COST
COUNCIL ON STATE TAXATION

Consequences of Significant Tax Law Changes on Financial Reporting

Policy Position

Position: *When enacting significant corporate tax law changes, states must mitigate the immediate and negative impact of those changes on a company's financial reporting. While it is evident that companies may experience a change in their actual tax liability as a result of some tax law changes, the financial impact of having to immediately recognize additional tax expense for financial reporting purposes is not always evident.*

Explanation: Companies record deferred tax assets and liabilities for financial reporting purposes under Generally Accepted Accounting Principles (GAAP) rules. The Internal Revenue Code and associated state rules for recording income and expenses are often different from the GAAP rules for recording income and expenses. The different accounting methods typically result in the creation of tax assets and tax liabilities on the balance sheets of companies. Significant tax law changes—for example, a move to mandatory unitary combined reporting or the adoption of an entirely new tax structure—typically requires companies to re-compute the value of tax assets or liabilities they had previously recorded. The cumulative effect of that re-computation often requires companies to immediately record additional tax expenses under Accounting Standards Codification (ASC) 740, "Income Taxes." The recognition of those expenses may result in an immediate market adjustment of the company's stock price and value.

Examples – Companies can have deferred tax liabilities and assets. An example of a deferred tax liability for a company arises from greater depreciation for tax purposes than for book purposes (GAAP). The difference is reflected as a liability on a company's balance sheet because there is a temporary difference between the company's accounting and tax liabilities. For instance, if a taxpayer has depreciated its assets for tax purposes to $200 million net tax value but those same assets for GAAP purposes are only depreciated to $300 million net book value, the $100 million difference causes a deferred tax liability. If a company is subjected to a new state income tax at an 8% effective tax rate, the company would have to record a deferred tax liability of $8 million because it will not be able to use $100 million in depreciation previously taken for tax purposes. This new deferred tax liability may negatively impact a company's stock price and value.

An example of a deferred tax asset is a company with a net operating loss (NOL). An NOL is recorded as an asset on a company's balance sheet that may be used to reduce any subsequent period's income tax expense. For instance, if a taxpayer has a $10 million NOL assigned to state X with an 8% effective tax rate, it has recorded a deferred tax asset of $800,000. If the legislature eliminates the corporate income tax and instead adopts a non-income based tax, the company is required to immediately expense that deferred asset which may negatively impact that company's stock price and value.

Mitigation – Some states that have enacted significant corporate income tax changes have enacted special provisions to mitigate the financial reporting impact of major income tax changes. For example, a State adopting mandatory unitary combined reporting might include a provision that allows a recovery of book/tax differences by allowing a deduction to be claimed in the future that can be spread equally over a specified period of time. By providing a reasonable schedule to allow the future deduction of the additional expenses triggered from any book/tax differences, a State could eliminate any financial reporting impact that may be required under ASC 740.

States should ensure that such ramifications are addressed to avoid companies being detrimentally impacted twice—through actual tax payments and through a reduction in market value—by tax law changes enacted by their legislatures.