

# International Overview Training: Post-2017 Tax Reform

## Topic III

### Global Effective Tax Rate Analysis – Post Tax Cuts and Jobs Act of 2017



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# IRS Front Matters

- The IRS Mission Statement
- 14 General Principles of Ethical Conduct for Federal Employees
- Your Rights as a Taxpayer

# Introduction

- Topic II covered the major Tax Cuts and Jobs Act (“TCJA”) provisions which brought sweeping changes to federal tax law. The Topic III presentation will focus on how the international aspects of the TCJA affect Global Effective Tax Rate (“ETR”) analysis and why ETR is an important tool for compliance risk identification.
- ETR analysis, along with Topic IV Global Tax Org Chart (“GTOC”) analysis, is a useful tool in identifying issue risk indicators for large US multinational entities (“MNEs”) examinations.
- Generally, ETR is a more accurate reflection of a company's tax liability than its statutory tax rate. ETR analysis helps to determine if there is “no risk”, “low risk” or “risk indicators” that require further review.

# Overview

- ETR is a US Generally Accepted Accounting Principle (“GAAP”) financial statement ratio by which investors can evaluate a company’s performance.
  - $ETR = \frac{\text{book income tax expense}}{\text{pre-tax book income}}$
- Generally, issue teams will review a company’s financial statement income tax footnote as a part of the initial risk analysis in an examination.
- Although no tax exam adjustments can be proposed simply from reviewing the income tax footnote, issue teams can use the information to help develop questions about a company’s tax positions.

# Overview (Cont'd)

- ETR analysis combined with the study of the tax org charts provides an overall idea of the tax planning strategies and the main value drivers of the ETR.
  - This is true whether ETR is high or low compared to US statutory rate and other industry competitors.
- A trending change in ETR may indicate a change in the tax situation, particularly if it is an increase or decrease in taxes due to prior transactions.
  - This may be difficult to gauge in the early Post-TCJA years.

# Overview (Cont'd)

## For purposes of this training:

- ETR discussed in this training is under US GAAP and not under International Financial Reporting Standards (“IFRS”). Hence, ETR, as discussed in this session, applies primarily to US-based companies reporting their financial results under US GAAP rather than to foreign companies reporting in IFRS or some other accounting standard.
- This training will NOT go into detail concerning domestic (as opposed to international) tax items that reduce ETR such as the Research & Development (“R&D”) credit and tax exempt interest.

# Pre-TCJA ETR Analysis

- Pre TCJA, a United States Parent (“USP”) was taxed under US tax law at a 35 percent statutory rate on the following income:
  - Income recognized (received or earned) by USP directly
  - Income of foreign branch held directly (or indirectly through pass-through entities) by USP
  - Foreign subsidiary income recognized by USP under subpart F / passive foreign investment company rules (generally passive / mobile income) *Note: Subpart F applies to certain foreign subsidiaries of USP: controlled foreign corporations (CFCs) See IRC 957.*
- An MNE’s effective tax rate could be different than the statutory rate for several reasons and we will discuss some of those during this training.

# Indefinite Reinvestment Assertion

## Pre-TCJA

- For US GAAP purposes, foreign subsidiaries were presumed to repatriate all earnings to USP.
  - Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 740-30-25-3.
  - The future tax on such earnings is taken into account for book purposes even though such earnings are not subject to tax yet.
- However, USP could make an assertion under ASC 740-30-25-17 (former AICPA APB Opinion No. 23) that its earnings are indefinitely reinvested, i.e., the indefinite reinvestment assertion (IRA)\*, if USP has specific plans for reinvestment of those earnings.
  - As such, an MNE can defer when GAAP financial statements include the tax liability on foreign subsidiary earnings.





# Post-TCJA – IRA's Limited Application

- **TCJA reduced MNE's control** over when US GAAP financials include US tax on foreign subsidiary earnings. Generally,
  - Historic foreign subsidiary earnings were included as taxable income to USP in 2017 and 2018 even if such earnings were not distributed to USP, i.e., the transition tax (IRC 965).
  - New CFC earnings are now subject to US tax immediately as either subpart F or global intangible low-taxed income (GILTI).
- GILTI requires a US shareholder to include certain foreign earnings of certain CFCs as taxable income even though such earnings have not actually been distributed to the US shareholder.

# Post-TCJA – IRA's New Limited Relevance

- If no IRA, in addition to US federal tax liabilities on taxable income such as subpart F and GILTI, companies will need to currently account for the following:
  - Deferred tax liability for foreign withholding taxes on actual repatriations of previously taxed foreign earnings.
  - Deferred tax liability for foreign currency movements related to that withholding tax liability from year to year.
  - Deferred tax liability for state taxes.

# Comparison of Pre & Post TCJA Taxes on Foreign Sub Income of US MNEs & Effect on ETR

Provision	Pre-TCJA	TCJA, 2018-2025*	Effect on ETR
US tax on dividends from foreign subsidiaries	35% tax with FTC limited to US tax on foreign source income	100% DRD for foreign source portion of dividend received from a specified 10-percent owned foreign corporation; No FTC	<ul style="list-style-type: none"> <li>• ETR increase due to inability to use FTCs</li> <li>• ETR decrease due to no limitation on DRD</li> </ul>
Current tax on CFC income (absent subpart F and IRC 956 inclusion)	No tax until repatriated	21% tax on GILTI, deduction = to 50% GILTI inclusion (through 2025), credit for 80% of FTCs	<ul style="list-style-type: none"> <li>• ETR increase</li> </ul>
Current tax on subpart F income and IRC 956 inclusion	35% tax with FTC limited to US tax on foreign source income	21% tax on subpart F with FTC limited to US tax on foreign source income Limited taxation of IRC 956 inclusions and no FTCs	<ul style="list-style-type: none"> <li>• ETR decrease as a result of statutory rate decrease</li> <li>• Increased ETR as a result of decreased deferred tax assets associated with FTC carryforwards.</li> </ul>

# Comparison of Pre & Post TCJA Taxes on Foreign Sub Income of US MNEs & Effect on ETR

Provision	Pre TCJA	TCJA, 2016*	Effect on ETR
Tax on historical earnings and profits of foreign subsidiaries (Applies to CFCs and some non-CFCs)	Generally, no tax until earnings repatriated; then taxable at 35% with FTCs to extent of US tax on foreign source income	<p>Tax imposed at rates of:</p> <ul style="list-style-type: none"> <li>• 15.5% on foreign subsidiaries' earnings equal to foreign subsidiaries' cash position, and</li> <li>• 8% on earnings in excess of cash position;</li> <li>• FTCs reduced 55.7% with respect to taxes on earnings equal to cash position, and</li> <li>• 77.1% with respect to taxes on earnings in excess of cash position.</li> </ul>	One-time increase in ETR

\* Tax years beginning in 2016.

# Learning Objectives

At the end of this lesson you will be able to:

- A. Identify taxpayer's objectives for achieving a low ETR
- B. Explain how the ETR of a corporation is calculated
- C. Identify issues for risk analysis purposes using the income tax footnote and tax rate reconciliation
- D. Locate additional sources of information for further investigation of LUQ items



**A. Why does a Taxpayer want to achieve a lower ETR?**



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# Taxpayer Motivation for Low ETR

- Sustained, predictable improvements in earnings per share (“EPS”):
  - Increase share price and total market capitalization
  - Possibly boost executive compensation
- Reduce Tax Expense
  - US GAAP Tax expense directly reduces net income, which unfavorably lowers EPS
  - Taxpayer pressure to manage ETR in comparison to peers
- Control Costs
  - Companies try to manage costs efficiently (including taxes) to produce shareholder value
  - Tax costs can be managed efficiently through legitimate planning

# Taxpayer Objectives

- The company's goal is to –
  - Operate as efficiently as possible
  - Produce the greatest possible net return to investors
- Improve EPS - a critical Wall Street and management metric
- Manage tax expense - as a percentage of revenue, tax expense tends to be one of the largest costs incurred by a company
- **Important to note:** An ETR lower than the statutory rate does not indicate abuse but may suggest further inquiry is required. A higher ETR may be common in implementation of TCJA transition tax provisions.



# Is Striving for a Low ETR Wrong?

No!

- A lower tax expense results in higher earnings per share (EPS)
- Sustained, predictable improvements in EPS add shareholder value and drive market prices
- Companies try to manage costs efficiently (including taxes) to produce shareholder value
- Tax costs can be managed efficiently through legitimate planning

# Will a Company Take Every Opportunity to Reduce its ETR?

No!

- Depending on the magnitude of the benefit, vis-à-vis net earnings, a tax strategy may lead to a benefit that is not significant enough to impact ETR or EPS
- No change in ETR doesn't mean no tax planning
  - A tax strategy could be employed to maintain the prior year rate such that there will be no change in ETR
- Note that companies are not solely focused on reducing US tax, but also on foreign tax
- Also, a one-time tax strategy may not result in a sustained increase in shareholder value and may cause a fluctuation in ETR that needs to be explained to management and/or Wall Street
- Note, sometimes a company may do things for reasons other than tax benefits and those things could decrease ETR for a period

# How Does ETR Planning Relate to Tax Planning Strategy?

- ETR reduction is a major component of a US MNE's tax planning strategy. ETR reduction will generally produce beneficial financial results.
- As a percentage of revenue, tax expense is one of the highest expenses incurred by an MNE (behind Cost of Goods Sold ("COGS") and Selling, General and Administrative ("SG&A")).

# How Does ETR Planning Relate to Tax Planning Strategy? (Cont'd)

- Awareness of a company's motivation for its tax planning goals will help issue teams understand why taxpayers adopt and undertake certain organizational structures and transactions.
- Understanding these tax planning goals is critical for issue teams to perform transactional analysis using global tax organizational charts.
- Issue teams will be able to evaluate transactions, structures and technical issues with not only absolute understanding (what and how) but also relational understanding (why and when).



**B. Where is ETR found and how  
is it calculated?**



# Effective Tax Rate

- The Tax Rate Reconciliation is found in US GAAP financial statements in the Income Tax Expense footnote.
- The Tax Rate Reconciliation reflects worldwide (“WW”) consolidated book earnings
  - Note that this will not necessarily represent US taxable income on the US tax return of the multinational enterprise (“MNE”).
    - For example, uncertain tax benefits associated with transfer pricing adjustments (IRC 482) might not be reflected in the financial statements, but could be reflected on the US tax return.
- Financial Book tax expense is not the same as the US tax return tax expense.

# Book & Tax Rules: Foreign Earnings Post TCJA

## Book

- Financial accounting rules **generally** require that tax expense be calculated on WW income (including foreign subsidiaries) at US statutory tax rate regardless of whether such income is subject to tax for tax law purposes

## Tax

- USP's income does not necessarily include all foreign subsidiary income.
  - Subpart F
  - GILTI



# Income Tax Footnote

## Tax Rate Reconciliation Schedule

- Represents the reconciliation from Federal statutory tax rate (generally 21%) to ETR

$$\text{ETR} = \frac{\text{book income tax expense}}{\text{pre-tax book income}}$$



# Example B-1: ETR Rate Reconciliation

Fiscal Year ended July 31, 2018, 2017, and 2016

Federal statutory rate	28.1%	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	(8.9)	(12.1)	(14.7)
Impacts of TCJA	29.4	-	-
Industry business losses	(4.1)	(5.7)	(0.8)
Excess tax benefits – compensation	(2.5)	(1.3)	(1.9)
Interest, net	3.3	2.4	1.2
Other reconciling items	<u>(2.1)</u>	<u>(2.2)</u>	<u>(0.9)</u>
Effective tax rate	<u>43.2%</u>	<u>16.1%</u>	<u>17.9%</u>

# Common Items Impacting ETR and Tax Rate Reconciliation Schedule

- Permanent difference items (e.g., fines or penalties)
- Valuation allowance considerations
  - Net Operating Losses (NOLs) and Tax Credit Carryovers (i.e., FTC, foreign NOLs, etc.)
- Effects of transfer pricing adjustments
- Other tax incentives (i.e., local country tax holidays and incentives)
- Allocation of taxes (e.g., Other Comprehensive Income (“OCI”), Additional Paid In Capital (“APIC”), Goodwill, etc.)



# **C. Exam Tips: Using the Income Tax Footnote and Rate Reconciliation**



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# What are Standard Sections of an Income Tax Footnote?

## US GAAP Tax Footnote Contains:

- Schedule of Income Tax Expense
- Schedule of Deferred Tax Assets and Liabilities
- Rate Reconciliation Schedule
- Other tax attributes
- Uncertain Tax Positions – Portions of FASB ASC Subtopic 740-10 (formerly FIN 48, *Accounting for Uncertainty in Income Taxes*)

# Exam Tips: Schedule of Income Tax Expense

- Provides detail of income tax expense shown on the income statement
- Breaks out income tax expense between current and deferred
- Further breaks out current and deferred income tax expense between Federal, state and local, and foreign

# Example C-1: Schedule of Income Tax Expense

Amounts in Thousands	2018	2017	2016
Federal	\$ 20,087	\$ 3,001	\$ 879
State and local	890	37	256
Foreign	<u>5,576</u>	<u>1,960</u>	<u>2,380</u>
Total current income tax expenses	26,553	4,998	3,515
Federal	(3,817)	(786)	2,009
State and local	(657)	345	199
Foreign	<u>(297)</u>	<u>(609)</u>	<u>389</u>
Total deferred income tax expense	<u>(4,771)</u>	<u>(1,050)</u>	<u>2,597</u>
Total income tax expense	<u>\$ 21,782</u>	<u>\$ 3,948</u>	<u>\$ 6,112</u>

# Exam Tips: Deferred Tax Assets and Liabilities

- **TCJA affects the determination of Deferred Tax Assets (DTAs) and Deferred Tax Liabilities (DTLs) at 31 December 2017.**
  - Deferred tax balance may change from both (a) new or existing timing differences or (b) changes in anticipated future tax rates.
- **Lower Corporate Income Tax Rate Effects (35% to 21%):**
  - The effect of the remeasurement is reflected entirely in the interim period that includes the enactment date and allocated directly to income tax expense (benefit) from continuing operations. The effect on prior year income taxes payable (receivable), if any, is also recognized as of the enactment date.
  - Lower corporate income tax rate = **future benefits** of existing DTAs computed at new tax rate resulting in lower DTAs and increased income tax expense in the period of enactment. Issue teams should see lower DTAs.
  - Lower corporate income tax rate = lower expected **future cost** of existing DTLs decreasing income tax expense in the period of enactment. Issue teams should see lower DTLs.

# Exam Tips: Deferred Tax Assets and Liabilities (Cont'd)

- **Apply Appropriate Rate:** Companies will schedule when temporary differences are expected to reverse in order to apply the appropriate rate. Fiscal year-end companies will determine the appropriate blended rate to apply mid-year based on their respective year ends.
  - Temporary differences reversing during the fiscal year that includes the enactment date should be remeasured using the **blended rate**.
  - Temporary differences reversing in subsequent fiscal years should be remeasured at the **new 21% rate**.



# Example C-2: Schedule of Deferred Tax Assets and Liabilities

	Post TCJA	Pre TCJA	
	As of	As of	As of
	<u>07/31/18</u>	<u>07/31/17</u>	<u>07/31/16</u>
Allowance for bad debts	1,175	1,175	1,000
Net operating loss carry-forwards	2,650	2,650	3,000
Impact of TCJA	(1,100)	-0-	-0-
Other	<u>300</u>	<u>300</u>	<u>300</u>
	3,025	4,125	4,300
Less: valuation allowance	( <u>700</u> )	( <u>700</u> )	( <u>700</u> )
Total deferred tax assets	2,325	3,425	3,600
Leasing transactions	700	700	-0-
Depreciation and amortization	800	800	1,500
Impact of TCJA	(400)	-0-	-0-
Other	<u>300</u>	<u>300</u>	<u>200</u>
Total deferred tax liabilities	<u>1,400</u>	<u>1,800</u>	<u>1,700</u>
<b>Net deferred tax asset (liability)</b>	<b>\$ 925</b>	<b>\$ 1,625</b>	<b>\$ 3,300</b>

# Exam Tips:

## Rate Reconciliation Schedule

- Review the Rate Reconciliation schedule for potential exam risk indicators:
  - ETR is unusually low compared to US statutory federal rate of 21%
  - ETR trends downward from year to year (may indicate significant shifting of profits offshore and not taken into account for US tax purposes because of certain planning)
  - Large ETR variations from year to year
  - ETR is significantly lower than industry peers
  - Large, Unusual or Questionable (LUQ) items in the tax rate reconciliation
    - e.g., provision for restructuring line item

# Example C-3: ETR Rate Reconciliation

## Rate Reconciliation Schedule

Year ended December 31, 20XX:

Item	Amount (in Millions)	Percent
<b>Worldwide book income before taxes</b>	500	
Taxes at Federal statutory tax rate	105	21.0
State income taxes, net of Federal benefit	25	5.0
Impact of Tax Act of 2017: One-time transition tax	40	8.0
Impact of Tax Act of 2017: Deferred tax effects	(18)	(4.0)
Non-deductible goodwill impairment	15	3.0
Research & Development	(20)	(4.0)
Other	(15)	(3.0)
<b>Effective Tax Rate</b>	<b>\$ 132</b>	<b>26.0</b>



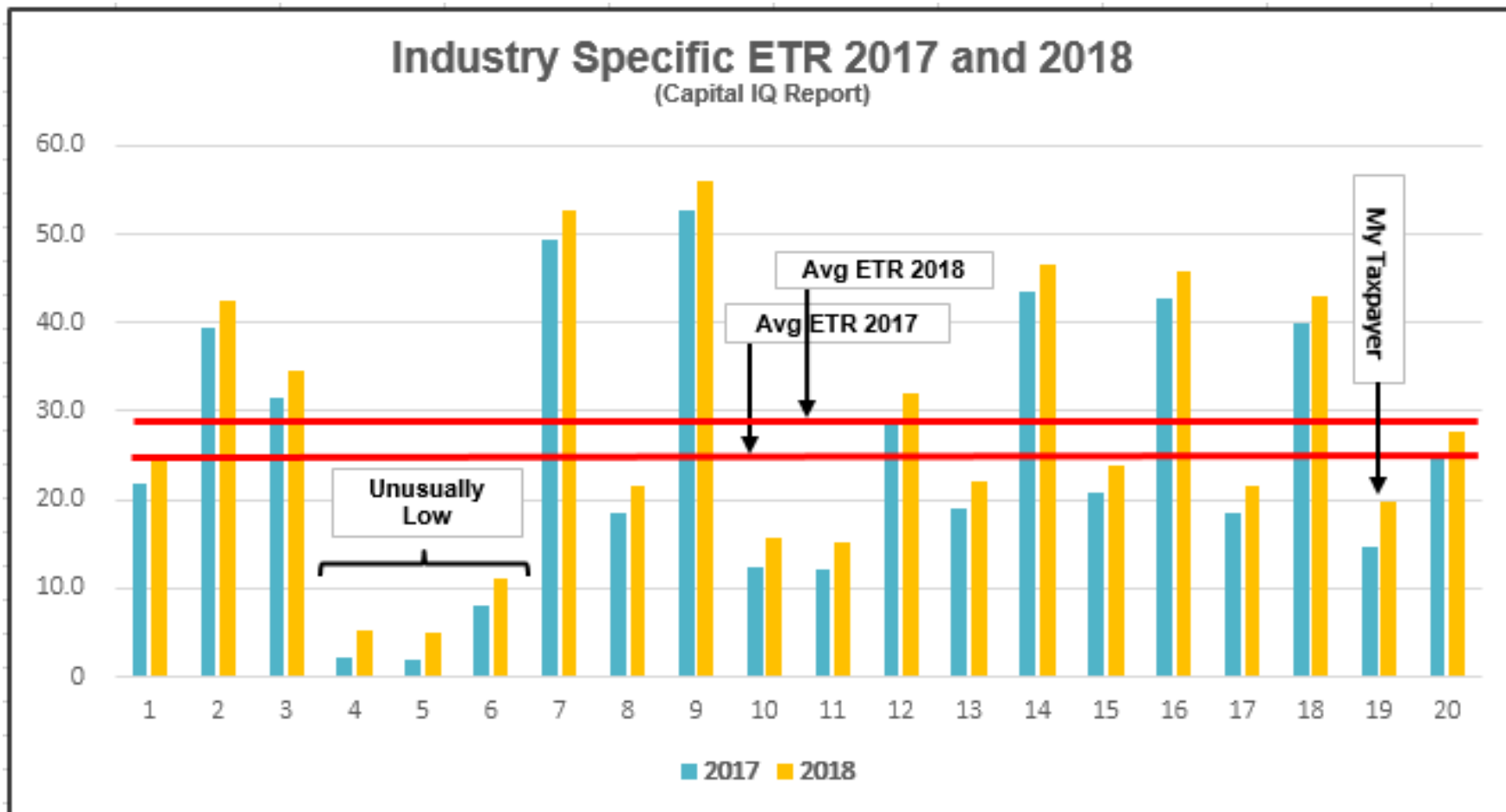
# Example C-4: ETR Rate Reconciliation Trending

## Rate Reconciliation Schedule For Years 2018, 2017, and 2016

Federal statutory rate	21.0%	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	(8.9)	(12.1)	(14.7)
Impacts of TCJA	5.4	0.0	0.0
Industry business losses	(4.1)	(5.7)	(0.8)
Excess tax benefits – compensation	(2.5)	(1.3)	(1.9)
Interest, net	1.3	2.4	1.2
Other reconciling items	(2.1)	(2.2)	(0.9)
Effective tax rate	10.1%	16.1%	17.9%

# Example C-5: ETR Industry Comparison

ETR is significantly lower than industry peers

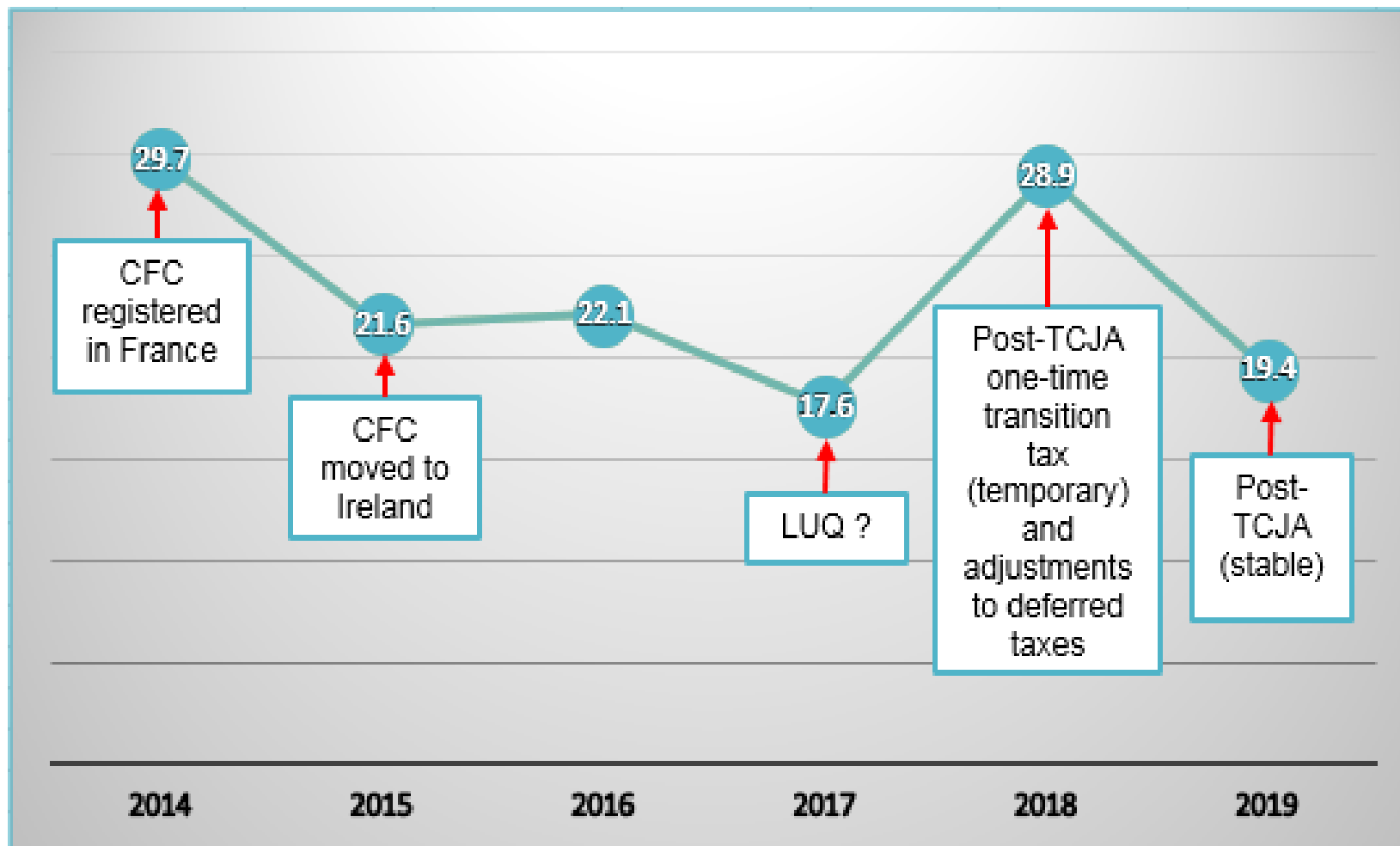


# Exam Tips:

## Large, Unusual or Questionable (LUQs)

- Look for LUQ items in the Tax Rate Reconciliation Schedule and associated footnotes
- Common examples:
  - “Provision for restructuring” line item, or
  - “Transition tax on foreign earnings for TCJA”

# Example C-6: Fluctuation – Restructuring, LUQ, and TCJA



# Example C-7.1:

## Income Tax Footnotes

### TCJA Examples:

- On December 22, 2017, the **TCJA** was enacted into law, which significantly changes existing US tax law. The TCJA reduced the US federal statutory tax rate from 35% to 21% effective January 1, 2018. For fiscal year 2018 entities, **the US federal statutory tax rate would be equal to a blending of the pre-TCJA tax rate of 35% and a post-TCJA tax rate of 21%.** *(This footnote would likely also include the entity-specific narrative explaining exactly how the TCJA affected the entity's financial statements.)*
- The **TCJA** includes a provision to tax **global intangible low-taxed income (“GILTI”)** of foreign subsidiaries and a **base erosion anti-abuse tax (“BEAT”)** measure that taxes certain payments between a US corporation and its foreign subsidiaries. *(This footnote would likely also include the entity-specific narrative explaining exactly how the GILTI and BEAT affected the entity's financial statements.)*



# Example C-7.2:

## Income Tax Footnotes- (Cont'd)

### TCJA Examples:

- US Tax Reform Legislation. On December 22, 2017, the US government enacted comprehensive tax reform legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act transitions the US tax system to a new territorial system and lowers the statutory federal corporate income tax rate. As a result of the reduction in the federal corporate income tax rate, we remeasured our net deferred tax liabilities as of the enactment date and the remeasurement resulted in a one-time, non-cash tax benefit of \$1.8 billion and was recorded in the year ended July 31, 2018. In transitioning to the new territorial system, the Tax Act requires us to include certain untaxed foreign earnings of non-US subsidiaries in our fiscal 2018 taxable income. This tax, referred to as the “transition tax”, was estimated to be \$1.3 billion and was recorded in the year ended July 31, 2018. The transition tax will be paid over a period of eight years as permitted by the TCJA. See Note 13—Income Taxes to our consolidated financial statements.

# Example C-7.3: Income Tax Footnotes (Cont'd)

## TCJA Examples:

- **Adjusted effective income tax rate.** Our financial results for fiscal 2018 and 2017 reflect the impact of TCJA on certain significant items. As such, we have presented adjusted effective income tax rates for years 2018 and 2017.
- **Remeasurement of deferred tax balances.** During fiscal 2018, in connection with the TCJA's reduction of the corporate income tax rate, we remeasured our net deferred tax liabilities as of the enactment date, resulting in the recognition of a non-recurring, non-cash income tax benefit of \$1.8 billion.

# Example C-7.4: Income Tax Footnotes (Cont'd)

## TCJA Examples:

- **Transition tax on foreign earnings.** During fiscal 2018, in connection with the **TCJA** requirement that we include certain untaxed foreign earnings of non-US subsidiaries in fiscal 2018 taxable income, we recorded a one-time transition tax estimated to be approximately \$1.3 billion.
- **Remeasurement of deferred tax liability.** During fiscal 2016, we recorded a non-recurring \$88 million gain upon the remeasurement due to TCJA of a deferred tax liability, recorded upon the acquisition of XXX Company, to reflect a tax rate change in Country A.



## **D. Exam Tips – Using Other Sources for Review of LUQs**



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# Exam Tips: Using Other Sources

- Issue teams may review other sources to search for additional information on LUQs:
  - Public documents, press releases, analyst reports, etc.
  - SEC and other required US and foreign public filings
  - Use available software analysis tools
  - Board minutes
  - Country by Country Reports (CbCRs) and transfer pricing documents (looking for trends)
  - Short-period returns associated with transactions
  - Notes to Financial Statements
  - Tax forms and disclosure attachments

# Exam Tips:

## Using Other Sources (Cont'd)

- Review of certain tax forms may provide a link between the taxpayer's consolidated tax return and Financial Statements:
  - Form 1120, Schedule B for M-3 Filers
  - Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations
  - Consolidated M-3 Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More
  - Form 926, Return by a US Transferor of property to Foreign Corp
  - Form 1120, Schedule UTP (Uncertain Tax Positions)
  - Form 8886, Reportable Transactions
  - Form 8975, CbCRs
  - Disclosures and White Paper Statements

# Exam Tips:

## Using Other Sources (Cont'd)

- Under current guidelines, the Service may only request tax accrual workpapers in “certain circumstances” (see IRM 4.10.20, as modified by Announcement 2010-76).

# Example D-1: Exam Techniques

Form 1120, Schedule B, provides additional M-3 information related to the reconciliation of US GAAP Book Financial income with US taxable income (loss):

- Line 1 – identifies foreign partnerships with special allocations
- Line 2 and Line 3 – identifies transfers of Intangible Property (IP) between US taxpayer and its related parties (possible shifting IP offshore)
- Lines 4a and 4b – identifies cost sharing arrangements (CSAs) between US taxpayer and foreign related parties

SCHEDULE B (Form 1120)		Additional Information for Schedule M-3 Filers	
<small>(Rev. December 2018) Department of the Treasury Internal Revenue Service</small>		▶ Attach to Form 1120. ▶ Go to <a href="http://www.irs.gov/Form1120">www.irs.gov/Form1120</a> for the latest information.	
Name		Employer identification number (EIN)	
1	Does any amount reported on Schedule M-3 (Form 1120), Part II, line 9 or 10, column (d), reflect allocations to the corporation from a partnership of income, gain, loss, deduction, or credit that are disproportionate to the corporation's capital contribution to the partnership or its ratio for sharing other items of the partnership? . . . . .	Yes	No
2	At any time during the tax year, did the corporation sell, exchange, or transfer any interest in an intangible asset to a related person as defined in section 267(b)? . . . . .		
3	At any time during the tax year, did the corporation acquire any interest in an intangible asset from a related person as defined in section 267(b)? . . . . .		
4a	During the tax year, did the corporation enter into a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations? . . . . .		
b	At any time during the tax year, was the corporation a participant in a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471? . . . . .		



# Example D-2: Exam Techniques

## Form 1120, Schedule M-3, Part I, Line 4a

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock \_\_\_\_\_

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1 . . . . .	4a	
b	Indicate accounting standard used for line 4a (see instructions): (1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS (3) <input type="checkbox"/> Statutory (4) <input type="checkbox"/> Tax-basis (5) <input type="checkbox"/> Other (specify) _____		
5a	Net income from nonincludible foreign entities (attach statement) . . . . .	5a	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount) . . . . .	5b	
6a	Net income from nonincludible U.S. entities (attach statement) . . . . .	6a	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount) . . . . .	6b	

### Line Item Intent or Description

- In the past, taxpayers were not consistent in what they reported for WW consolidated income. The amount might reflect financial net income for
  - the WW group,
  - the US consolidated tax group, or
  - something in between.
- This line provides for consistency amongst taxpayers for the income statement source provided in question 1 of M-3, Part I.

# Example D-3: Exam Techniques

## Form 1120, Schedule M-3, Part I, Line 7a

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	
b	Indicate accounting standard used for line 4a (see instructions): (1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS (3) <input type="checkbox"/> Statutory (4) <input type="checkbox"/> Tax-basis (5) <input type="checkbox"/> Other (specify) _____		
5a	Net income from nonincludible foreign entities (attach statement)	5a	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6a	Net income from nonincludible U.S. entities (attach statement)	6a	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b	
c	Net income (loss) of other includible entities (attach statement)	7c	

### Line Item Intent or Description

- Line 7a is used by the taxpayer to include the financial book income or loss of each foreign disregarded entity that is not included in the financial book income but should be included for US tax purposes.
- Foreign disregarded entities not included in the consolidated financial book income that should be included in the consolidated tax group should be added to WW income to arrive at US taxable income for the US consolidated tax return.

# Example D-4: Exam Techniques

<b>SCHEDULE UTP</b> <b>(Form 1120)</b>  Department of the Treasury Internal Revenue Service	<b>Uncertain Tax Position Statement</b>  ▶ File with Form 1120, 1120-F, 1120-L, or 1120-PC. ▶ Go to <a href="http://www.irs.gov/ScheduleUTP">www.irs.gov/ScheduleUTP</a> for instructions and the latest information.	OMB No. 1545-0123  <b>2018</b>
	Name of entity as shown on page 1 of tax return _____ EIN of entity _____	

This Part I, Schedule UTP (Form 1120) is page \_\_\_\_\_ of \_\_\_\_\_ Part I pages.

**Part I** **Uncertain Tax Positions for the Current Tax Year.** See instructions for how to complete columns (a) through (g). Enter, in Part III, a description for each uncertain tax position (UTP).  
 Check this box if the corporation was unable to obtain information from related parties sufficient to determine whether a tax position is a UTP. See instructions.

(a) UTP No.	(b) Primary IRC Sections (for example, "61", "108", "263A")			(c) Timing Codes (check if Permanent, Temporary, or both)		(d) Pass-Through Entity EIN	(e) Major Tax Position	(f) Ranking of Tax Position	(g) Reserved for Future Use
	Primary IRC Subsections (for example, (f)(2)(A)(ii))			<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
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c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
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c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		
c				<input type="checkbox"/>	<input type="checkbox"/>	-	<input type="checkbox"/>		

## Schedule UTP

- Schedule UTP was created and is required as part of the IRS strategy to improve compliance through greater transparency.
- Schedule UTP may reduce the time it takes to find issues and give issue teams and taxpayers more time during tax exams to discuss the law as it applies to the facts, rather than looking for information.
- In addition, it is expected to help identify areas of uncertainty that require guidance and to allow prioritization in the selection of issues and taxpayers for examination.

# Example D-5: Exam Techniques

## Form 8886 Reportable Transactions

- Must be filed to disclose a taxpayer's participation in each reportable transaction (See Form 8886 instructions).
- Review Forms 8886 to identify international transactions that may provide further insight into taxpayer's Global ETR tax planning strategies and identified LUQs.
- Identify the tax benefits reflected on the tax return that are derived directly or indirectly from tax consequences or a tax strategy of the reported transaction.

Form <b>8886</b> (Rev. March 2011) Department of the Treasury Internal Revenue Service		<b>Reportable Transaction Disclosure Statement</b>		OMB No. 1545-1800	
		▶ <b>Attach to your tax return.</b> ▶ <b>See separate instructions.</b>		Attachment Sequence No. <b>137</b>	
Name(s) shown on return (individuals enter last name, first name, middle initial)				Identifying number	
Number, street, and room or suite no.			City or town	State	ZIP code
<b>A</b> If you are filing more than one Form 8886 with your tax return, sequentially number each Form 8886 and enter the statement number for this Form 8886 ..... ▶ Statement number _____ of _____ <b>B</b> Enter the form number of the tax return to which this form is attached or related ..... ▶ _____ Enter the year of the tax return identified above ..... ▶ _____ Is this Form 8886 being filed with an amended tax return? ..... ▶ <input type="checkbox"/> Yes <input type="checkbox"/> No <b>C</b> Check the box(es) that apply (see instructions). <input type="checkbox"/> Initial year filer <input type="checkbox"/> Protective disclosure					
<b>1 a</b> Name of reportable transaction					
<b>1 b</b> Initial year participated in transaction			<b>1 c</b> Reportable transaction or tax shelter registration number (see instructions)		
<b>2</b> Identify the type of reportable transaction. Check all boxes that apply (see instructions). <b>a</b> <input type="checkbox"/> Listed <b>c</b> <input type="checkbox"/> Contractual protection <b>e</b> <input type="checkbox"/> Transaction of interest <b>b</b> <input type="checkbox"/> Confidential <b>d</b> <input type="checkbox"/> Loss					
<b>3</b> If you checked box 2a or 2e, enter the published guidance number for the listed transaction or transaction of interest ..... ▶ _____ <b>4</b> Enter the number of "same as or substantially similar" transactions reported on this form ..... ▶ _____ <b>5</b> If you participated in this reportable transaction through a partnership, S corporation, trust, and foreign entity, check the applicable boxes and provide the information below for the entity(s) (see instructions). (Attach additional sheets, if necessary.) <b>a</b> Type of entity ..... ▶ <input type="checkbox"/> Partnership <input type="checkbox"/> Trust <input type="checkbox"/> Partnership <input type="checkbox"/> Trust <input type="checkbox"/> S corporation <input type="checkbox"/> Foreign <input type="checkbox"/> S corporation <input type="checkbox"/> Foreign <b>b</b> Name ..... ▶ _____ <b>c</b> Employer identification number (EIN), if known ..... ▶ _____ <b>d</b> Date Schedule K-1 received from entity (enter "none" if Schedule K-1 not received) ..... ▶ _____ <b>6</b> Enter below the name and address of each individual or entity to whom you paid a fee with regard to the transaction if that individual or entity promoted, solicited, or recommended your participation in the transaction, or provided tax advice related to the transaction. (Attach additional sheets, if necessary.)					
<b>a</b> Name		Identifying number (if known)		Fees paid \$	
Number, street, and room or suite no.			City or town	State	ZIP code
<b>b</b> Name		Identifying number (if known)		Fees paid \$	
Number, street, and room or suite no.			City or town	State	ZIP code



# Example D-6: Exam Techniques

## Disclosures and White Paper Statements

- Review various disclosures, white paper statements and attachments that are statutorily required.
  - IRC 965 – Transition Tax Statement
  - IRC 367 - Foreign Restructuring Transactions (e.g., Gain Recognition Agreement (GRA), etc.)
  - Corporate Non-recognition Provisions (e.g., IRC §§ 332, 351, 355, etc.)
  - IRC 1503(d) - Dual Consolidated Loss (DCL)
  - IRC 482 - Transfer Pricing (e.g., Cost Sharing (“CSA”) Statement, etc.)
  - Specific Form Attachments
    - Forms 5471 and 8858 (Org Chart attachments)
    - Form 926 (Regs.1.6038B-1(b) and 1.6038B-1T(c) & (d))
    - Form 8975, CbCR



**What did we learn?**



**Large Business  
& International**

# Summary

- Issue teams may review a company's financial statement income tax footnote as a part of the preliminary risk analysis in an examination.
- Reviewing a company's financial statement income tax footnote and ETR will assist in identifying helpful information about a company's tax planning strategies.
- Although no tax audit adjustments can be proposed simply from reviewing the income tax footnote, understanding a company's tax planning strategies is key to issue identification.

# Lessons Learned

You should now be able to:

- A. Identify taxpayer's objectives for achieving a low ETR
- B. Explain how the ETR of a corporation is calculated
- C. Identify issues for risk analysis purposes using the income tax footnote and tax rate reconciliation
- D. Locate additional sources of information for further investigation of LUQ items



# Appendix



**Large Business  
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# External Resources

- **ASC 740** – Obtain a free login to view copy of ASC 740 at <https://asc.fasb.org>
- **EDGAR** <https://www.sec.gov/edgar.shtml>

# Glossary of Terms

Acronym/Terms	Definition
BEAT	Base Erosion Alternative Minimum Tax
CFC	Controlled Foreign Corporation
DRD	Divided Received Deduction
DRE	Disregarded Entity for US Tax purposes
EPS	Earnings Per Share
ETR	Effective Tax Rate
FDII	Foreign-Derived Intangible Income
Financial Book	US GAAP Financial Statements
FTC	Foreign Tax Credit
GAAP	Generally Accepted Accounting Principles

# Glossary of Terms (Cont'd)

Acronym/Terms	Definition
GILTI	Global Intangible Low-Taxed Income
IRA	Indefinite Reinvestment Assertion (formerly called Permanently Reinvested Income "PRI")
IFRS	International Financial Reporting Standards
LUQ	Large, Unusual or Questionable - initial risking of tax return
MNE	Multinational Entity
PRI	Permanently Reinvested Income (now Indefinite Reinvestment Assertion "IRA")
TCJA	Tax Cuts and Jobs Act of 2017
USP	United States Parent
WW	Worldwide

