



April 27, 2017

Russell G. Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Chairman Golden,

The Committee on Corporate Reporting (CCR) and the Committee on Taxation (COT) of Financial Executives International (FEI) are writing to request that the Board undertake informal efforts to examine the accounting implications of fundamental tax reform proposals that are currently under consideration by the U.S. Congress and the Administration. As we see it, the financial reporting implications of these potential changes, and any potential standard setting implications they may have, will be an important part of the public dialogue and feedback to legislators on the viability of these proposals. It is therefore important to our members to have as much clarity as possible regarding the accounting before any new tax model is enacted.

FEI is a leading international organization of more than 10,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior-level financial executives. CCR and COT are technical committees of FEI, which review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. CCR member companies represent approximately \$6.5 trillion in market capitalization, and CCR and COT actively monitor the standard setting activities of the FASB.

Overview

Congress and the Trump administration are now considering fundamental changes to our tax laws. Early indications of the potential changes under consideration could have significant implications and consequences to the accounting for income taxes. The Board has expressed a strong desire to be proactive with respect to emerging developments that are significant to financial reporting. We believe that these developments represent one of those opportunities and that it would be prudent for the Board to engage with affected constituents to evaluate the tax accounting issues in advance of potential proposals for changes in the law. While certain potential changes may require standard setting to achieve alignment between the accounting and the economics sought by legislators, our initial request is simply for engagement with the Board with the goal of greater clarity on the potential implications. While the form of any changes passed by Congress are likely to differ from what has been proposed initially, we have highlighted specific examples that could be considered as these changes take shape.

Classification of tax

Traditionally, income taxes have been accounted for under ASC 740 while gross receipts taxes and equity taxes have been excluded from that guidance. Similarly, based on historic approaches, consumption taxes such as value added taxes (VAT) have, in our experience, been accounted for as an operating tax that also is outside of the scope of ASC 740. This is true whether the tax is computed on an invoice-by-invoice method (“credit-invoice method” VAT) or based on the difference between the business’s taxable sales and its purchases of taxable goods and services (“subtraction method” VAT) such as the Japanese VAT. Each of these taxes that fall outside ASC 740 are not subject to extensive rules on deferred taxes and underlying uncertainties are typically treated as contingent liabilities under ASC 450.

In addition, there are other forms of taxes that can, in many instances, have similarities to a VAT but may differ in some respects, such as the previous Michigan Single Business Tax and the Mexican Flat Tax, Impuesto Empresarial de Tasa Única (IETU). While there has been no authoritative guidance on the treatment of this category of taxes, practice has considered accounting for these taxes using the guidance in ASC 740. However, we believe there has been diversity in practice in the treatment of these and other similar taxes depending on how closely they correspond in practice to a tax on pretax income for a particular enterprise.

While the Trump proposal does not address this issue, based on the Republican “Blueprint” for tax reform released by the Ways and Means Committee Chair Kevin Brady, the U.S. may consider fundamental reforms of the tax system to a consumption tax that is a hybrid of an income tax and a VAT. Specifically, the model outlined in the Blueprint, which has also been called a “destination based cash flow tax,” would allow immediate expensing rather than depreciation for acquired assets, would disallow net interest expense and would be “border adjusted” by exempting export revenue but disallowing a deduction for the cost of imports. Therefore, depending on the significance of wages for a particular enterprise, the tax under the system suggested in the Blueprint may be much closer to a VAT than to an income tax.

Implications to consider:

Given the possibility of U.S. tax reform that would be a hybrid between an income tax and a VAT and the increasing prevalence of such taxes in other jurisdictions, we believe the Board will need to consider the question of classification of these taxes as an operating expense or as an income tax. Specifically, the question is whether: 1) the historic distinction between taxes treated as part of operating costs and income taxes should be maintained; 2) if the distinction is maintained, what factors have been utilized and/or should continue to be considered in classifying a tax (including how the economic characteristics of a tax should be evaluated); and 3) if the distinction is maintained, is the existing disparity in treatment between operating taxes and income taxes (i.e., that the latter are subject to deferred tax calculations and uncertain tax position rules) warranted.

Effect of deferred tax

Under VAT systems, there is typically a mechanism for a refund of VAT paid to the extent it isn't fully utilized as an offset for VAT due. The Republican Blueprint for tax reform doesn't utilize this mechanism. However, to achieve an economically similar result, losses can be carried forward indefinitely and are increased by an interest factor to compensate for inflation.

As noted above, the Republican Blueprint provides for immediate expensing of purchases. Therefore, to the extent a tax system follows the parameters suggested in the Blueprint but is accounted for as an income tax, there could be a deferred tax asset for the amount of the loss that grows over time but a significant deferred tax liability that is static over time.

Implications to consider:

We believe it would be prudent for the Board to examine several questions with respect to this and other proposed changes as they continue to take shape. First, should the existing deferred tax principles continue to apply to this type of tax system? Alternatively, what would the impacts be of accounting for certain types of such taxes solely on a current tax basis? In addition, if losses are permitted to be carried forward indefinitely and indexed, we believe it may be necessary to evaluate existing criteria for realizability in light of these changes.

Transition

Both the U.S. Administration and Congressional leaders have expressed an interest in acting quickly on fundamental tax reform. In addition to the potential major changes discussed above, a shift away from a worldwide tax system with deferral to a system that exempts foreign income from U.S. tax is likely to be under consideration as well as a transition rule for historic foreign earnings.

There is a strong possibility that a new system could be enacted late in an accounting period that could have significant impact on deferred and current taxes. Depending on the degree of public disclosure of potential changes to the system, there may be very limited time for an enterprise to analyze and report the effect of a change. In addition, taxpayers may not be able to fully determine the impact of a law change without the detailed guidance that typically follows enactment of a law.

Implications to consider:

Given the amount of time required to develop new standards, we believe the dialogue needs to start now so preliminary views can be developed. This will aid all parties in providing input and counsel to those involved in drafting and debating the impacts of various proposals. In addition, absent the formulation of preliminary views, depending on the outcome of potential legislation, the FASB and companies simply may not have sufficient time to react and implement required accounting and disclosure changes after laws are passed. Further, given the potential size and scope of these changes, it would be prudent for the Board to consider how to simplify reporting of the effect of a change prior to the availability of full guidance. In particular, the Board may wish to consider whether "safe harbor" methods to report changes that could be refined as more guidance on the impact of the law is provided and there is more time for analysis of the impact. As an example, a safe harbor on transition of historic earnings could be to record a tax equal to the applicable tax rate applied to historic indefinitely

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reinvested earnings. Subsequently, as detailed rules on the computation of the tax become available and can be applied to the company's tax profile, the amount could be refined as a change in estimate.

Disclosure

A fundamental change to the basis on which companies are taxed would have a pervasive impact on their financial results. The nature of disclosures about these changes will depend on the degree to which the above discussed topics result in a change in accounting treatment. Regardless of whether there are associated accounting changes required, such changes are likely to affect both current disclosures such as the reconciliation of the effective tax rate and the amount of indefinitely reinvested earnings as well as the direction of disclosure changes currently under consideration.

Implications to consider:

The Board may wish to consider revisiting current and potential disclosure rules in light of a reformed tax system.

Summary

We believe that engaging in dialogue with interested parties in order to obtain feedback on the questions and implications discussed above will be invaluable in assisting the Board in participating effectively in the process that is to come. We believe that this feedback should be gathered on an expedited basis given the possibility of tax reform in the near term that could result in major changes to the tax system. In addition to outreach to U.S. preparers and users, we believe that the Board would benefit from outreach with other key stakeholders to understand the impact in other countries that have had major changes in the basis of taxation.

Given the strong likelihood of tax changes in some form both in the U.S. and in other jurisdictions, we expect that companies are actively investigating the consequences and are forming opinions on the financial reporting effects. It will be important to improve the clarity of the accounting implications so that stakeholder positions are informed by the potential financial reporting effects. For the U.S., this resulting tax regime could be very different than the current worldwide income tax model.

Members of our Committees stand ready to make our experts available to speak with the Board at your earliest convenience.

Sincerely,

Committee on Corporate Reporting
Financial Executives International

Committee on Taxation
Financial Executives International