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

Angela Pitale
NextEra Energy Resources

Stephen Kranz
McDermott Will & Emery

August 19, 2016

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."

Current Income Taxes	vs.	Deferred Income Taxes
The amount of cash taxes expected to be paid to taxing jurisdictions in the current year.		**The expected future impact on income taxes related to temporary differences between GAAP and tax reporting of transactions.**

NEXTera ENERGY RESOURCES

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

Income Statement

	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)

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

NEXTera ENERGY RESOURCES

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	Before	After
Temporary Differences	(40,000,000,000)	(40,000,000,000)
Apportionment in State X	10.0%	13.0%
State X Statutory Tax Rate	6.0%	6.0%
Deferred Tax Liability - Temporary Differences	(240,000,000)	(312,000,000)
Net Operating Loss	5,000,000	5,000,000
Valuation Allowance (NOL not expected to be used)	(4,000,000)	(2,500,000)
Deferred Tax Asset - NOL	1,000,000	2,500,000
Net Deferred Tax Liabilities	(239,000,000)	(309,500,000)
Company A reduced GAAP earnings due to increase in income tax expense immediately upon enactment		(70,500,000)

NEXTera ENERGY RESOURCES

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

NEXTera ENERGY RESOURCES