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Late-year change in income tax rate leads to billions in unexpected profits and losses

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As politicians tout the merits of U.S. tax reform on personal returns and corporate investment, many companies are scrambling to deal with the law's immediate impact on the value of their deferred tax assets and liabilities and their bottom lines in the fourth quarter.

Under the Tax Cuts and Jobs Act, signed into law by President Donald Trump on Dec. 22, companies filing calendar-year financial statements using generally accepted accounting principles, known as GAAP, are required to re-evaluate their deferred tax assets and liabilities in the fourth quarter as a result of the late-year change in the corporate income tax rate from 35 to 21 percent

In a paper being published Feb. 5 in *Tax Notes*, professors from Indiana University's Kelley School of Business and the University of Virginia's McIntire School of Commerce report that this could result in a median drop in earnings of $100 million for 211 companies in the Standard & Poor's 500 needing to re-value their net deferred tax assets.

For the median company, that figure is equal to about 10 percent of prior net income. The total negative financial effect overall on these companies could total $108 billion.

"This tax act is going to have financial reporting considerations that have been largely overlooked so far in the discussion," said Bridget Stomberg, assistant professor of accounting at Kelley. "It's changing future cash flows. One company might be picking up a lot of income this quarter as a result, while their competitor might be recognizing a big expense."

Among the companies they found with potentially large decreases in net earnings are Citigroup Inc. ($18.67 billion or 125 percent of prior-year net income), General Motors Co. ($13.84 billion or 147 percent of prior-year income), American International Group ($8.28 billion, or 975 percent, after a small loss the previous year), Bank of America ($7.6 billion, 43 percent) and Ford Motor Co. ($3.6 billion, 78 percent).

On the other hand, the tax law will have unexpected benefits for 317 publicly traded companies in the sample, who could report a median increase in accounting earnings of $341 million or about $400 billion overall.

Some of the biggest beneficiaries of the tax law change could include Berkshire Hathaway, which could report the largest increase in net earnings, $30.78 billion or 128 percent of prior-year net income, followed by AT&T Inc. ($23.49 billion, 181 percent), Verizon Communications Inc. ($18.36 billion, 140 percent), Comcast Corp. ($13.92 billion, 160 percent), Pfizer Inc. ($12 billion, 167 percent), Exxon Mobil Corp. ($11.96 billion, 153 percent) and Apple Inc. ($11 billion, 23 percent).

By law, companies report differences between financial statement income and taxable income each year, leading to deferred taxes. For one-third of companies in the study's sample, future tax liabilities will go up because companies were recording an expected future benefit of 35 cents on the dollar, which the Tax Cuts and Jobs Act reduced to only 21 cents on the dollar.

Stomberg and her co-author, Jeri Seidman, an assistant professor at the McIntire School of Commerce, used disclosures of total deferred tax assets and liabilities from the income tax footnotes in the most recent annual reports of 528 companies that were listed in the Standard & Poor's 500 anytime in 2016 or 2017.

They calculated the magnitude of net deferred tax assets and liabilities and estimated the expected change at each company given the 14 percentage-point reduction in the corporate tax rate. They also estimated the effect of these adjustments on profits, leverage and effective tax rates.

The authors hope the findings in their paper, "The Financial Reporting

Consequences of Tax Reform: How the Corporate Tax Rate Will Affect Profits," will help those reading financial statements anticipate and better understand the nature of these one-time adjustments. They acknowledge that many investors, as well as some company CEOs and CFOs, will struggle to understand the real impact of the law on fourth-quarter results.

"Our anticipation is that companies are going to call it out as a transitory item," Stomberg said of the one-time adjustment to deferred tax assets and liabilities. "This quarter there should be more of a focus on non-GAAP earnings, or pro-forma earnings, where companies compute book income with this number in it, but then take it out and say to everybody, 'Try to focus on this other number instead.'

"Obviously, if you're a company that's getting hurt by it, you have a big incentive to do that," she added. "Because it's so big and because it's affecting everybody, it's going to be hard for companies to not call it out, even it is a benefit to them."

Stomberg said this is going to be a difficult financial reporting season for public companies because the legislation was passed so late in the year. Nearly all public companies are required to file their 10-K annual report within the first 60 days of the year, but many firms are unsure whether they'll be able to make the calculations in time.

"There's going to be a lot of work that companies have to do in a very short period of time to figure this out, to calculate the effects and communicate them to analysts and shareholders," she said. "The SEC is allowing companies some flexibility in reporting these numbers in their annual reports because the act was passed so quickly and so close to the end of the year. The companies really need more time to digest the financial statement information."

Although the large one-time adjustments do not affect taxes paid in the fourth quarter of 2017, these changes will affect the magnitude of future tax benefits and obligations.

Provided by Indiana University