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Good morning, Chairman Camp, Ranking Member Levin, and other members of the committee. I am Ashby Corum, a tax partner at KPMG LLP. I appreciate the opportunity to appear before you today as an invited witness to assist the Committee in understanding the importance of financial accounting and the relationship between tax and financial accounting, particularly as affected by changes in tax law. The views expressed here are my own and do not necessarily reflect the views of KPMG LLP, its partners, principals and employees, or other KPMG International member firms. KPMG has no position on any of the various tax reform proposals put forth, and no position should be inferred from my testimony.

The accounting and reporting of income taxes by corporate enterprises in their financial statements is a critical element of their overall reporting to stakeholders. Financial statements present the financial position and operating results of the company and are used by analysts, shareholders, lenders and directors. Income tax expense is often a significant expense for an enterprise and it can have a major impact on earnings. Income tax amounts on the balance sheet can also have a significant influence on the financial ratios of a corporate enterprise. Accordingly, investors, analysts and other stakeholders monitor the income tax amounts reported by businesses closely, and make assumptions about the long-term trends of the reported amounts. Changes in tax law can have significant effects on financial statements.

The Internal Revenue Code specifies how an enterprise's annual federal current income tax liability is determined. Accounting standards provide for the financial accounting and reporting of the effects of income taxes that result from an enterprise's activities during the current and preceding years.[1] The objectives of accounting for income taxes are to:

- recognize the amount of taxes payable or refundable for the current year,
- recognize deferred tax liabilities and assets that reflect the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns, and
- measure current and deferred tax assets and liabilities based on the provisions of enacted tax law.

Total income tax expense of an enterprise consists of both the current tax expense and deferred tax expense or benefit associated with changes in the balance of deferred tax liabilities and assets. The result of dividing total income tax expense by pre-tax accounting income is commonly known as the effective tax rate and may differ substantially from the statutory tax rate of a group's parent company or the rate of current tax paid.

[1] Specifically, for U.S. GAAP reporting, FASB ASC Topic 740, *Income Taxes*.

Financial statement pre-tax income for a global enterprise can differ substantially from taxable income in a particular jurisdiction. Most of these differences are attributable to:

- when income or expense is recognized for tax purposes versus when it is recognized for financial reporting ("temporary differences"),
- items of income or expense that are permanently allowed or disallowed for taxable income purposes (commonly referred to as "permanent differences"), and
- the allocation of income to different jurisdictions around the world with different statutory tax rates (sometimes referred to as "allocation differences").

Changes to the tax law often produce financial accounting consequences, some of large magnitude. Some common examples of the financial accounting impact of changes in tax laws or rates are as follows:[2]

- An adjustment to the timing of when an amount is deductible – An example of this would be bonus depreciation on new machinery and equipment purchases. If an enterprise were to purchase an eligible piece of machinery for $100 while a 100% bonus depreciation incentive was in effect, the enterprise would be able to reduce its current tax expense by $35. The financial accounting treatment of that purchase is more complicated. For book purposes, while the company has a current tax deduction of $100 and a current tax benefit of $35, it must create an account, called a deferred tax liability, to reflect the fact that the immediate deduction of the cost of the asset reduces the enterprise's tax basis in the asset to zero. As the machinery on the books is depreciated the difference between the book balance and tax basis will be reduced resulting in the deferred tax liability being reduced. If the enterprise were to recover the book value of the asset, it would incur $35 of additional income tax. Accordingly, a deferred tax liability of $35 would be recognized.
- An adjustment to the statutory rate – If an enterprise were to have post-retirement obligations for which a pre-tax book expense of $100 was recognized in a prior period, but for which a tax deduction is not be permitted until the liability is settled, the entity would have a deferred tax asset of $35[3]. If the statutory rate were reduced from 35% to 25%, then the applicable rate used to measure the deferred tax asset would be adjusted downward since the company would now expect to receive a smaller future tax benefit upon settling the liability. This would result in a reduction of the deferred tax asset from $35 to $25 and an income tax expense of $10 in the period of enactment. In other words, the enterprise's book net income for the period of enactment would be reduced by $10. The opposite effect would occur in the period of enactment for an enterprise's deferred tax liabilities where a reduction in tax rates would result in an increase in book net income. In future periods, that same enterprise may have a reduced income tax expense due to the reduced statutory rate. That is, a rate reduction will impact book income for the period of enactment to the extent that existing deferred tax assets and liabilities are re-measured and for the effects of retroactive provisions. Thus, while the enactment of a rate change for future periods does not

[2] All examples are intended to be generic and are not intended to be an interpretation of the application of the Internal Revenue Code.

[3] For this example, we will assume the deferred tax asset is not reduced by a valuation allowance.

necessarily affect the current tax position of the company during the period of enactment it may have a significant effect on reported earnings.

- An adjustment to the statutory rate for an enterprise with net operating loss carryforwards – A similar example would be an enterprise that incurs $100 of operating losses in a prior year and has a $100 net operating loss carryforward. The enterprise would recognize a $35 deferred tax asset for the net operating loss carryforward.[4] The deferred tax asset represents the $35 of future tax the enterprise would avoid if it earns $100 in the future during the carryforward period and utilizes the net operating loss carryforward against that income. If the statutory tax rate were reduced from 35% to 25%, then the deferred tax asset for the $100 net operating loss carryforward would be remeasured to $25, since it will now only offset $25 of potential future tax expense. The enterprise would recognize $10 of deferred tax expense in the period of enactment of the tax rate change.
- An adjustment to the deductibility of a particular item – An example of this would be the recent change to the deductibility of expenses related to Medicare Part D reimbursement rights. For example, assume an enterprise has accrued post-retirement benefits costs of $100, prior to consideration of the Medicare Part D subsidy. After consideration of the subsidy, the carrying amount of accrued post-retirement benefit costs is $72. Based on pre-2010 tax law, the enterprise would have anticipated recovering the $72 accrual through the payment of $100 of fully deductible expenses, partially offset by a tax-exempt subsidy of $28.[5] Accordingly, the enterprise would have recognized a $35 deferred tax asset related to this accrual. The Patient Protection and Affordable Care Act reduced the amount of health care payments that would be eligible for a deduction. After enactment of the legislation, the enterprise would only be able to deduct $72 of the accrued post-retirement benefit costs, and would have non-deductible post-retirement benefit costs of $28 to match the $28 of tax-exempt subsidy. Accordingly, the enterprise would remeasure its deferred tax asset to $25 ($72 x 35%) and would recognize a deferred tax expense of $10 in the period of enactment of the legislation.
- Change to the tax treatment of distributions from foreign subsidiaries – Currently, many enterprises with foreign operations have a significant amount of foreign earnings that are held offshore. An exception in the literature provides that a deferred tax liability is not recognized for temporary differences related to investments in foreign subsidiaries that are essentially permanent in duration.[6] Accordingly, an enterprise would not recognize a deferred tax liability for the future tax consequence of repatriating past earnings of a foreign subsidiary, assuming sufficient evidence shows that the subsidiary has invested the undistributed earnings indefinitely. If a reduction of the tax rate applicable to repatriated earnings caused an enterprise to change its intent with respect to those earnings and it decided to repatriate the earnings to the U.S. parent, then a tax expense would be recognized in the financial statements.

The foregoing are just a few examples of the ways tax and financial accounting differ—and the financial reporting consequences of those tax changes. There are, of course, many others that will arise as you deliberate changes to the Code. I am happy to answer any questions you may have.

[4] For this example, we will assume the deferred tax asset is not reduced by a valuation allowance.

[5] See Section 139A of the Internal Revenue Code of 1986.

[6] ASC subparagraph 740-10-25-3(a)(1).