Financial Reporting
Publicly Traded Companies
(and why it matters for state tax policy)

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What Does GAAP Mean Anyway?

• Generally Accepted Accounting Principles, or GAAP in accountant-speak, are codified in the Accounting Standards Codification (ASC) system. ASC740 is the section that deals with accounting and financial reporting for income taxes.

• Accounting and financial reporting for income taxes includes both “current income taxes” and “deferred income taxes.”

<table>
<thead>
<tr>
<th>Current Income Taxes</th>
<th>vs.</th>
<th>Deferred Income Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>The amount of cash taxes expected to be paid to taxing jurisdictions in the current year.</td>
<td>The expected future impact on income taxes related to temporary differences between GAAP and tax reporting of transactions.</td>
<td></td>
</tr>
</tbody>
</table>
### Why do we have deferred taxes?

Deferred taxes result from **temporary differences** between GAAP and Tax Basis due to book/tax differences in timing of income and expense recognition.

<table>
<thead>
<tr>
<th></th>
<th>GAAP</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before depreciation</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>(5,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td><strong>Book/Tax taxable Income</strong></td>
<td><strong>495,000</strong></td>
<td><strong>485,000</strong></td>
</tr>
<tr>
<td>Income Tax Expense @ 40% ETR</td>
<td><strong>(198,000)</strong></td>
<td><strong>(194,000)</strong></td>
</tr>
<tr>
<td><strong>GAAP Net Income</strong></td>
<td><strong>297,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Summary of GAAP Tax Expense:**

- **Current Tax Expense**: (194,000)
- **Deferred Tax Expense**: (4,000)
- **Total GAAP Tax Expense**: (198,000)
Why should legislators care?

• Corporations are required to calculate income in two ways: (1) taxable, and (2) book income.

• When a legislature changes tax laws, it is exclusively focused on #1. However, the change may also inadvertently affect #2.

• An unintended change to GAAP income may actually have greater impact on a company than the intentional change made by the legislature to the state’s tax laws.

• Corporations are required to IMMEDIATELY recognize the impact of any tax law change on its deferred taxes
  – Recognized when law is enacted, not when effective
State X enacts law changing its apportionment method from standard 3 factor to sales only

- Company A is a capital intensive company having little physical footprint, i.e. payroll and property, in state X, and conducting significant sales in the state
- Company A also has a Net Operating Loss Carryforward in State X

### GAAP ACCOUNTING

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary Differences</td>
<td>(40,000,000,000)</td>
<td>(40,000,000,000)</td>
</tr>
<tr>
<td>Apportionment in State X</td>
<td>10.0%</td>
<td>13.0%</td>
</tr>
<tr>
<td>State X Statutory Tax Rate</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Deferred Tax Liability - Temporary Differences</td>
<td>(240,000,000)</td>
<td>(312,000,000)</td>
</tr>
<tr>
<td>Net Operating Loss</td>
<td>5,000,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Valuation Allowance (NOL not expected to be used)</td>
<td>(4,000,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td>Deferred Tax Asset - NOL</td>
<td>1,000,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Net Deferred Tax Liabilities</td>
<td>(239,000,000)</td>
<td>(309,500,000)</td>
</tr>
</tbody>
</table>

Company A reduced GAAP earnings due to increase in income tax expense **immediately upon enactment** (70,500,000)
Considerations for Tax Policy Changes

• Each tax regime and tax policy has pros and cons and none is a panacea to solve all of a state’s budget issues.

• State legislatures should carefully evaluate all of the impacts of tax law changes, particularly when changing the base of taxation.

• Most tax statutes result in unintended consequences and state legislatures should seek to understand and consider them as much as possible.

• If State legislatures do enact tax policy changes, they should attempt to mitigate unintended consequences to the extent possible.
Why States Should Grant Relief

- What’s recorded on the books is based on the historic tax policy/regime
  - Adjustments should be made to allow the historic tax policy/regime to continue to apply to the turn-around of those historic items
  - Change in tax policy without corresponding relief creates business and economic uncertainty and potential market implications for publicly traded companies

- Change in tax policy/regime is intended to capture future transactions
  - Potential for state windfall when, for example, an asset is fully depreciated under one tax policy, and the asset is sold under a different tax policy
  - There is a mismatch between the benefit of depreciation deductions, and the tax on the gain

- Inequities occur because business cycles do not fall neatly within a tax year
Relief Provided by Some States - Examples

• Deduction equivalent to increase in deferred tax liability
  – CT – enacted 2015; 7 year deduction beginning in 2018
  – MA – enacted 2008; 30 year deduction beginning in 2021(1)
  – DC – enacted 2011; 7 year deduction beginning in year 10(2)
  – MI – enacted 2007; 15 year deduction beginning in 2015(3)

• Preservation of NOL
  – NY – Deduction for NOLs generated pre-law change to Combined Reporting; deduction ratable over 10 years from year of change
  – TX – Credit for NOLs generated pre-law change to Margin Tax; credit carry forward up to 20 years from year of change
  – OH – Credit for NOLs generated pre-law change to Corporate Activity Tax (CAT); credit carryforward through 2028

(1) As originally enacted, 7 year deduction available beginning in 2012 tax year. Statute has been amended to postpone the deduction
(2) As originally enacted, 7 year deduction available beginning in year 5 of the combined reporting. Statute has been amended to postpone the deduction
(3) MI subsequently changed tax regime from SBT to CIT