BDO Canada

CROSS-BORDER TAX PODCAST SERIES

Episode 16: Update on U.S. tax landscape - LIVE in Toronto

Kevin Macnab:

Hi, this is Kevin Macnab with Dan Lundenberg and you're listening to the BDO Cross-Border Tax Podcast live.

Dan Lundenberg:

Has anyone tried dealing with the IRS lately? Show of hands. Show of hands. I see some hands here.

Anyone have a good experience with the IRS recently? Head shaking, no. Actually, no hands up.

It's no secret that the IRS' customer service has declined significantly over the last few years. This is mainly the result of the Republican's desire to starve the system of needed funds to operate. Their computer systems are terrible. I had to call for a personal matter and I called up and after waiting on hold for half hour, someone said "That I'm not a person, I'm not an individual, but I'm really an entity," and they transfer me to the entity section where I waited on hold for five minutes and they disconnected me. And I've been one of those people yelling at my phone saying, "I am a person," and they don't believe me.

So, the system's role, the misnamed Inflation Reduction Act, which had little to do with fighting inflation, but was really actually a significant climate change legislation, did something significant for the IRS. It provided significant increase in funding $80 billion over 10 years. And according to the nonpartisan Congressional Budget Office, this increase in funding will result in new revenue: $200 billion over 10 years.

All governments think there's a huge gap between what they think is owed and what is actually paid. It's called the tax gap. Governments like to talk about ensuring a taxpayers pay their fair share of taxes. As tax professionals, we know that tax planning provides choices, and what's fair to the government, might not be perceived as fair for taxpayer.

We'll talk about the legislative landscape in the US shortly, but it's clear that tax increases are not on the table in the US in the next few years. As a result, the IRS is forced to raise revenue through various compliance initiatives.

You can see on the slide the IRS has announced a whole bunch of new compliance initiatives dealing with high income, high wealth taxpayers, corporations and partnerships, global tax issues, basically covering everything.

And these initiatives are designed to identify and address areas like under-reporting, non-filing and fraud. But things are not all great in Washington.

So the legislative landscape is pretty dim for accomplishing anything, in the short, medium, and over the next few years. And there's many factors that call into play. There's a presidential election next year and traditionally nothing happens the year before a presidential election. There are wars in both Ukraine and the Middle East now. There's actually very few days that Congress gets to work between now and the time they adjourn the end of the year. As of a few minutes ago, there's still no Speaker in the House of Representatives, so the House can't do anything. Very little desire to compromise even within parties.

There's a need for a budget resolution. The last Speaker lost his job when he kicked the budget down the road until mid-November, so they need to do something. Republicans really want to gut the tax credits that were in the Inflation Reduction Act.

There's talk about deficit reduction. There's talk about reducing spending, but you have to increase military spending. You can't cut Medicaid, Medicare, and you can't increase taxes. So, there's very little appetite to do anything meaningful.

From a tax perspective, there's three things that tax practitioners are focusing on.

One is reinstating the hundred percent deduction for R&D Expenses. Two, fixing the interest deductibility rules. And three, restoring a hundred percent bonus depreciation through 2025.

Will this happen in a budget bill? Not likely. And given sort of the cycle of legislative change, probably nothing meaningful will happen probably going into 2025. My crystal ball.

What about the Biden's administrations to be more Pillar Two compliant? We sort of have a minimum tax. It's really not Pillar Two compliant from what everyone said, but that seems to be dead in the water.

So, I'm going to talk a little bit about research and development expenses. The Tax Cuts and Jobs Act changed the longstanding deductibility R&D expenses from a current deduction to capitalization and amortization. It's five years if the costs are incurred in the US, 15 years if the costs are incurred outside the US. This kind of snuck up on a lot of people, in part because there's an expectation that Congress would change the law and go back to current deductibility, but it did not and it probably won't in the short term.

Obviously, this has a significant impact on businesses that are heavily invested in research and innovation and impact that companies need to understand the impact and take steps to potentially minimize the impact.

Next few slides have a lot of detail on R&D amortization. In the interest of time, I will not go into this level of detail. You'll have the slides. You can ask questions at coffee if you'd like.

Impacted companies need to spend time to determine what avenues exist, to take positions that certain expenditures are outside the scope of 174 and be claimed as, for example, a current R&D credit, such as certain internal use software development.

So with that, I will just kind of go through a few slides, then move to slide 10, and talk about interest deductibility and changes made by the Tax Cut and Jobs Act in 2017.

Many people here may know that this TCJA significantly expanded the previous 163(j) limitation on interest deductibility. Before TCJA, 163(j) impacted related party debt and third party debt that was guaranteed by a foreign related party. So, your classic Canadian parent, US sub loan down, loan through a structure, or if the US has a third party debt and Canada guaranteed it. And so the interest was subject to this allowance where the US entity's debt to equity ratio exceeded 1.5 to 1.0 and where its net interest expense exceeded 50% of adjusted taxable income.

In practice, that really did not bother a lot of our clients. It didn't really have a significant impact on what they can deduct.

By the way, if I had a dollar for every time someone thought the 1.5 to 1.0 debt equity ratio was some kind of thin capitalization, safe harbor, I'd be a rich man. I'd be on a beach someplace. I wouldn't be talking to you now.

Any kind of discussion of interest deductibility assumes that you have debt that would be respected for US tax purposes and we have thin capitals. We have lots of different factors that look into what debt would be when you have a related party type transaction. And that 1.5 to 1.0 was just for earning stripping purposes only, and not some kind of broad safe harbor for whether debt would be respected.

So, the TCJA made lots of changes. That debt to equity ratio safe harbor was eliminated. Most importantly applies to all debt. There is a small safe harbor for small companies, but when you're over that, it applies to all debt, even third party debt. And the 50% of adjusted taxable income was reduced from 50% to 30%, but confusingly it went back up to 50% for a certain period of time during COVID.

Adjusted taxable income was defined similar to what I heard earlier from Laura and Jessica, as earnings before interest, taxes, depreciation and amortization, otherwise known as EBITDA. However, for years beginning after December 31st, 2021, adjusted taxable income was revised to be earnings before interest and taxes, EBIT. What does this mean? It means many more taxpayers will have disallowed interest under this rule.

The next few slides have detail on what the disallowed interest calculation looks like. But in interest of letting Kevin talk, I'll move on to bonus depreciation.

So, code section 168(k) allowed businesses to take additional depreciation deductions, in addition to regular depreciation that a business could typically claim. This slide describes the criteria to be eligible for bonus depreciation.

Business like bonus depreciation has allowed substantial tax recovery of the cost of qualified property in the year was placed in the service. Businesses could choose to time their investments and acquisitions to take advantage of bonus depreciation.

You can see from this slide, that the percentage of bonus depreciation has varied over years. It was a hundred percent from late 2017 through the end of 2023 and is being reduced 20% each year, until 2027, when it's going to be eliminated. So, it's going to be 80% this coming year.

The Tax Cuts and Jobs Act may use property eligible, which is pretty significant, particularly in the acquisition context.

Now that the percentage is subject to reduction, there are lots of proposals to maintain a hundred percent recovery. With the other tax key items we discussed, the future of this bonus depreciation is in legislative limbo, and companies should assume that the 20% reduction will apply over the next few years.

With that, I will transition over to Kevin, who's going to talk about different types of penalties.

Kevin Macnab:

Thanks, Dan.

I didn't get a chance to see by a show of hands how many people had dealt with the IRS, but in terms of US tax reporting, is there, by a show of hands, are there people here that have had to deal with 5471 or 5472 filings? And hopefully not, but the penalties that are often associated with them.

So for us as tax practitioners, I think 5472s and 5471s are the things that kind of keep us up and scare us, just because of how punitive those penalties can be. If you're not familiar with them, 5471s are basically forms they used to report information for controlled foreign corporations. And 5472s are forms that are used to report intercompany related party transactions when you've got foreign companies doing business in the US, or you've got US companies that are foreign owned. So, it's reporting forms that we see quite a bit in Canada, and so as a result of that, we have to deal with these forms a lot and the penalties associated with them are extremely punitive.

For 5471s, the penalties for that are $10,000 per form, per year. And for 5472s, it's $25,000 per form, per year, in US dollars. So, you can have companies that have six, eight, 10, 20, 5472s and if you fail to file those, the IRS will automatically assess those penalties, without question.

And then as Dan was alluding to, dealing with the IRS to potentially get those penalties abated, based on reasonable cause, can often be quite challenging. So, that's why this case was kind of such a big deal for everyone because it was the first time where we saw kind of a pushback and a questioning of whether or not the IRS could actually assess those penalties.

So, the case was with respect to a taxpayer, Alon Farhy, he owned two Belize entities. So, one entity was a police corporation from 2003 to 2010, the other from 2005 to 2010. The taxpayer admitted to participating in an illegal scheme to reduce his income tax liability, and as a result of his admission, he was granted immunity from prosecution. And so during the time he owned those two Belize entities, those being controlled for in corporations, he had a requirement to file form 5471, which he did not. The IRS determined that his failure to file was willful, and as a result of that, the IRS can then assess more severe penalties related to that.

So, in February of 2016, the IRS sentiment notice letting him know that he had failed to file the returns. He did not respond to that notice. And so in 2018, they assessed penalties of $10,000 for each failure to file form 5471 and a continuation penalty of $50,000.

So, as a result of that, the taxpayer was issued a final notice of intent, and as a result, the taxpayer submitted a request for collection for a due process hearing. After conducting the hearing, the IRS sent the taxpayer a notice of determination, upholding the collection and the penalties previously assessed.

So, the taxpayer petitioned the US tax court to determine whether the IRS had the authority to assess the penalties. And I think somewhat surprisingly, the US court's decision regarding the assessment clarified that while Congress had authorized the assessment of the penalties, the penalties, these specific penalties, fell outside of their specific authorization and the tax court determined that Congress did not authorize the assessment of the penalties under section 6038, which is the section under which the 5471 penalties would otherwise be assessed.

The tax court stated the term assessable penalties does not apply to all penalties in the code. And that while section 6038(b) does grant authority to impose penalties, it does not grant the authority to assess them.

So, that kind of put the IRS in a difficult position where they have the ability to assess these penalties, but they have no means of collection. So as a result of the decision, the IRS was essentially barred from proceeding with the collection on these, but the tax court did indicate that under U.S.C. section 2468(a), they did have a viable avenue to pursue collection of the penalties through civil court actions.

So, it did leave the door open a little bit, but obviously it makes the ability to collect those penalties a lot more complicated.

So this decision, it has implications for the IRS, as well as taxpayers. It's very favorable for the taxpayers who are subject to 5471 penalties and also similar penalties for other international reporting forms like 926 and 8938. But taxpayers that are contemplating, I guess whether or not they can actually apply for a refund for the claims and for the penalties that were previously assessed, there are still some questions whether or not that's actually going to be a valid path forward.

Despite the findings, it remains unclear whether the decision creates an automatic right to a refund and it also kind of leaves in limbo whether or not other kind of international reporting forms like the 5471, 926, 5472, also could benefit from this ruling.

And I think it's important to note that while the case specifically addressed penalties related to the failure to file forms 5471, it doesn't really change the fact that there's still a requirement to file the forms. It doesn't relieve the taxpayer of their obligation and not filing those forms, leaves the taxpayer open to not closing the statute of limitations, the tax returns are considered incomplete, and as a result of that, the IRS has other means to go after taxpayers as well.

And so overall, we're seeing that there is a little bit of uncertainty at this point in time. As to what this means, I think it's something that's being very closely monitored to understand what the implications for this will be going forward.

In a perfect world, it'll mean that the IRS potentially will be less aggressive in assessing these penalties, knowing that they have to go to a much higher level in order to be able to collect them.

But as of today, we aren't seeing any change in the IRS' approach and we're seeing that the IRS is still very aggressive in assessing the penalties, and in situations where we're asking for penalty abatement requests, they're often denying that we're just sending it to appeals. So, they're kind of still continuing with the same kind of modus operandi, in terms of how they're approaching things, but there could be developments on that in the future.

We have a couple of slides that we're going to talk about in terms of 5471 reporting and 5472 reporting. We won't spend a lot of time on these. And as Dan was saying, you have these slides as well, so you can take a look through. But at a high level, the 5471 forms are seen when you've got US persons, its individuals, corporations, partnerships, that have interest in controlled foreign corporations.

The intention of 5471 is to assist the IRS in disclosing various international transactions. It also is in support of anti-deferral regime, so if you're subject to Subpart F income, or global intangible low tax income or GILTI, you might have to file these forms to pick up income related to that. And it serves a purpose as well for foreign corporations to track their distributions, dividends, and the other foreign tax credits that are associated with that, that might be beneficial to the US person.

So, I've mentioned that the penalties are $10,000 that are imposed.

Non-compliance can have implications beyond penalties. So again, the statute of limitations won't start to run.

Another consequence is the potential reduction in foreign tax credits that are available, and this reduction can affect the ability to claim foreign taxes paid, which can impact the overall tax liability of the company.

In addition to the $10,000 penalty in the foreign tax credits, non-compliance can also result in a 40% accuracy related penalty. This penalty is imposed when there's substantial understatement or negligence issues. So that is as well on the table if we decide to take a more aggressive approach and not file these forms.

So I think, again, the recommendation and it has to be to continue to file. This does open the door for some potential recouping of past the taxes paid, or penalties that were paid, but it doesn't really give us an avenue to do anything else at this point in time.

And then similarly, the 5472s, I mean they're going to be kind of similar to, I think, the T106s and T1134s in Canada. Its information provided to the IRS related to related party transactions that indicates the related parties that are both foreign and US and the funds that are flowing between them. Usually these disclosed transactions such as sales, rents, royalties, commissions, management fees, intercompany loans, and it essentially gives the IRS a roadmap to be able to look at where the transactions are flowing. It's very critical source of information for transfer pricing audits, provides data to the IRS to be able to understand who are US companies making payments to and vice versa, and are these being done at arm’s length rates? So, it's very important that these forms are filed completely and correctly because again, similar to the 5471s, they have very hefty penalties and failure to do proper record keeping, or failure to disclose the appropriate amount of information can lead to the IRS deeming that the forms are incorrectly filed, which then can have that knock on effective, causing the tax returns to be filed incorrectly, or not considered to be filed timely.

And then beyond the civil penalties, there are potential criminal penalties to be aware of. So, the internal revenue code does outline criminal penalties that may apply to various forms including form 5472. So that would include failure to submit required information, or knowingly filing false or fraudulent information. That can lead to a potential criminal penalty. I mean, I haven't personally thankfully seen that ever happen and I've seen very few go that civil penalty route or civil collection route, but it is something that is very prevalent that we deal with on a daily basis.

So with that, I'm going to skip over to uncertain tax positions.

And so when we're talking about uncertain tax positions, we're generally talking about the tax positions that are taken that are in that range between realistic probability, which is around greater than 33%, and the more likely than not, or probable, which is in the greater than 50% range.

So, if there's anyone here that is familiar with US GAAP, you're obviously probably familiar with ASC 740 and ASC 740 establishes the rules for recognizing, measuring, presenting, and disclosing uncertain tax positions on financial statements.

More recently, within the last few years under IFRS, there is now clear guidance for uncertain tax positions as IFRIC 23 provided a defined approach for how to measure and disclose the information on the financial statements that didn't previously exist.

So, until recently, IAS 12 did not provide specific guidance on how to account for income tax treatments.

Before IFRIC 23, various measurement methods were applied in practice, for uncertain tax positions, leading to inconsistency and ambiguity.

The first step under IFRS, is to determine whether the tax position is probable to be sustained upon examination by tax authorities. If it is probable, the tax position will be disclosed consisting what's recorded on the tax return. If it's not probable, then the tax position will be sustained. There are two alternative methods that need to be considered: one is to recognize the most likely amount or the other one is to use a probability waiting method and pick an expected value for that amount to be disclosed on the financial statements.

Each uncertain tax treatment is considered either separately or together, depending on the approach. The better reflects the likely resolution of the uncertainty and consistent with US GAAP, IFRS assumes that tax authorities will examine the treatment and have full knowledge of the information that's available.

So, IFRIC applies exclusively to income taxes, which all fall within the scope of IAS 12 for income taxes. What that means is that it does not apply to non-income taxes or levies, so it's really focused on income taxes.

While IFRIC doesn't introduce new disclosure requirements, it places a notable emphasis on existing disclosures requirements related to uncertain tax positions.

IFRIC 23 does not provide specific guidance on the treatment of interest and penalties associated with uncertain tax positions.

And companies applying IFRIC, are also required to do so on a full retrospective basis.

So, I'm going to jump into a couple of comparisons here in terms of issues of recognition, measurement, if the recognition requirement is met or not met, and kind of the comparisons between US GAAP and IFRS.

Under ASC 740, for US GAAP, companies are required to recognize the benefit of tax positions, only if it's more likely than not, based on technical merits, that the position will be sustained upon examination by tax authorities, if the taxpayer takes the dispute to the court of last resort. So while the tax law and why they understood administrative practices of tax authority are taken into account, the possibility of negotiation with the tax authority is not considered in this case.

IFRS on the other hand, follows the guidance of IAS 12. So under IFRS, a company recognizes the entire benefit of a tax position, if it is probable that the position will be sustained on examination.

So in terms of measurement of uncertain tax positions, if the recognition requirement is met under ASC 740, a tax position that meets the more likely than not recognition threshold, is measured at the largest amount of the tax benefit that is greater than 50% likely of being settled. So, essentially it looks at a probability weighted approach for that as well.

Whereas under IFRS, the approach is taken that, if the amount is considered to be recognized and is more probable than not, the amount that will we reflect on the tax returns is consistent with the entity's income tax filing. And generally that means, for IFRS, that it's a more optimistic view or approach when you're comparing the two.

Now, in situations where a measurement of uncertain tax positions is not met under ASC 740, that does not meet the more likely than not recognition threshold, then no benefit associated with the tax position is recognized. So in this case, it's essentially like an all or nothing. If you don't meet that 50% probable treatment, or more likely than not, you don't get to recognize any benefit.

To reflect the effects of the uncertain tax treatments under IFRS, an entity uses either the most likely amount or the expected value amount, as we previously discussed, is anticipated that the most likely amount will generally provide the better prediction where you have situations where there's binary, whereas the probability weighted method will be more accurate when you're dealing with scenarios where there's potential multiple outcomes.

And in terms of balance sheet classification, both accounting standards require the uncertainty and income taxes to be reflected as part of the income tax accounts. An entity cannot record a separate provision for tax uncertainty.

Under US GAAP, liabilities for income taxes, payable resulting from unrecognized tax benefits on positions taken or expected to be taken, and a tax return should be classified based on the timing of expected payment. If the entity expects payment within one year, the liability is classified as current. If not, the liability is classified as non-current.

And deferred taxes are classified as non-current under both sets of accounting standards.

And then finally, under disclosure, when comparing US GAAP versus IFRS, US GAAP has specific disclosure requirements for unrecognized tax benefits, including a tabular roll forward, the amount that, if recognized, would affect the effective tax rate, the classification of interest and penalties, the amount of interest and penalties recognized, the amount that are reasonably possibly to significantly change in the next 12 months, and a description of open tax years by major jurisdiction.

In contrast, IFRS does not have a specific disclosure requirement on uncertain tax treatments. Under IFRS, when there's uncertainty over income tax treatments, an entity needs to determine if it should provide disclosures above significant judgments, assumptions or estimates used in determining current and deferred tax balances recognized in the financial statements, or anticipated to have significant impact within the next financial year.

So, we've already kind of covered, I guess, some of the differences between GAAP and IFRS, so I'll jump down to some of the things that can be done to monitor and maintain and clean up UTPs, historically and going forward.

One of the main things I think is the importance of maintaining detailed documentation. So, proper documentation, analysis support that you have behind the uncertain tax positions, is critical. Retaining this documentation is important for demonstrating with accounting standards and for potential discussions with tax authorities. Documentation is crucial to substantiate uncertain tax positions under both US GAAP and IFRS. This can include calculations, memos, legal opinions, correspondence with tax authorities, and other relevant evidence.

Inaccurate or insufficient documentation can pose a significant risk during tax audits or examinations. Proper documentation helps companies defend their tax positions and demonstrate that they have made a reasonable effort to comply with the accounting standards.

It's important to do a reconciliation between financial statements and tax returns. Differences will often exist in the recognition and measurement of income and expenses between US GAAP, IFRS and tax reporting.

Reconciliation is essential to explain these disparities. The reconciliation process and enhances transparency and clarity in financial reporting. Reconciliation also further ensures that financial statements accurately reflect the company's tax position, reducing the risk of misreporting or non-compliance with accounting standards and tax regulations.

And Schedule UTP, which is a specific form for US corporations, is required to be filed if you have over $10 million of assets and file Form 1120. It's crucial to understand that Schedule UTP deals with tax positions rather than accounting positions, so this is focusing strictly on the uncertain tax positions that are being taken from a tax return reporting perspective. It serves as a disclosure mechanism for the IRS, so it basically requires a disclosure of positions that are being taken in the financial statements and as well as those that are being taken on the tax return. And Schedule UTP implies that the IRS may scrutinize the disclosed positions, therefore companies must ensure that their tax positions are well supported and documented if being disclosed on their 1124.

And then in terms of regular review and updates, it's important as tax laws change, regulations change, that there should be a frequent review of these changes, to ensure if there's any changes to the tax positions themselves that require additional disclosure or reporting. Similarly, accounting standards will change over time, so affecting how the uncertain tax positions are recognized and measured for financial statement purposes. So, it's important that we're kind of constantly reviewing and updating that information.

And the final three points we have; engage external experts. Obviously, it's important to work with your advisors on these issues, so advisors can provide valuable guidance on evaluating and documenting UTPs, ensuring compliance with both financial reporting and tax regulations.

There's ethical and transparency reporting components of this. We want to make sure we're being ethical and transparent in maintaining the trust and confidence of stakeholders, investors, regulators. It demonstrates the company's commitment to integrity in financial reporting. Accurate and transparent disclosures provide stakeholders with a clear understanding of the company's financial position, including uncertainties related to tax positions.

And then finally, having a clear communication strategy is important. Ensuring that a company is communicating with stakeholders to share this information, especially if you have a global company where you have different reporting standards across your group. Different understandings require different explanations. A well-defined strategy promotes clarity and consistency in how the company communicates its financial results. And being proactive in doing so, just ensures that everyone is up to speed in terms of a lot of these differences that we're seeing under at uncertain tax positions.

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