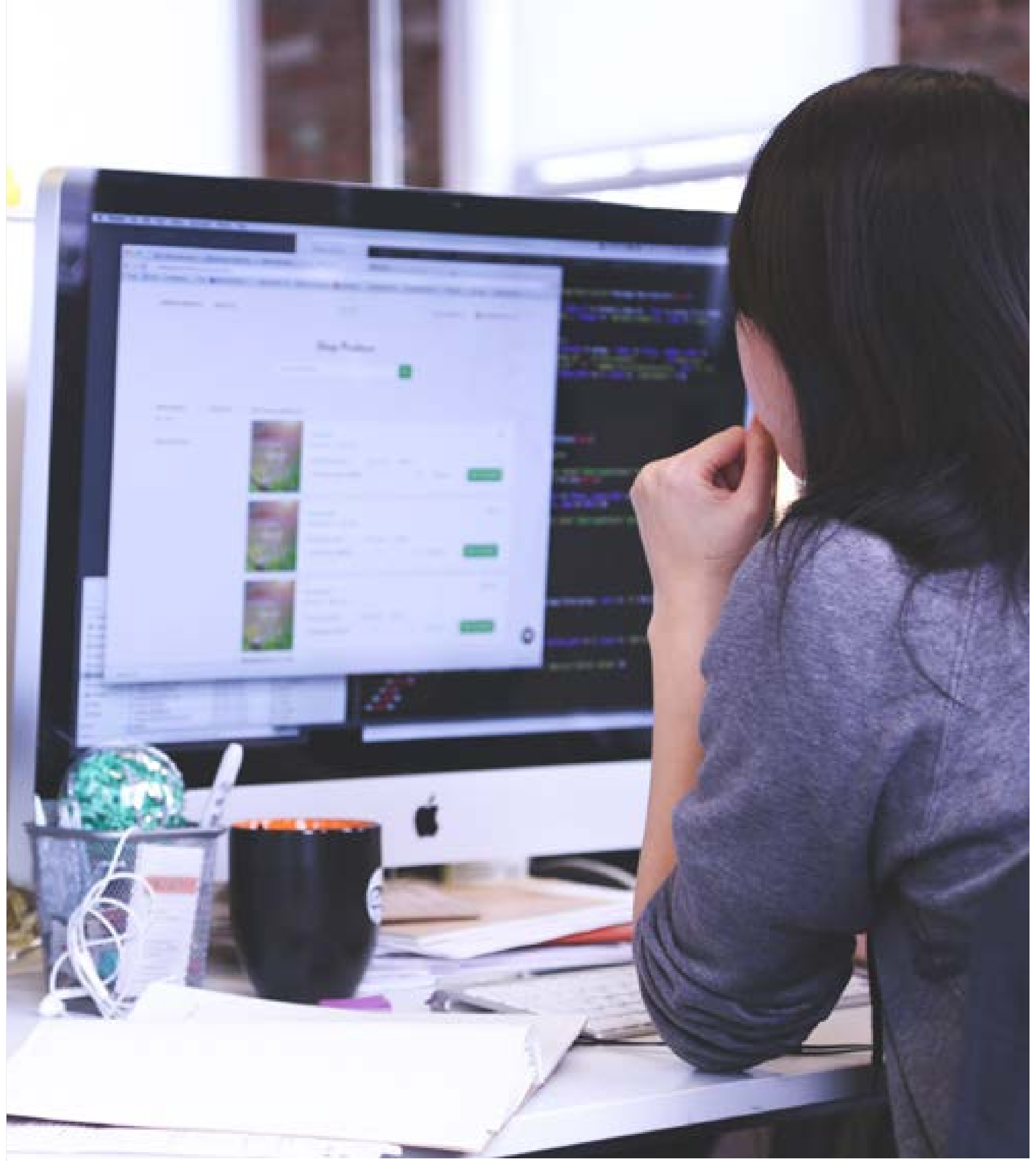
Multinational corporations in scope for the Pillar Two global minimum tax will need to pay at least 15% in taxes on profits made in all countries. Although the tax is designed to avoid double taxation by applying a top-up tax to bring the total amount of income tax paid to the minimum of 15%, multinational corporations could be subject to double taxation if jurisdictions do not implement the rules consistently.

All those legislative and regulatory changes add complexity to the computation of the tax provision and taxes owed, straining corporate tax functions that lack adequate resources and knowledge. Consulting with an experienced tax service provider can help tax departments avoid costly risks, penalties, and restatements stemming from material weaknesses and financial statement errors.

Understanding Complexities Presented by Valuation Allowances

Tax consultants can be especially helpful to tax teams in analyzing valuation allowance considerations. Because of economic volatility, many companies had to revisit their profit and loss operating forecasts in 2023. As a result, some changed their positions on whether the deferred tax assets (DTAs) on their balance sheets can be recoverable in the future, making tax provision and liability estimations more complex. Also, the TCJA allowed for the indefinite carryover of net operating losses and interest limitations, like those under Internal Revenue Code Section 163(j), that were generated post-TCJA. That makes the proper documentation and prediction of DTA realization more important because there is theoretically no expiration date for some. In practice, ASC 740 requires companies to apply a valuation allowance to any DTA that will likely not be realized in the near future to reflect a more accurate valuation of the business.

The TCJA amended IRC Section 174 to require the capitalization of some research and experimental expenditures, which can further complicate when and if a valuation allowance is required. Determining how to apply a valuation allowance is a complex process that requires careful judgment. For small tax departments without robust technological resources, determining when a valuation allowance is appropriate and how to apply it correctly can be difficult.



Taking Advantage of Tax Technology

Today's tax departments are charged with doing more with less and might still be relying on spreadsheet models, which can be prone to errors and difficult to maintain, for income tax accounting.

Many companies have turned to tax provision and automation software to overcome those challenges. Tax software can help teams be more accurate and complete in their traditional tax functions, enabling employees to dedicate more time to strategic tax processes. It is also important to thoroughly train tax professionals to ensure technology is used to its full capacity.

Tax departments often encounter budget obstacles in building the business case to add technology. Although some business leaders are concerned about the resources needed to integrate tax technology, the benefits of tax software can reduce costs in the long term by boosting efficiencies.

Over the last year, tax departments learned a lot as they dealt with increasing complexity. Recent policy changes have added to that, and we expect more of the same in the year ahead. But 2022 taught tax professionals that with proper control frameworks, improved processes, and tax technology, teams can manage challenges and mitigate risk with improved accuracy and efficiency. As obstacles persist in the near term, we expect tax functions equipped with the right resources and support to thrive.

Expanded Use of the Proportional Amortization Method for Tax Equity Investments Simplifies Accounting for Investors

More equity investors involved with projects to receive income tax credits and other income tax benefits might be able to use the proportional amortization method (PAM) to account for their investments.

On March 29, 2023, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2023-02, "Investments – Equity Methods and Joint Ventures," to expand the use of the PAM for some tax credit equity investments. As the required adoption date for public business entities nears, investors should revisit their tax equity investments to determine whether they will elect the PAM.

Qualifying equity investments are investments with yields generated primarily through income tax credits and other income tax benefits and that meet other criteria. Previously, the PAM was available only to account for low-income housing tax credit (LIHTC) investments as an alternative to either the cost or equity method.

Before, noncontrolling equity investments in other tax credit programs, such as the new markets tax credit (NMTC) and renewable energy tax credit (RETC) programs, were generally accounted for under the equity method of accounting. Under that method, the accounting for the investment and the credits was presented on a gross basis in the income statement, which many stakeholders believed did not accurately reflect the true economics.

After considering stakeholder input, the FASB expanded the use of the PAM to a greater population of tax credit equity investments. That should provide more consistent accounting and a greater understanding of those arrangements by financial statement users. Accordingly, tax equity investments in NMTC structures, RETC structures, or other tax credit programs can now be accounted for using the PAM if all criteria are met and the tax equity investor elects to use that method.

The update also affects tax equity investments in LIHTC structures through limited liability entities that are not accounted for using the PAM method – that is, entities accounted for using the cost or equity method.

New disclosure requirements apply to investments that generate income tax credits and other income tax benefits from a tax credit program for which the entity has elected to apply the PAM (including investments within that elected program that do not meet the conditions to apply the PAM).

PAM Overview

The PAM recognizes the amortization of the equity investment, income tax credits, and other income tax benefits (such as depreciation) on the income tax line of the income statement. The amortization of the equity investment is recognized each period in proportion to the tax equity investor's share of the income tax benefits for that period over the investor's share of the total anticipated income tax benefits for the life of the investment.

For a tax equity investor to elect the PAM for an equity investment, it must meet five requirements:

1. It is probable that the income tax credits allocable to the tax equity investor will be available.
2. The tax equity investor is unable to exercise significant influence over the operating and financial policies of the underlying project.
3. Substantially all the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other non-income-tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate that is consistent with the cash-flow assumptions used by the tax equity investor in making its decision to invest in the project.

PAM Overview (Cont.)

4. The tax equity investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.
5. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes and its liability is limited to its capital investment.

Explanation of Provisions

The PAM applies only to arrangements in which a tax equity investor has an equity investment that is within the scope of ASC 323, "Equity Method Investments." To determine whether an investor has an equity investment in a qualifying entity, it may first need to evaluate intermediary entities for consolidation under ASC 810, "Consolidation." Whether an investor would consolidate those entities will vary depending on facts and circumstances.

A tax equity investor makes an accounting policy election to apply the PAM based on each tax credit program, rather than by electing to apply the PAM method at the tax equity investor level or to individual investments. Further, a tax equity investor that applies the PAM to qualifying tax equity investments must account for the receipt of the investment tax credits using the flow-through method under ASC 740, "Income Taxes," even if the investor applies the deferral method for other investment tax credits received.

A tax equity investor should evaluate its eligibility to use the PAM at the time of the initial investment based on facts and conditions that exist at that time. It should reevaluate if there is a change in either the nature of the investment (for example, the investment is no longer a flow-through entity for tax purposes) or the relationship with the limited liability entity that could result in the tax equity investor no longer meeting the conditions to apply the PAM.

Non-income-tax credits (for example, refundable credits) are accounted for in pretax income under U.S. GAAP. Tax credits generated pursuant to the Chips and Science Act of 2022 and some credits enacted in the Inflation Reduction Act of 2022 meet the definition of refundable credits. In applying the "substantially all" test in the third criterion listed above, those credits are considered only as part of the denominator in the fraction, which could make it more difficult -- but not impossible -- to meet that criterion.

Other Changes

ASC 323-740, "Investments-Equity Method and Joint Ventures-Income Taxes," included specialized guidance for LIHTC investments not accounted for using the PAM. ASU 2023-02 changed some of those rules, including removing the ability to account for LIHTC investments under a specialized cost method. Therefore, if the tax equity investment is not in the scope of the equity method, it will be accounted for under ASC 321, "Investments-Equity Securities." The update also removed the specific equity method impairment guidance for LIHTC. Now, if a tax equity investment is accounted for under the equity method, impairment will be measured using the other-than-temporary model in the general sections of ASC 323. The update also requires all tax equity investments accounted for using the PAM to use the delayed equity contribution guidance in ASC 323-740-25-3, which requires a liability to be recognized for delayed equity contributions that are unconditional and legally binding or for equity contributions that are contingent on a future event when it becomes probable.

Disclosure Requirements

ASU 2023-02 prescribes disclosure requirements for all investments that generate income tax credits and other income tax benefits from a tax credit program for which the tax equity investor has elected to apply the PAM. Those disclosures are required for interim and annual periods and should include the nature of the investments, as well as the effect of the recognition and measurement of its investments and the related income tax credits and other income tax benefits on its financial position and results of operations.

The required disclosures are:

- the amount of income tax credits and other income tax benefits recognized during the period, including the line item in the income statement and cash flow statement in which it has been recognized; and
- the amount of investments and the line item in which the investments are recognized in the balance sheet.

For investments accounted for using the PAM, the required disclosures are:

- the amount of investment amortization recognized as a component of income tax expense (benefit);
- the amount of non-income-tax-related activity and other returns received that is recognized outside of income tax expense (benefit) and the line item in the income statement and cash flow statement in which it has been recognized; and
- the significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project.

Effective Date and Transition

Public business entities must adopt ASU 2023-02 in fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. All other entities must adopt for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.

Early adoption is allowed for all entities in any interim period. If an entity adopts the provisions in an interim period, it must adopt them as of the beginning of the fiscal year that includes that interim period.

Entities may choose between the retrospective or modified retrospective transition options (see special rules below for LIHTC investments not accounted for using the PAM).

Retrospective Method

The tax equity investor evaluates all investments in which it expects to receive income tax credits or other income tax benefits as of the beginning of the earliest period presented. Determining whether the investment qualifies for the PAM is made as of the investment date. A cumulative-effect adjustment reflecting the difference between the previous and new accounting is recognized in the opening balance of retained earnings as of the beginning of the earliest period presented.

Specific transition rules apply to LIHTC investments that are affected by the changes with respect to:

- the cost method guidance in ASC 323-740;
- the impairment guidance for equity method investments in ASC 323-740; and
- the delayed equity contribution guidance in ASC 323-740.

To recognize the effect of those changes, the tax equity investor must either use its general transition method (for example, retrospective, modified retrospective) or apply a prospective approach. That election may be made separately for each of the three transition adjustment types described above. However, a tax equity investor applies a consistent transition method for each transition adjustment type.

Modified Retrospective Method

The tax equity investor evaluates all investments in which it expects to receive income tax credits or other income tax benefits as of the beginning of the year of adoption. Determining whether the investment qualifies for the PAM is made as of the investment date. A cumulative-effect adjustment reflecting the difference between the previous and new accounting is recognized in the opening balance of retained earnings as of the beginning of the adoption period.

Planning Tips

As the required adoption date for public business entities nears, investors should review their tax equity investments to determine whether to elect the PAM, as well as whether to early adopt.

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Lumsden McCormick meets the needs of individuals and businesses with a breadth of tax, audit, and consulting services, including annual tax planning, compliance, and wealth management strategies.

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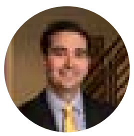

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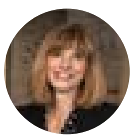

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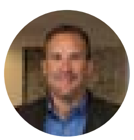

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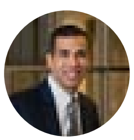

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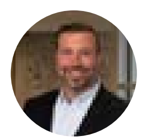

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