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Income Tax Process & Valuation Allowance

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Valuation Allowance

What is a Valuation Allowance (VA)?

- Reserve against tax “assets” that are likely not going to provide value or be turned into cash in the future
- Accounting rules provide guidance on how to calculate a valuation allowance
- If a company’s income tax calculations are complex, so is the calculation of the VA

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Basin Electric & Subsidiaries Income Tax

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Income Tax Process

- Income Tax Accounting
  1. Taxes are calculated for each subsidiary on a stand-alone basis
  2. Taxes are calculated for the Consolidated group
  3. Any difference between 1 & 2 above are recorded as Basin's stand-alone taxes

- Based on tax sharing agreements between Basin and each of its subsidiaries

- Patron vs Non-patron tax attributes
  – Basin/Basin Cooperative Services (Patron)
  – All other subsidiaries (Non-patron)

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Income Tax Process

1. Start with net income or loss before tax as recorded for accounting purposes ("book" net income or loss)
2. Identify timing differences between book and tax treatment of transactions
   - Permanent timing differences
   - Temporary timing differences
3. Identify any uncertain tax positions
4. Calculate federal income taxes
5. Calculate state income taxes
6. Evaluate whether a Valuation Allowance is necessary
7. Calculate the Valuation Allowance

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Tax Timing Differences

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GAAP versus Internal Revenue Code

- Financial statements are prepared by following the rules as established by the Generally Accepted Accounting Principles (GAAP)

- Federal income tax returns are prepared using the rules as established by the Internal Revenue Code, Treasury Regulations, and other Internal Revenue Service guidelines

- The differences in recognition of income and expenses result in tax timing differences

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Permanent Timing Differences

- Permanent timing differences occur when income or expenses recorded for financial statement (book) purposes are never recognized on the federal consolidated income tax return
  - Examples: Lobbying costs & Entertainment expense
    Patronage allocation (income exclusion)

- Approximately 10 permanent differences each for Basin and DGC

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Temporary Timing Differences

- Temporary timing differences occur when income or expenses are recorded on the financial statements (book) in one year but recognized or deducted on the income tax return in a different year.

- The net tax differences are recognized as either -
  - A deferred tax asset - results in additional deductions on future income tax returns, or
  - A deferred tax liability - results in additional income on future income tax returns

- Approximately 40 types of temporary differences for Basin and 30 types for DGC

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Examples of Temporary Differences

- Revenue Deferral - revenue deferred for Book purposes must be recognized for Tax purposes in the year it was earned, deducted for Tax in the year included in income for Books
- Book / Tax Depreciation - different lives and methods are used for Book and Tax purposes
- Asset Retirement Obligation - a Tax deduction is not allowed for any expenses accrued for Books but rather is required to deduct the expenses when they are incurred and paid.

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Calculation of the Income Tax Provision & Deferred Tax Assets/Liabilities

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Federal Income Tax Provision

- Timing differences for each company are used to calculate both Federal and State taxable income or loss and current and deferred income tax benefit or expense
- Federal income tax expense or benefit is calculated on both a consolidated and a stand-alone basis.
  - Any difference between the consolidated and the total of the stand-alone calculations flows to Basin as Parent of the Consolidated group (example - NOL utilization)
  - Any loss from Basin/BCS is not allowed to offset income of the other subsidiaries but income from Basin/BCS can offset losses of the subsidiaries after Basin has utilized all of its Patronage NOL to offset its own income

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State Income Tax Provision

- Most states begin with Federal taxable income or loss
  - Each states has its own rules and regulations regarding various state adjustments
  - Each state has a different tax rate
  - Each state has a methodology for calculating the factor used to apportion taxable income
  - Each state has its own carryforward / carryback rules regarding state net operating losses (NOLs) and/or tax credits generated
- Basin Electric and subsidiaries file in 17 states

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Tax Cuts and Jobs Act of 2017

- New corporate rate - 21%
- Repealed corporate Alternative Minimum Tax (AMT)
- Changed NOL treatment
- Limited business interest deductions
- Changed depreciation deductions
- Changed meals, entertainment, parking deductions

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Federal Income Tax Attributes

- Interest expense limitation from current and previous years
- Federal net operating losses (NOLs)
  - Generated prior to 2018 have 20-year carry forward limit
  - Generated after 2017 are carried forward indefinitely but limited to 80% of annual taxable income
  - Patronage losses (unable to offset non-patron income)
- Federal R&D Credits - 20 year carry forward

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Allowance for Uncertain Tax Positions

- Federal and State R&D Credits
  - 30% allowance due to history of only being allowed to use 70% of total R&D credits generated in audited years

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Calculation of the Valuation Allowance

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Is a Valuation Allowance Required?

- There is a basic requirement to reduce the measurement of deferred tax assets not expected to be realized

- All evidence, both positive and negative, must be considered to determine whether a valuation allowance is necessary

- Future realization of a deferred tax asset depends on the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law

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Assessing the Realizability of DTAs

Sources of Taxable Income for “Positive Evidence”

- The four available sources are:
  1. Future reversals of book/tax differences creates taxable income ***(not book income)*** in the future for Basin /DGC
  2. Future taxable book income
     a) Due to DGC’s recurring losses (three-year general rule), this positive evidence cannot be taken into consideration
  3. Taxable income in prior carryback year(s)
  4. Tax planning strategies
- Sources (1) and (3) can often be objectively verified
- Tax planning strategies are given more weight than a forecast of future taxable income in item (2) above as they are more objectively verified

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Timing Difference Turnaround

- The DTAs/DTLs related to cumulative timing differences are rolled forward and provide input to the scheduled Federal Deferred tax reversals used in the VA analysis
  - Turnaround of each cumulative temporary timing difference must either be scheduled over the future years or classified as indefinite (turnaround time is unknown but can be used due to the indefinite NOL carryforward)
  - Scheduling of temporary timing difference turnarounds can go out many years
    - Currently 2104 for Basin

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Valuation Allowance Overview

- Basin calculates the taxable or deductible reversing differences based on the deferred tax assets and deferred tax liabilities at the end of the year
- The use or buildup of deferred tax attributes is based on tax return ordering rules
  - If there is *tax deductible reversing difference* (creating a taxable loss) in a year, there is a buildup of either NEW NOL or NEW PATRON NOL (patron NOLs cannot offset non-patron income)
  - On the contrary, if there is a *taxable reversing difference* (creating taxable income) in a year:
    - First, the interest expense carryforward is offset (subject to the 30% limitation)
    - Second, the OLD NOL is offset (until it expires in 2037)
    - Finally, the NEW NOL / NEW PATRON NOL (indefinite carryforward) is offset subject to 80% of taxable income

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Valuation Allowance Overview (Cont)

- This process continues each year going forward (through 2104) until all timing differences that result in deferred tax assets and liabilities have reversed

- *Each future year must be analyzed separately to determine taxable income or loss*

- Any tax attribute (interest expense, OLD NOL, or NEW NOL / NEW PATRON NOL) balances remaining in 2104 indicate the amount of deferred tax assets related to these tax attributes that are unsupported and a valuation allowance is warranted

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Questions/Discussion