State and Local Tax Policy Statement
Regarding Financial Statement Impact of Tax Law Changes

Tax Executives Institute encourages states adopting corporate income tax policy changes such as rate increases or the enactment of combined unitary reporting to consider the immediate impact such changes may impose on the financial statement earnings of publicly-traded companies under U.S. Generally Accepted Accounting Principles (GAAP). Further, TEI requests states adopting such tax policy changes to mitigate the financial statement impact of those changes by providing a future tax deduction that would permit the immediate recognition of a deferred tax asset to allow corporations to offset the negative financial statement impact that often occurs when states adopt such policy changes.

Publicly-traded companies are required to publish their financial results in accordance with GAAP. The requirements for accounting for income taxes under GAAP are contained in Accounting Standards Codification (ASC) 740. ASC 740 requires companies to report income tax expense on their book (GAAP) earnings, rather than on their taxable income. The differences between book earnings and taxable income that reverse over time are known as temporary differences.[1] Temporary differences result in differences between when income taxes are reported for GAAP purposes and when they are reported and paid under applicable tax statutes.

GAAP reporting for income taxes includes both "current income tax assets/liabilities," i.e., cash taxes currently payable to the taxing authorities, and "deferred income tax assets/liabilities," i.e., the portion of income taxes that relate to the temporary differences. Deferred income taxes relate to the timing of when the corresponding revenue and/or expenses are reflected in GAAP earnings as compared to income tax returns and must be recorded at the effective tax rate that is expected to apply, based on enacted statutes, when the temporary differences reverse in a future reporting period.

If a company's effective tax rate changes as a result of legislation implementing a tax policy change, the company must restate its deferred tax assets and liabilities to reflect the result of applying the new effective tax rate to its temporary differences during the quarter in which such legislation is enacted. The company includes the adjustment to these balances in its income statement, thus directly impacting the GAAP earnings of the company. This consequence to a

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[1] With temporary differences, an amount is different for GAAP and tax purposes in a given reporting period but over time the cumulative amount of differences will be the same for both GAAP and tax purposes. Using depreciation as an example, a piece of equipment costing $100,000 will be depreciated at different rates for GAAP and tax purposes, but by the end of the equipment's life, $100,000 will have been recovered for both.

public company's financial statements may have serious implications in the financial markets, such as downgrades in outlook, access to capital, cost of capital, or market capitalization (stock price).

Accelerated tax depreciation also generally results in a temporary difference that gives rise to a deferred tax liability, particularly for capital intensive companies. Over time, as accumulated GAAP depreciation for a specific asset catches up to accumulated tax depreciation for that specific asset, the temporary difference attributable to accumulated depreciation for that specific asset reverses. Thus, there will be more GAAP depreciation than tax depreciation attributable to that specific asset during the last years of that asset's depreciable life, and thus more taxable income than GAAP income during those years. Cash taxes paid in those future years will be higher than indicated by GAAP income. Therefore, for GAAP purposes, the tax liability associated with the temporary difference is deferred until the depreciation deduction is reflected in GAAP earnings. Cash taxes are not impacted by the accounting for deferred tax assets and liabilities in accordance with GAAP.

Example:

- ABC Co. is a publicly-traded company with $500,000 in earnings before depreciation, a 40% effective tax rate ("ETR," federal + state), and purchased an asset for $300,000 on July 1, 2001.
- ABC Co.'s depreciation for GAAP purposes is $5,000, and its depreciation for tax reporting purposes is $15,000 using 15-year MACRS tax depreciation (a $10,000 difference)

	Income Statement	
Year 1	**GAAP**	**Tax**
Earnings before depreciation	500,000	500,000
Depreciation Expense	(5,000)	(15,000)
Book/Tax taxable Income	495,000	485,000
Income Tax Expense @ 40% ETR	(198,000)	(194,000)
GAAP Net Income	297,000	
Summary of GAAP Tax Expense:		
Current Tax Expense	(194,000)	
Deferred Tax Expense	(4,000)	
Total GAAP Tax Expense	(198,000)	

Income Statement

A Future Year	GAAP	Tax
Earnings before depreciation	500,000	500,000
Depreciation Expense	(5,000)	(0)
Book/Tax taxable Income	495,000	500,000
Income Tax Expense @ 40% ETR	(198,000)	(200,000)
GAAP Net Income	297,000	
Summary of GAAP Tax Expense:		
Current Tax Expense	(200,000)	
Deferred Tax Expense	2,000	
Total GAAP Tax Expense	(198,000)	

Using the above example, assume State A, a state where ABC Co. does business, changes its policy at the end of Year 1. The policy change results in ABC Co.'s effective tax rate increasing from 40% to 40.5%, causing ABC Co. to record an additional deferred tax liability, and tax expense, of $50 ($10,000 * .5%), for a total of $4,050.

Such impacts are an unintended consequence of tax policy changes as, typically, legislators are focused on tax collections, i.e., "current income taxes", when they enact a change in tax policy rather than how such changes will impact a company's reporting of its deferred taxes as required by GAAP and the consequence in the financial markets.

States should grant relief to public companies whose financial statement earnings are negatively impacted because their deferred tax assets or (liabilities) are required to be revalued due to a tax policy change. Such relief should be granted in the form of a future tax deduction and is warranted for the following reasons:

- Deferred taxes are initially recorded on the books based on the historic tax policy/regime in effect when the timing difference first arises, while tax policy changes are intended to capture future transactions. Thus, adjustments should be made to allow the historic tax policy/regime to continue to apply to the reversal of temporary differences attributable to historic transactions;
- Changes in tax policy without granting deferred tax relief creates business and economic uncertainty and potential market implications for publicly-traded companies;
- There is a potential windfall for states when, for example, an asset is fully depreciated under one tax policy/regime and the asset is sold under a different tax policy/regime, as it creates a mismatch between the benefit of depreciation deductions and the tax on the gain; and
- Inequities occur because business cycles do not fall neatly within a tax year.

A number of states have granted relief in the form of a future tax deduction in an amount sufficient to result in a deferred tax asset that the company can recognize to offset the increase in deferred tax liabilities resulting solely from the change in tax policy. States have a great deal of flexibility in the timing of such deductions such that they can control the impact on the state coffers. Such deductions range in timing from beginning three years after the law's enactment and being deducted ratably over a period of seven years in Connecticut, to beginning in 2025 and being deducted ratably over a period of 30 years in Massachusetts.

Each tax regime and tax policy has pros and cons and none is a panacea to solve all of a state's budget issues. Therefore, state legislatures should carefully evaluate the pros and cons, as well as the unintended consequences of tax law changes, particularly when changing the basis of taxation. If state legislatures do enact tax policy changes after such considerations, they should attempt to mitigate unintended consequences to the largest extent possible, and incorporate into the tax statute enacting the tax policy change a deferred tax relief provision in the form of a future tax deduction that grants affected taxpayers a meaningful and timely deduction.

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